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# China's Energy Security at 70

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As China celebrated the 70th anniversary of the founding of the People's Republic of China (PRC) on 1 October 2019, it seems to have gone full circle back to its 1949 assessments of the US: "a greedy and violent nation, struggling to remain the wealthiest and strongest on earth".[1] For the first two decades of the PRC's existence, Mao Zedong used anti-Americanism in his efforts to rally the country's vast population in support of the communist revolution and realise international communist solidarity. Over the years and despite Mao's (and subsequent leaders') efforts to make China a strong and prosperous state—which in the 1970s also included a rapprochement with the US—Beijing never fully shed its conviction that Washington was determined to contain and transform China, keeping it weak and divided.[2] Similarly, in the US, the Chinese Communist Party's (CCP) takeover from the Nationalists in 1949 after decades of assistance from the US government, missionaries, businessmen and soldiers, was regarded as "the loss of China", and was greeted with disillusionment and a sense of betrayal.[3] These narratives of anxiety and disillusionment have been latent over the past fourty years, as the US and China normalised diplomatic ties and their cooperation deepened. But they are now re-emerging as defining features of US-China relations as the trade war continues to highlight the deepening gulf between the two countries.[4] In this context, China's biggest oil supply vulnerability is now the US, as crystalized by events in September 2019. While China has long seen Middle Eastern geopolitics as a source of energy insecurity, and even though the attacks on Saudi Arabia's oil facilities on 14 September 2019 raised concerns among Chinese buyers, these have faded since. Aramco has sought to guarantee supplies to its largest buyer and global crude prices have essentially fallen back to their pre-strike levels. But US sanctions on two subsidiaries of China's largest shipping company could cause a more significant disruption to China's oil trading activities. Going forward, even if a trade truce is reached in the next few months, Beijing and its traders will increasingly seek to nationalise their commodity supply chains, insurance providers and financial flows.

## Growing economic footprint in the Middle East, limited strategic engagement

Oil insecurity in China has long been associated with turmoil in the Middle East. Since China emerged as a net importer of crude oil in the 1990s, its reliance on oil flows from the Middle East has surged, with imports rising from 0.33 mb/d in 1998 to just over 4 million b/d in 2018, according to statistics from China's General Administration of Customs. Debates about energy security and the means to mitigate the vulnerabilities associated with China's newfound reliance on waterborne flows flourished subsequently,[5] leading also to a slew of research in China and the West about the inevitable change to China's foreign policy and the country's inevitable entanglement in Middle Eastern politics,[6] especially if it were to displace the US as the largest importer of Middle Eastern oil.

But twenty years later, China remains on the sidelines of regional politics and its approach to the Middle East can be characterised as a portfolio of investments rather than a single regional strategy.[7] China's national ambitions in each country are narrowly focused on economic ties, and while the country's security footprint in the region has also grown to include participation in UN peacekeeping

[1] Tu Wei-ming, "Chinese Perceptions of America", in Michel Oksenberg and Robert B. Oxnam (eds), *Dragon and Eagle,* New Yokr: Basic Books, 1973, p. 104

[2] Nancy Bernkopf Tucker, "The Evolution of US-China Relations", in David Shambaugh (ed), *Tangled Titans: The United States and China*, New York: Rowman & Littlefield, 2013, p. 30

[3] Nancy Bernkopf Tucker, "The Evolution of US-China Relations", in David Shambaugh (ed), *Tangled Titans: The United States and China*, New York: Rowman & Littlefield, 2013, p. 29-31

[4] Michal Meidan, "US-China: The Great Decoupling", *OIES Energy Insight 53*, July 2019, https://www.oxfordenergy.org/publications/us-china-the-great-decoupling/?v=79cba1185463

[5] Erica Downs, "The Chinese Energy Security Debate", *The China Quarterly,* no. 177 (Mar., 2004), pp. 21-41; Andrew B. Kennedy, "China's New Energy Security Debate", *Survival,* Volume 52. Issue 3, 2010, pp. 137-158; Michal Meidan, "The Implications of China's Energy-Import Boom", *Survival,* Volume 56. Issue 3, 2014, pp. 179-200

[6] Jin Liangxiang, "Energy First: China and the Middle East", *Middle East Quarterly,* Vol. 12, no. 2, Spring 2005, pp, 3-10; https://dev.meforum.org/694/energy-first; Guang Pan, "China's Energy Strategy and Primary Role of the Middle East in This Strategy", *Journal of Middle Eastern and Islamic Studies* Vol. 2, No. 2, 2008, https://www.tandfonline.com/doi/pdf/10.1080/19370679.2008.12023117

