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China’s Energy Policy Towards Central Asia

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Author: Bobo Lo

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Executive Summary

- Energy has been at the heart of China’s transformation from a peripheral presence in Central Asia to the region’s leading economic actor.

- Chinese energy policy in Central Asia serves multiple purposes. In the first instance, it is designed to access the region’s rich oil and gas resources. It is also key for promoting socioeconomic development and political stability in China’s poorer western regions, and for strengthening bilateral relations with the Central Asian states.

- The Chinese approach towards regional energy cooperation is defined principally by a determination to acquire as much equity as possible. To achieve this, they are prepared to pay or lend generous sums that appear economically unjustifiable, but which have longer-term economic and strategic logic.

- In pursuing their energy interests, the Chinese have adopted an integrated approach that involves the senior Party leadership, state-owned energy majors (such as the China National Petroleum Corporation) and financial institutions.

- Beijing’s strategic ambitions in Central Asia remain relatively modest for the time being. Notwithstanding its prominent involvement in the Shanghai Cooperation Organization, it does not seek to become the regional leader. It is sensitive to concerns that others – Russia and the United States, as well as the Central Asians – may have about a potentially dominant China.

- Nevertheless, China’s emergence as a leading energy actor in Central Asia has transformed the regional environment. The former Soviet republics now have greater strategic choice than at any time since independence, while Russian influence has been significantly undermined. It is likely that as China’s economic presence grows, it will become more politically assertive.

- The implications of China’s expanding energy interests are almost entirely negative for the EU. EU Member States will find it more difficult to access Central Asian gas, while the Nabucco pipeline project is set to become a prime casualty. Western companies face ever stiffer competition from the Chinese energy majors, and could be squeezed out over time.

- China’s growing influence in Central Asia will also mean that local regimes will remain highly resistant to democratisation, the rule of law, and Western principles of good governance.
I. China’s energy strategy in Central Asia

(i) Background

In just over a decade, China has grown from being a marginal presence in Central Asia into its leading economic actor. At the heart of this remarkable transformation is an energy policy that has not only produced major oil and gas deals, but also fundamentally changed the region’s strategic outlook.

Curiously, this transformation has come about more by accident – or series of accidents – than grand design. Four factors, in particular, have been critical:

- **China’s growing dependence on energy imports.** Since it first became a net importer of oil in 1993, this dependence has increased dramatically as a result of the country’s continuing industrial boom and the heightened demands for oil and other natural resources.

- **The rise in global oil prices after 1999.** This underlined the importance of diversifying external sources of supply, all the more so given anxieties at that time about China’s ‘Malacca dilemma’ – the vulnerability of sea lines of communication and the existence of potential choke-points.

- **Difficulties in Sino-Russian energy relations.** Beijing’s preferred choice in diversifying foreign imports - cooperation with Russia - became increasingly problematic after 2003. Moscow’s balancing act between Chinese and Japanese interests stalled construction of the East-Siberian Pacific Ocean oil pipeline, while a Sino-Russian gas supply agreement remained elusive due to disagreements over price. Frustrated by protracted delays, and Moscow’s refusal to allow Chinese companies into the Russian energy sector, Beijing searched for alternatives. Central Asia’s huge energy reserves made it an attractive alternative.

- **9/11 and the American-led military intervention in Afghanistan.** These events created a new set of realities in Central Asia. The strategic environment was no longer dominated by Russia, the long-time hegemon, but became much more open. This posed new challenges for Beijing, such as America’s geopolitical and normative presence next to China’s sensitive western regions. But it also offered opportunities, not least because Russia’s position had been severely weakened. It became clear, too, that Beijing would need to rely on its own efforts to advance Chinese economic and security interests.

(ii) Chinese objectives

Beijing’s energy policy in Central Asia encompasses a range of interests and objectives that extend well beyond the basic aim of accessing new oil and gas reserves.

- Central Asia is primarily important to China as a long-term source of natural gas. Although gas currently accounts for only 3 percent of national primary energy
consumption, this share is set to rise to around 10 percent by 2020. The growing use of natural gas reflects the government’s commitment to cleaner and more sustainable forms of energy, although China will remain heavily dependent on coal for some decades yet.

- The development and consumption of Central Asian gas is a key element of Beijing’s ‘Go West’ strategy. This not only looks to meet energy consumption needs in western China, but also to promote socioeconomic development in these regions and bind them more closely to the rest of the country. The expansion of China’s natural gas capacities is as much a political and security project as it is an economic objective.

- Central Asian oil is of niche rather than central importance to China’s energy mix. The facts do not support the conventional wisdom that Beijing is seriously concerned about the safety of international sea-lanes. In recent years, Chinese oil imports from the Persian Gulf and Africa have increased, both in absolute terms and as a share of the total – from 66 percent in 1999 to 77 percent today. Central Asia, specifically Kazakhstan, is a useful source of oil, with considerable potential for future growth. But for the time being it is only one of many external sources of supply, accounting for only 3 percent of Chinese oil imports in 2010.

