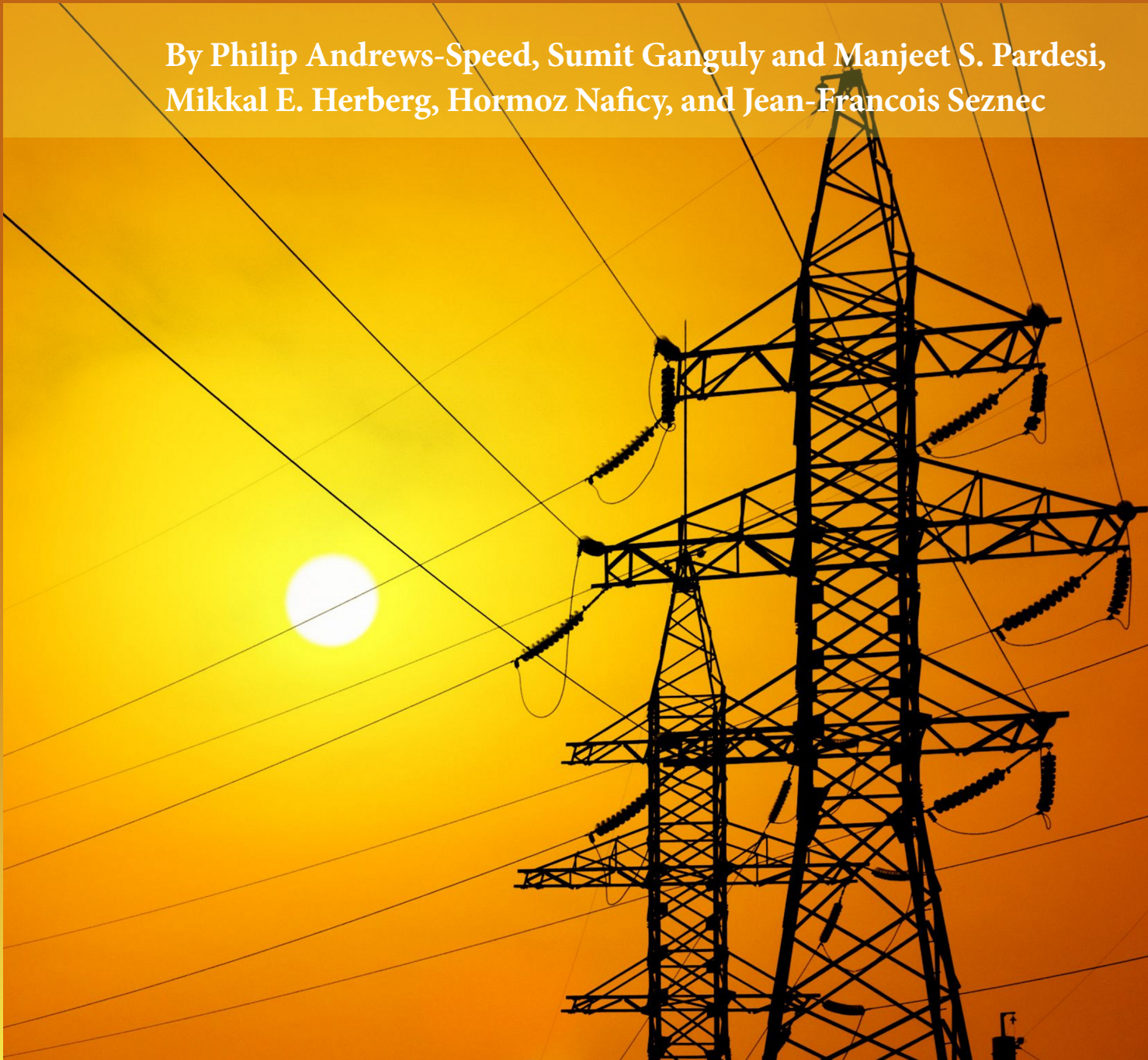


THE NEW ENERGY SILK ROAD

The Growing Asia–Middle East Energy Nexus

By Philip Andrews-Speed, Sumit Ganguly and Manjeet S. Pardesi,
Mikkal E. Herberg, Hormoz Naficy, and Jean-Francois Seznec



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The New Energy Silk Road: The Growing Asia–Middle East Energy Nexus