[7] Jon B. Alterman, "China's Middle East Model", CSIS Commentary, 23 May 2019, https://www.csis.org/analysis/chinas-middle-east-model

mission and a military base in Djibouti,[8] it remains limited compared to the scale of economic and trade engagement. China's trade with the Middle East reached $135 billion in the first six months of 2019 (see Figure 1), making it China's fourth largest trading partner behind Japan ($140 billion), according to China's General Administration of Customs while foreign direct investment (FDI) into the Middle East, through the Belt and Road Initiative, totalled an estimated $28 billion in 2018.[9] And while China remains heavily reliant on the Middle East for its oil supplies, the regions' share of China's total imports has actually fallen from 61 per cent in 2008 to 43 per cent in 2018.[10]

**Figure 1: Chinese imports and exports from the Middle East, H1 19, US$ billion**

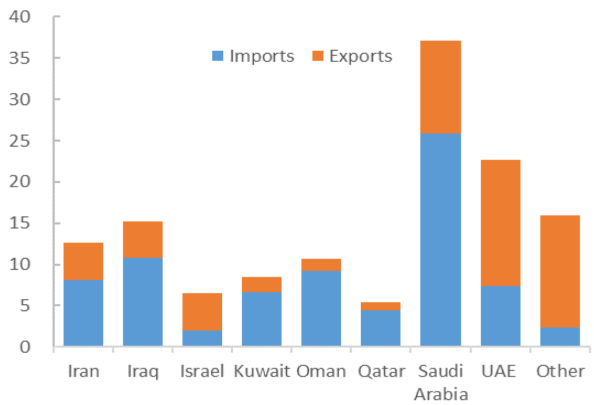
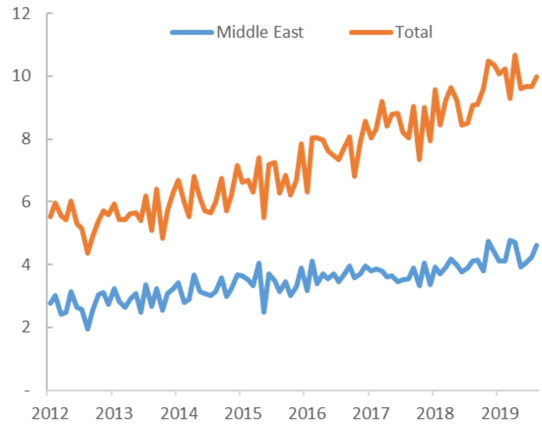



**Figure 2: Chinese crude imports, mb/d**




Source: China Customs

To be sure, as China's economic footprint in the region has expanded, alongside its reliance on oil supplies, so too has its vulnerability to regional shocks. But Beijing has also tried to hedge its exposure to the region by limiting its oil and gas inflows from it (as a share of total supplies, see Figure 2), diversifying supply sources and by building up a Strategic Petroleum Reserve (SPR), among other actions. And the US has been deemed a threat to China in the Middle Eastern context insofar as US actions and policies impact regional dynamics, but Washington's involvement in the region has not been commonly perceived as a direct threat to China's energy security. The vulnerability most often pointed out by China's strategists is the US's ability to choke off maritime supplies to China.[11] If anything, the US security umbrella in the region, as flawed as it may be, has given China cover to expand its own relationships and networks in the region, allowing Beijing to present itself implicitly or explicitly as an alternative to US hegemony,[12] without, however, taking an active multilateral role in regional affairs. It is in fact this secondary role that has allowed Beijing to pursue its bilateral engagements with all Middle Eastern countries, including Saudi Arabia, Iran and Israel, a feat that would have been challenging if Beijing were to take political sides. Moreover, Chinese strategists note that US entanglement in Middle Eastern security can help keep it away from Asia.

[8] Nicholas Lyall, "China in the Middle East: Past, Present, and Future", *The Diplomat*, 16 February 2019, https://thediplomat.com/2019/02/china-in-the-middle-east-past-present-and-future/

[9] Afshin Molavi, "China's Global Investments Are Declining Everywhere Except for One Region", *Foreign Policy*, 16 May 2019, https://foreignpolicy.com/2019/05/16/chinas-global-investments-are-declining-everywhere-except-for-one-region/

[10] Authors' calculation based on Customs data

[11] Zhang Wenmu, ''China's Energy Security and Policy Choices,'' *World Economics and Politics* (Chinese), 14 May 2003, pp. 11–6.