- China’s oil and gas projects in Central Asia are a critical component of its broader relationships with the former Soviet republics. Such projects represent the most effective means of portraying China as a key contributor to regional economic and security cooperation. They give substance to Beijing’s rhetoric about ‘win-win’ solutions, and are intended to facilitate a neighbourhood of friendly states. In short, China’s energy interests serve larger foreign policy and strategic goals, as well as more specific security objectives, such as containing ethnic Uighur nationalism.

II. China’s approach to energy cooperation in Central Asia

The approach of the Chinese government and state-owned companies such as China National Petroleum Corporation (CNPC) in Central Asia does not differ greatly from their modus operandi in other resource-rich, governance-poor regions of the world.

- Its principal feature is what has been called an ‘equity approach’. The Chinese are not content simply with receiving contracted amounts of oil and gas, but aim to be active project partners. They acquire as much equity as possible, often by paying well above the odds and offering huge loans on generous terms. The logic is straightforward: direct ownership of resources is the best way of ensuring project efficiency and of securing reliable, long-term supply. It is the main reason why CNPC and other energy majors, such as CNOOC (China National Offshore Oil Corporation) and SINOPEC (China Petroleum and Chemical Corporation), have switched their focus to Central Asia away from Russia.

- The Chinese do not attach political conditions to loans and investments. Considerations of good governance, democratisation, the rule of law, and human rights are moot.
Beijing’s message to the Central Asians, as it is to authoritarian regimes around the world, is that it is interested in doing business and little else. This attitude reflects, in part, the principle of ‘non-interference’ in Chinese foreign policy. But it is also informed by the belief that any attempt to introduce conditionality would jeopardise major deals. Indeed, Beijing has sought to make a virtue out of non-conditionality, contrasting it to the more intrusive and legalistic approach of the West.

- Chinese political leaders, energy companies and banks appear less concerned than their Western counterparts about value for money, given the vast sums that are lavished on various equity acquisitions and project loans. In reality, the Chinese simply have a different conception of ‘value for money’. They are motivated in the first place by considerations of strategic (long-term) security of demand. Second, since Chinese objectives are as much political as commercial, the basis for assessing the cost-benefit balance is multifaceted. This is demonstrated by their energy cooperation with the two principal Central Asian resource economies, Kazakhstan and Turkmenistan.

  - In 2005, CNPC paid what many industry pundits regarded as an exorbitant USD 4.18 billion (EUR 3.14 billion) to buy PetroKazakhstan. Beijing calculated that this acquisition would establish China as a major energy player in Central Asia, following on from CNPC’s 1997 purchase of 60 percent of Kazakhstan’s third largest oil company, AktobeMunaiGaz (it now owns 85 percent). Subsequently, CNPC purchased 50 percent of MangistauMunaiGaz in April 2009, as part of a USD 10 billion (EUR 7.5 billion) loan-for-oil deal with Astana. Again, the motivation was less the commercial attractiveness of the company than the opportunity to consolidate CNPC’s position in the Kazakhstan oil sector, where it is now the third largest oil producer after the state oil and gas company, KazMunaiGaz, and Chevron. Finally, the completion in 2009 of the Atyrau-Alashankou oil pipeline extending from western Kazakhstan to Xinjiang province has tied the two countries more closely than at any time in their history. These various projects have not only strengthened the position of Chinese energy interests, which currently control about 25 percent of Kazakhstan’s oil sector, but also boosted the political relationship, and helped legitimise China’s expanding presence in Central Asia.

  - Similarly, in Turkmenistan Beijing’s intimate involvement in developing the local gas industry has implications that go far beyond individual projects. The 30-year agreement to provide 65 billion cubic meters of gas per annum (up from 30 bcm when the original agreement was signed in 2006); the 2007 production-sharing agreement for the exploitation of the Baktyyarlyk fields on the right bank of the Amu Darya; the China Development Bank’s USD 4 billion (EUR 3 billion) loan for first phase development of the huge South Yolotan field, followed by an additional USD 4.1 billion (EUR 3.1 billion) for the second phase; and the construction of the Central Asian Gas Pipeline from Turkmenistan to China via Uzbekistan and Kazakhstan (at an estimated cost of USD 7.3 billion [EUR 5.5 billion]) – all these represent major steps in China’s progressive domination of the Turkmenistan gas market. As a result of its involvement in these projects, Beijing’s economic influence has penetrated deep into Central and West Asia,
while its bargaining position over a possible long-term gas supply agreement with Russia has also been greatly strengthened.

- The Chinese adopt an integrated approach in pursuit of their energy interests. This brings together various actors – senior Party leaders, the energy majors (CNPC in particular), and financial institutions (China Development Bank, China Investment Corporation, China International Trust and Investment Corporation) – to promote China’s diverse agendas in Central Asia. In the first instance, this means securing reliable access to the region’s oil and gas resources. But just as important is the use of energy cooperation to develop closer political ties with the Central Asian regimes. This was exemplified by the decision in June 2009 to grant a USD 10 billion (EUR 7.5 billion) loan to the Shanghai Cooperation Organization (SCO) to help its member states recover from the global financial crisis. There was no tangible economic dividend, but the loan was important in selling China as a good pan-regional citizen at a time when Russia, the United States and Europe were preoccupied with their own problems. In this circumstance, it made sense to deploy a tiny portion of China’s vast foreign currency reserves to enhance its economic and political influence in a strategically important region.