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Since the mid-1990s Asian energy demand has increased at truly stunning rates as consumption of the full range of fossil fuels—oil, natural gas, and coal—has rapidly grown. Though China has been at the center of this demand surge, growth has also been strong in developing Southeast Asia, India, and the rest of South Asia. At the same time, the Middle East and the Persian Gulf have remained at the center of the global oil supply system because the region is home to some of the largest oil producers and exporters in the world and holds roughly two-thirds of the world's proven oil reserves. The Gulf has also become a much larger supplier of liquefied natural gas (LNG) over the past decade, as Qatar's rapid LNG growth has added to LNG supplies from the United Arab Emirates (UAE) that have been flowing to Japan and other parts of Asia for two decades.

Quite naturally then, energy trade and investment between Asia and the Gulf have boomed since the mid-1990s. This is one important manifestation of a rapidly shifting architecture of global oil and gas markets away from a system dominated by flows of oil and LNG from the key producing regions to the rich, industrialized world of the United States, Europe, and Japan and toward fast-growing markets in developing Asia. New capital flows, energy partnerships, and strategic relationships are rapidly being built based on this historic shift in energy demand.

In an effort to explore this historic shift in some depth, The National Bureau of Asian Research (NBR), in coordination with the Global Energy and Environment Initiative at the School of Advanced International Studies of the Johns Hopkins University, organized a major conference in May 2009 in Washington, D.C., that brought together a select group of experienced analysts and policy experts. The conference, entitled “The New Energy Silk Road: The Growing Asia–Middle East Energy Nexus,” was supported by the generous contributions of ExxonMobil, Chevron, Conoco Phillips, and the Japan Oil, Gas and Metals National Corporation.

In addition to nearly two days of discussion, four essays were commissioned for the conference that focus on the key state players in this growing nexus of energy and political ties: China, India, Saudi Arabia, and Iran. The conference also included presentations and discussion on the energy and diplomatic roles and interests of Japan, Korea, and Russia in the Middle East, and a concluding panel sought to draw together the various strands of the discussion toward a better understanding of the long-term strategic and energy implications for the United States of this rapidly evolving process. This report includes those four essays along with a review of the discussion of long-term U.S. strategic interests. Read as a group, the essays convey a range of the issues raised in the conference. In addition, each essay provoked an active panel discussion that provided a wider range of issues and opinions and added immeasurably to the exploration of the issues under discussion. Hence, this brief introduction seeks to place each of the essays in the context of the broader discussion it provoked.

Asia–Middle East Energy Ties

Japan and South Korea have long been major buyers of both crude oil and LNG from the Gulf. Both countries are virtually 100% dependent on imports for their oil and natural gas supplies and the Gulf provides between 80%–90% of their crude imports and a significant share of their LNG needs. Japan and South Korea have become major investors in upstream LNG projects in the Gulf and have also sought to invest in upstream oil development, although with much less success. Both have been active in forging stronger diplomatic ties with the Gulf producers. With the emergence

of China and India as booming new markets for crude and LNG, these two countries have now also become prominent buyers, investors, and diplomatic players in the Gulf alongside Japan and Korea. All four of the major Asian powers are intently focused on broadening their access to energy supplies in all the main exporting regions of the world and each is raising its future targets for so-called equity oil to be controlled by their own national oil companies (NOC) and boosting their financial and diplomatic support for their NOCs or quasi-NOCs. In particular, they all are intensifying supply efforts among the key Gulf oil and LNG exporters.

Importantly, the rise of China and India as major energy buyers and investors in the Gulf coincides with their broader rise as economic and political powers regionally and globally. This is clearly most salient in the case of China whose economic and political rise promises to transform the global economic and security environment. Yet India too seems destined to play a far larger role economically and geopolitically—probably more as a regional power but also to some extent as an important player in global affairs. The convergence of both countries' growing energy as well as geopolitical impact suggests that they are likely to have increasingly important influence in key energy exporting regions in the future, with especially significant implications for the future of the Gulf and Middle East.