[12] For example, despite concerns that China would find itself blocked out of Iraq following the 2003 US-led invasion of Iraq, China's national oil companies have emerged as the largest foreign investors in the country's oil sector. See Zha Daojiong, Michal Meidan, "China and the Middle East in a New Energy Landscape", *Chatham House research paper*, October 2015, https://www.chathamhouse.org/sites/default/files/publications/research/20151021ChinaMiddleEastEnergyDaojiongMeidan.pdf

## Despite attacks on Saudi infrastructure, short term oil flows to China are not a major concern

To be sure, a massive disruption to oil supplies, as seen on 14 September with the attacks on Saudi Arabia's oil facilities, sent jitters through the oil market, reverberating in China too. The attacks on Saudi Arabia's 7 mb/d Abqaiq field—the Kingdom's largest oil processing facility—and the shut in of an estimated 5.7 mb/d of crude production and 0.7 mb/d of NGLs output led Brent crude futures to spike as markets opened on Monday 16 September, rising by 19.5 per cent to $72 per barrel, but the contract fell back to $61 on 30 September. China's crude futures contract similarly jumped from 460 yuan ($64) on 13 September to close to 500 yuan ($70) on17 September (taking its cues from other global benchmarks) before falling back to 447 yuan ($63) on its 30 September 2019 close. With over 1 mb/d of Chinese refining capacity designed with Saudi crude as baseload, and imports from Saudi at 1.6 mb/d between January and July 2019, Chinese buyers had reason to panic, yet on the whole, they remained relatively sanguine. Chinese refiners—and Saudi term buyers include PetroChina, Sinopec, Hengli and Rongsheng—expect that Saudi will fill contractual commitments, even if this means drawing down Saudi domestic stocks. Aramco has reportedly asked Chinese buyers to take more Arab Medium and Arab Heavy instead of planned deliveries of Arab Light, but China's refiners typically take less Arab Light than other Aramco clients, and the strength of distillate prices in China makes heavier grades appealing to refiners. Perhaps counter intuitively then, the attacks also highlighted the importance of demand security as large oil producers are opting to supply their biggest client.

**Figure 3: Crude imports, select countries, mb/d**

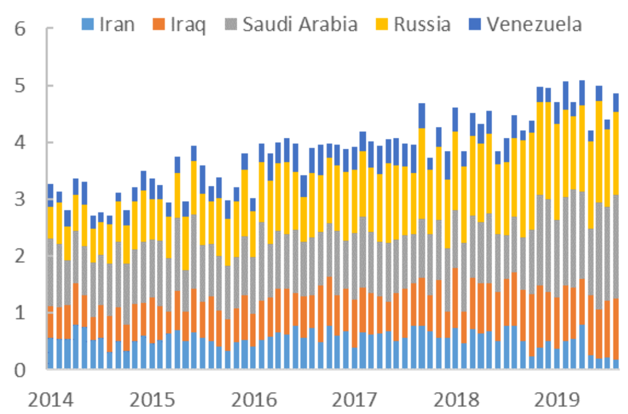
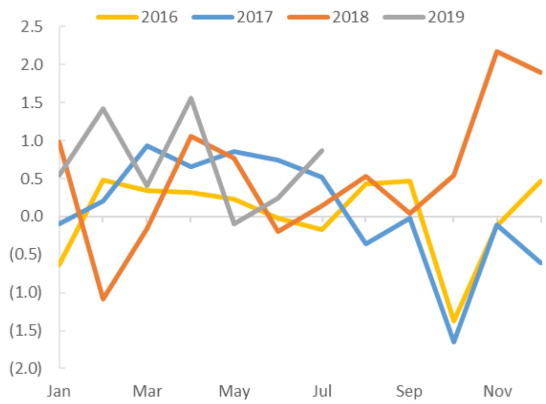



**Figure 4: China implied stock builds, mb/d**




Source: China Customs, NBS OIES

Saudi has long sought to present itself as a reliable supplier to China, a track record that has allowed it to increase its footprint in the Chinese market and diversify its relationships in the country and as such, it will also likely work hard to limit potential supply cuts to China. Should Saudi supplies fall, however, Chinese refiners can draw down commercial stocks which have built over the past few months, including Iranian crude which has been sitting in bonded tanks offshore China. A formal SPR release from China remains unlikely given the abundance of commercial stocks and the fact that the country has never formally done an SPR release. Indeed, the head of China's National Energy Administration, the country's de facto energy ministry, stated a week after the attacks on Saudi that "it will not affect China's crude oil supply", further noting that China had enough oil to last about 80 days.[13] This suggests close to 800 mb, likely in both the SPR and commercial tanks.[14]

[13] Tom Daly, "China has enough oil inventories to last about 80 days: NEA", *Reuters*, 20 September 2019, https://uk.reuters.com/article/us-china-energy/china-has-enough-oil-inventories-to-last-about-80-days-nea-idUKKBN1W514V.