- It is important not to overestimate the extent of Chinese engagement in Central Asia. For the time being at least, Beijing’s goals remain relatively modest. It does not seek to become the regional leader, and has shown little inclination even to assume a major role in security-building. It has been quite active within the SCO, but mainly to promote China as a benign and constructive presence rather than out of any active desire to project power. Beijing remains sensitive to the concerns that other players – not only the Central Asians, but also Russia and America – may have about a potentially dominant China. It is keen to avoid unnecessary complications that might harm its political and security, as well as energy, interests.

III. Implications of China’s energy presence in Central Asia

China’s growing footprint has considerable implications for the region and beyond, although its full impact is yet to be felt.

- The most immediate outcome is that the former Soviet Central Asian republics enjoy greater strategic choice than at any time since their independence. Although they remain economically reliant on Russia, both for direct trade and as a transit country to Europe, they are in a far stronger position compared with a few years ago. For example, before the signing of the Sino-Turkmen gas agreement in 2006 Ashgabat had been obliged to sell its gas at discount prices to Russia, its sole customer. Today, however, it is able to turn to China, which has not only become its principal market, but also one which is more reliable and lucrative. The re-orientation has not been as dramatic with Kazakhstan and Uzbekistan (which consumes most of its own gas), but even here there has been a pronounced shift. China’s re-entry into Central Asia after a hiatus of some two centuries has enabled Astana (in particular) and Tashkent to pursue more independent and multi-vectored foreign policies.
• By contrast, Russia has lost out substantially from the expansion of Chinese energy interests. It has seen the end of its monopsony over Turkmenistan’s gas exports; its position in the Kazakhstani and Uzbekistani energy sectors has weakened considerably; its political and strategic influence in Central Asia is in long-term decline; and it now looks unlikely that Moscow will be able to finalise a long-term gas supply agreement with the Chinese on favourable (or possibly any) terms.

• The impact of Chinese energy activity in Central Asia on the Sino-Russian ‘strategic partnership’ has, however, been relatively limited. Moscow is uncomfortable with the erosion of its regional influence, beginning (but not ending) with the energy sector. On the other hand, it can still count on several enduring advantages: close inter-elite networks with the Central Asian regimes; long-standing economic, cultural and linguistic ties; and local fears about Chinese economic dominance. Crucially, too, the fact that Central Asia is a secondary priority of both Russian and Chinese foreign policy makes it easier to manage any bilateral tensions.

• Nevertheless, the news is not all good for Beijing. There is already significant anti-Chinese popular sentiment in Kazakhstan, while Central Asian elites are concerned about the increasingly unbalanced nature of economic relations with the Chinese. This is not confined to the energy sector, but is also reflected in worries about the influx of Chinese consumer goods and labour. On a more general level, the Central Asians do not wish to replace one regional hegemon (Russia) with another (China). They are mindful of the need to preserve their strategic independence by diversifying their foreign relations as far as possible.

Despite impressive progress over the past decade, the overall Chinese presence in Central Asia is still fairly modest and limited largely to the economic sphere. China remains a peripheral political and security actor, and has shown little desire to translate economic influence into more comprehensive power projection. However, as its energy interests expand, and the stakes increase, it may pursue a more active and multifaceted approach to the region. This could lead to increased frictions with smaller neighbours and great powers alike.

IV. Implications for the EU

The growth of Chinese energy interests in Central Asia is bad news for the EU in several respects.

• It will make it much harder for EU Member States to access Central Asian gas, principally from Turkmenistan. Moreover, if and when a Trans-Turkmen gas pipeline is eventually built, much of the gas in the Caspian Sea area earmarked to go west will go to China instead. This would effectively kill off the EU’s already struggling Nabucco pipeline project.

• Although Western companies are involved in a number of Central Asian oil and gas projects, the arrival in force of the Chinese makes their operating environment more
problematic. Ashgabat has indicated that it would like to reach a long-term gas supply agreement with Brussels. But the EU’s cumbersome decision-making processes, divisions between Member States, the scarcity of project finance at a time of economic crisis, and political conditionalities add up to a highly uncompetitive package. By comparison, China enjoys the advantage of being a unitary actor, with a proven capacity to develop and implement energy projects quickly, and without the constraints of democratic accountability and the rule of law.

- It is possible that Chinese companies may seek partnerships with European companies in order to access advanced technology. But more likely they will look to squeeze out Western interests, if necessary by working closely with the Russians, who have an obvious commercial interest in seeing Central Asian gas go anywhere but Europe.

- Finally, as Chinese energy interests consolidate and expand their presence in Central Asia, local regimes will continue to be highly resistant to democratisation, the rule of law, and Western principles of good governance. EU attempts to promote such values in the region have been almost entirely ineffectual, a state of affairs that will not change anytime soon.