Conversely, the Middle East Gulf producer states have also increasingly recognized that Asia, and particularly China and India, will become the region's largest and fastest-growing oil and gas export markets in the future. Already, two-thirds of the Gulf's oil exports go east to Asia, reflecting this profound shift in the balance of global oil demand. As a result, Gulf producers are busy developing new energy trade, investment, and diplomatic relationships with the newly rising Asian states while also maintaining their traditional market and political relationships with Japan and Korea. Both Saudi Arabia and Kuwait are now major new investors downstream in China in the refining and petrochemical sectors, adding to their existing large downstream investments in Japan and Korea. Iran has sought to draw the Asian powers into investing in its energy sector in order to escape the constraints of the Western sanctions effort led by the United States, with only very limited success so far. Although Iraq has only recently begun to focus on the East in order to resurrect its oil and gas industry, its enormous, low-cost oil and gas resource base promises to make the country a major factor in this Asia–Middle East energy nexus (assuming a modest level of future stability and physical security). Not surprisingly, virtually all Asian NOCs are now active participants in the new round of exploration and development contracts being auctioned in Iraq. Alongside this booming energy trade and investment nexus, the Gulf producers are also building an expanding network of cultural, economic, and diplomatic ties with the Asian powers—especially with China and India—which promises to draw the two regions ever closer together in political, economic, and strategic relations.

As Asia's geopolitical relationship with the Gulf evolves alongside the energy relationship, this seems destined to have important long-term implications for the United States. The United States has been the dominant outside strategic and energy power in the Gulf since the 1950s and has profound strategic stakes in ensuring both political stability and stable energy flows from the region. The U.S.–Saudi strategic alliance has been a cornerstone of U.S. strategic and energy policy and remains so despite the stresses and strains in the alliance since September 11. U.S. economic interests in the stable flow of energy from the Gulf have drawn the country into two major wars in Iraq/Kuwait, a series of diplomatic and military confrontations with Iran, and deep involvement in the 1980–88 Iran–Iraq War. The U.S. Navy remains the guarantor of security of the vital energy

sea lanes of communication (SLOC) in the Gulf, the Strait of Hormuz, and surrounding seas. At the same time, low domestic oil prices and consequently strongly growing U.S. oil demand until very recently have underpinned the growth of world oil demand and, de facto, growing demand for Gulf oil. This has reinforced the imperative to maintain U.S. strategic power in the Gulf to ensure stable energy flows and reasonable energy prices to help fuel U.S. prosperity.

Though U.S. strategic and energy interests in Gulf stability remain central to U.S. prosperity, the strategic ground beneath engagement with the Gulf is beginning to shift as the nexus of this new “Energy Silk Road” takes shape. Thus far the signs of change are modest and diplomatic relationships are growing gradually. Beijing’s ability and interest in seeking to project influence in Gulf geopolitical affairs appears to remain low. This seems very likely to change over time, however, as China’s capabilities, import dependence, and vital energy interests inevitably expand. As India’s regional power grows, it also seems likely to become a more active player in the Gulf region, which New Delhi has traditionally seen as crucial to regional security as well as to energy security. Japan and Korea are additionally seeking to step up diplomatic, economic, and financial engagement with the key Gulf producers in order to compete with China and India for energy access and influence, although these states have traditionally followed the U.S. lead in the Gulf’s geopolitical affairs.

Asia’s expanding footprint in the Gulf raises a range of important questions about the long-term geopolitical implications for U.S. strategic and energy interests that were the focus of this conference. Foremost from a U.S. perspective, what does growing involvement of China and India mean for long-term U.S. power and influence in the Gulf? How will these states’ growing engagement with Saudi Arabia, Iran, and Iraq impact the ability of the United States to achieve its energy security and strategic goals? Will China’s and India’s growing involvement contribute to U.S. efforts to stabilize this vital region or could their involvement lead to a damaging competition for influence and access to energy resources? Below is a brief review of the four essays, which address these and other questions, as well as the discussions that they provoked.

China

At the conference, Philip Andrews-Speed, from the University of Dundee in Scotland, presented an overview of China’s energy security strategy and how the Middle East fits into that effort. He argued that although China is seeking to diversify its sources of crude oil toward overland sources of supply such as Russia and Central Asia, the reality of the balance of oil reserves globally means that China has little choice but to seek new reserve access in the Middle East through supporting the expansion of Chinese NOCs. China’s NOCs are compelled to invest abroad if they are to become major, competitive oil companies because China’s oil reserves are limited and domestic price controls often sharply undermine profitability.