Refiners can also source alternative North Sea, West African, Urals and Iraqi barrels to offset a potential shortfall in Saudi grades. And while replacing Saudi grades when both Iranian and Venezuelan supplies are also curtailed due to US sanction is undoubtedly more complicated, it would still only limit China's appetite for crude at the margins. Another spike in flat price could limit crude imports for stockpiling but refiners would continue to source crude for a number of reasons: First, new mega-refiners Rongsheng and Hengli continue to conduct test runs as they bring secondary units online because of shareholder pressure to ramp up. Even if margins in China weaken (although they are currently still positive), these plants have sunk considerable costs and will want to start selling products. Second, Shandong independent refiners will continue sourcing crude in order to utilise their crude import licences, as this will determine their 2020 crude import allocation, and their finances will be somewhat cushioned by improved margins over the past few months. Finally, the state-owned majors are likely to continue sourcing crude and raising runs as they will want to ensure product supplies over Q4 19—when demand for transport fuels tends to increase during the Mid-Autumn Festival and the National Holiday, and ahead of the Lunar New Year which will fall this year in late January 2020.

## It's the US, stupid!

Increasingly, then, even as China remains concerned about its vulnerability in the Middle East, the US is emerging as its biggest source of energy insecurity. China's refiners remained relatively sanguine following the attacks on Saudi, but they fretted about the US response and whether or not either Washington or Saudi would retaliate, after having determined Iran was responsible for the attacks. And while this is still a cause for concern, the US's decision to sanction six Chinese entities—including subsidiaries of COSCO Shipping Energy, the worlds' largest shipping operator in terms of fleet and capacity—for trading with Iran, has become a bigger headache for Chinese traders and oil traders more broadly.

On Wednesday 25 September, the US Treasury Department announced that it was blacklisting two affiliates of COSCO Shipping—COSCO Shipping Tanker (Dalian) and COSCO Shipping Tanker (Dalian) Seaman & Ship Management Co—alongside two CNPC subsidiaries—Kunlun Holding Co., Kunlun Shipping Co—as well as Pegasus 88 and China Concord Petroleum Co.[15] While US Treasury further noted that the sanctions did not apply to the parent company COSCO Shipping Energy or to other subsidiaries, COSCO Shipping Energy nonetheless halted trading in Hong Kong on Thursday after the announcement, resuming trading on 30 September stating only that 'The Company is comprehensively organizing its various businesses, assessing the relevant impact, and conducting various response work'.[16] As China takes off for the week-long national holiday, it initial response will only emerge in early October. In the interim, given uncertainty on how widely sanctions will be implemented and whether or not they could be further extended in future, buyers were reportedly holding off on bookings, seeking legal clarity. Even Unipec, the trading arm of Sinopec and India's largest refiner Indian Oil Corp, reportedly cancelled bookings of some COSCO ships. The White House's announcement also raised uncertainty among shippers on whether cargoes that have already been loaded onto the vessels of sanctioned firms would be allowed to deliver, or whether they would have to transfer their loads to unsanctioned tankers. After the news broke, and as importers scrambled to find alternative ships to move their crude on, rates for chartering supertankers, or very

[14] In line with the lower end of our estimates, see Michal Meidan, "US-China: The Great Decoupling", *OIES Energy Insight 53*, July 2019, https://www.oxfordenergy.org/publications/us-china-the-great-decoupling/?v=79cba1185463

[15] Ian Talley, Costas Paris, Courtney McBride, "U.S. Sanctions Chinese Firms for Allegedly Shipping Iranian Oil", *The Wall Street Journal*, 25 September 2019, https://www.wsj.com/articles/u-s-sanctions-chinese-firms-for-allegedly-shipping-iranian-oil-11569424569

[16] "COSCO Shipping Energy Transportation Co, LTD, Inside Information and Resumption of Trading", Company notice, 29 September 2019, http://en.energy.coscoshipping.com/module/download/down.jsp?i_ID=119277&colID=1467

large crude carriers (VLCCs), to load crude oil from the Middle East to North Asia in October surged nearly 19 per cent.[17] This latest round of US sanctions has also hit the LNG tanker industry, as a US-listed company, Teekay LNG announced that its 50-50 Yamal LNG Joint Venture has been blocked because its partner, China LNG Shipping, is partly owned by COSCO Dalian.[18]

COSCO has more than 1,000 vessels in its fleet, including the world's largest dry bulk and container fleet, including an estimated 100 tankers (VLCCs, suezmaxes, aframaxes, and panamaxes). Its sanctioned subsidiaries are estimated to control or manage some 49 ships, including 21 VLCCs, but the uncertainty as to whether marine service providers could ultimately be penalised saw charterers, oil companies, banks, and bunker suppliers begin to reassess exposure to the shipping giant last week.

China's response is unlikely to be a sharp drop in Iranian flows, even though it is cutting its import volumes,[19] but rather to indigenise as much of the supply chain as possible. Already, in the early 2000s, Beijing's efforts to develop a Chinese tanker fleet stemmed from a desire to nationalise the entire commodity supply chain for energy security purposes,[20] offering tanker operators political support to develop commercially both in China and overseas. The rationale was that while the internal instability of supplier countries may be unavoidable, an importer with its own tanker fleet (and a blue water navy capable of defending it) would be better able to ensure energy security once the oil leaves the exporting country. Protecting tankers and downstream infrastructure (refineries and distribution networks) was deemed simpler than trying to protect an upstream facility in a third country.[21] China's next steps therefore, are unlikely to be a deepening of ties with Iran or even greater involvement in the Middle East, but they will likely start shifting their marine insurance to Chinese companies and look to develop commodity trading in the Chinese currency. Given that the Chinese currency is still not freely convertible, settling commodity trading using the Chinese yuan, or transforming China's crude contract into a global benchmark are still distant prospects,[22] but rising concerns that the US will start sanctioning capital and currency flows to China could accelerate Beijing's efforts to expedite moves toward the de-dollarisation of commodity flows. China's other trading partners could also, perhaps somewhat reluctantly, contemplate the notion. Indeed, despite positive soundings ahead of a potential US-China trade agreement at the side-lines of the APEC meeting in mid-November 2019, the structural trend remains one of decoupling: in technology and perhaps also in trade, services and currencies.

So, as Beijing celebrates the 70th anniversary of the founding of the PRC with grand military parades, many features of its geopolitical landscape seem to harken back to the Cold War and the preliminary conclusion for China from these tumultuous few weeks in the oil market is that its biggest energy security problem is not the Middle East, it's the US.

[17] Florence Tan, Chen Aizhu, Jonathan Saul, "Oil shipping rates soar as U.S. supertanker sanctions rattle crude trade", *Reuters*, 27 September 2019, https://www.reuters.com/article/us-iran-nuclear-usa-cosco-energy/global-oil-freight-rates-rocket-as-u-s-sanctions-tanker-units-of-chinese-giant-cosco-idUSKBN1WC07F

[18] Sabina Zawadzki, Ekaterina Kravtsova, "U.S. sanctions on COSCO hit LNG tankers in Russia's Arctic", *Reuters*, 30 September 2019, https://www.reuters.com/article/us-iran-nuclear-usa-cosco-lng/us-sanctions-on-cosco-hit-lng-tankers-in-russias-arctic-idUSKBN1WF13U

[19] Michal Meidan, "Why China will keep importing Iranian crude, but volumes will remain limited", *Oxford Energy Comment*, 6 August 2019, https://www.oxfordenergy.org/publications/why-china-will-keep-importing-iranian-crude-but-volumes-will-remain-limited/?v=79cba1185463

[20] Andrew Erickson, Gabe Collins, "Beijing's Energy Security Strategy: The Significance of a Chinese State-Owned Tanker Fleet", Orbis, Fall 2007, http://www.andrewerickson.com/wp-content/uploads/2010/11/Chinas-New-Tanker-Fleet_Orbis_Fall-2007.pdf

[21] Andrew Erickson, Gabe Collins, "Beijing's Energy Security Strategy: The Significance of a Chinese State-Owned Tanker Fleet", Orbis, Fall 2007, http://www.andrewerickson.com/wp-content/uploads/2010/11/Chinas-New-Tanker-Fleet_Orbis_Fall-2007.pdf

[22] Oxford Energy Forum, Oil Benchmarks, issue 113, May 2018, https://www.oxfordenergy.org/publications/oxford-energy-forum-oil-benchmarks-issue-113/?v=79cba1185463