Despite their efforts, China’s NOCs have had only modest success in investing in oil and LNG deals in the Gulf, but the region has become a major supplier of crude oil to China’s refineries. The Middle East now accounts for roughly one-half of China’s oil imports, equal to one-quarter of China’s daily oil consumption. Saudi Arabia is now in most months the largest single supplier of crude oil to China. Given that Saudi Arabia’s oil and gas industry is largely closed to private investment, the relationship is based mainly on major Saudi crude sales to China and rapidly growing Saudi downstream investments in China. Iran has been a focus and is a significant crude

exporter to China while China's NOCs have recently signed several large oil field development deals and LNG contracts. With Iran facing the uncertainties of international sanctions, however, the NOCs have been reluctant to follow through with these large investments, whereas Beijing remains concerned about the risks to China's critical relationship with the United States. Moreover, Iran's investment terms remain relatively unattractive. Iraq is becoming a major focus for China, but much depends on the evolving security situation. Nevertheless, China has already signed two large oil development deals with Iraq and sees a wide range of potential opportunities for its NOCs and increasingly capable oil service companies. China's NOCs also seem more willing than many Western companies to take on the security and other risks that investing in Iraq entails.

In further discussion, a number of key points emerged. Ironically, for China and its NOCs, the Middle East is relatively low on the priority list of regions for new oil and gas investment opportunities because access to reserves is so limited in Saudi Arabia and Kuwait and the political risks and complications of investing in Iran and Iraq are so extensive. Beijing sees other areas such as Africa, Russia, and Central Asia as more promising opportunities, even though the reserves in those regions are smaller than in the Gulf. Moreover, for China investing in the Gulf raises a range of vexing difficulties for relations with the United States, which further reduces the energy attractiveness of the region. Despite the growing stream of oil coming from the Gulf to China, Beijing sees the Middle East as a peripheral region where it has few major strategic interests beyond energy supplies. This contrasts with the convergence of energy and vital security interests around China's immediate periphery in Central Asia, Russia, and Southeast Asia. Africa, as well, is seen as an area where China is not facing strong and entrenched U.S. power and involvement. Beijing is disinclined to confront powerful U.S. interests in the Gulf region while at the same time trying to reassure the United States and the West that its future economic rise will be benign and beneficial to the world.

Nevertheless, some conference participants questioned whether China's current willingness to "free ride" on U.S. strategic power in the Gulf would last indefinitely. It was pointed out that in ten years time it is quite possible that one-half of China's total oil needs, as well as much of its LNG, will come from the Gulf. Also, U.S. power globally and in the Gulf cannot be taken for granted if the U.S. economy continues to struggle in the wake of the financial crisis, large deficits continue to weaken the United States financially, and the dollar continues to decline. At the same time, China's economic and political power is likely to continue growing, as will its naval capability to project stronger strategic weight in the vital energy transport sea lanes. Some felt that China's role in the Gulf is destined to grow in the future—albeit gradually and strongly dependent on the future evolution of U.S.-China relations and relative economic and political power.

India

Sumit Ganguly, from the University of Indiana, presented an overview of India's strategic and energy approach to the Middle East, which was followed by a lengthy discussion. Ganguly argued that India's approach to the Middle East and Gulf has shifted from a politically and ideologically driven strategy prior to the 1990s toward a highly pragmatic approach based on the country's strong import-dependence on Gulf oil and gas supplies. This shift also reflected the strategic importance of the Gulf region in India's regional security. India receives more than 80% of the country's imported oil from the Gulf and virtually all of its LNG imports. Although Saudi Arabia

is the largest oil supplier to India and New Delhi has worked to strengthen ties with Riyadh, much of India's focus in the Gulf has been on Iran due to Iran's regional strategic and energy importance. Iran is a major crude supplier and New Delhi recently signed a memorandum of understanding (MOU) for a long-term LNG project and supply from Iran. There have been ongoing negotiations for a pipeline to ship Iranian natural gas across Pakistan to India, though these have stalled by India's reluctance to rely on Pakistan as a transit state as well as U.S. opposition to the project. From New Delhi's perspective, good relations with Iran are vital as a regional counterweight to Pakistan as well as an offset to strong Sino-Pakistan ties. Nevertheless, this is a difficult balancing act as India tries to maintain constructive relations with the United States. As part of this balancing, India recently voted at the UN to refer Iran to the IAEA despite ties to Iran. Israel has also been a strategic priority for New Delhi since the 1990s—both as a source for advanced weaponry and to improve relations with the United States.

Ganguly suggested that India's increased energy and security focus on the Gulf is driving two key longer-term energy and geopolitical developments. First, the sense of competition for energy supplies with China in the Gulf region and elsewhere is aggravating tensions in Sino-Indian relations. India senses that China and Chinese NOCs are winning the race in the acquisition of new oil supplies and that India and the Oil and Natural Gas Corporation (ONGC) are constantly losing out to China's more aggressive energy diplomacy and overpayments by Chinese NOCs. Hence, growing involvement by China and its NOCs in the Gulf will impel India to step up engagement in the region. A further effect is that energy security concerns are accelerating the naval development that New Delhi feels is necessary to secure its energy sea lanes to the Gulf region. This converges with concerns over China's growing presence in the Indian Ocean through port access arrangements with Pakistan, Bangladesh, Myanmar, and Sri Lanka—the so-called string of pearls. Indian strategic planners increasingly are concerned about encirclement as China establishes strong alliances in Central Asia and with Pakistan, Bangladesh, Sri Lanka, and Myanmar. Hence, energy security concerns risk fueling an expanding military and naval competition with China, both in the Indian Ocean and approaches to the Gulf and in looking east toward being able to project a future economic and naval presence in Southeast Asia and the Malacca Strait. India has recently forged naval cooperation pacts with Qatar and Oman, held naval exercises with the Gulf Cooperation Council (GCC) states and Iran, and is building what will be the largest naval base in Asia at Karwar on the Arabian Sea while recently participating in regional cooperative naval exercises in the East China Sea.

Further discussion revealed additional dimensions to India's Middle East energy diplomacy. It was emphasized that while the Gulf remains peripheral in a strategic and energy sense for China, the region is highly significant strategically to India. This is strengthened by the long cultural, historical, and human linkages to the Gulf, including major Indian companies working in the region, as well as huge numbers of Indians working in the Gulf and sending remittances back to India. Given this importance, India strives to maintain a delicate balance in its energy and security interests by keeping its options open; maintaining good relations with the United States, Saudi Arabia, and Iran; and firmly confronting Pakistan while hedging its position toward China in the case that China's rise turns out to be not so benign for the South Asian region.

Saudi Arabia

Jean-Francois Seznec, of the Georgetown University Center for Contemporary Arab Studies, provided an overview of Saudi Arabia's perspectives on growing energy and political engagement with Asia. Seznec suggested that Saudi Arabia sees the country's strategic and energy future as revolving around becoming a global economic and energy power, "an indispensable economic power," based on being a dominant global supplier not only of oil but also of large-scale petrochemicals and other energy-based commodities such as cement, steel, and fertilizers. He argued that this is consistent with China's emphasis on economic and trade power rather than relying heavily on military power for global influence. Moreover, Saudi Arabia sees China and Asia as the country's main future market for energy-based industries, gradually replacing the United States and Europe. Saudi Arabia can be expected not only to increase production of oil, petrochemicals, and other energy-based products for export to China and Asia but also to make new investments in refining and petrochemical production in Asia, especially China. Moreover, China is becoming a major investor in Saudi Arabia, less so in the energy sector but more in petrochemicals, mining, and railroads. Finally, expanding Saudi-Chinese relations would allow the Saudis to become less dependent on the United States for their economic and even strategic future. Deepening anti-Saudi sentiment in the United States in the wake of September 11 and Saudi opposition to the 2003 Iraq War increasingly strained U.S.-Saudi relations during the Bush administration. There has always been a level of discomfort within Saudi Arabia about their country's dependence on the U.S. security umbrella, especially in light of Washington's close alliance with Israel as well as the constant threat of a military confrontation with Shia Iran, which risks opening up a destabilizing Pandora's box of potential backlash from the Shia populations in eastern Saudi Arabia and the lower Gulf. Of course, Saudi Arabia needs the United States to remain the major strategic force in the Gulf—in particular to constrain potential military threats from Iran and Iraq—but China's growing weight is more consistent with the Saudi view of the new energy silk road and an increasingly multi-polar, "post-American" world. The old "oil for security" paradigm of U.S.-Saudi relations will inevitably weaken as China's economic and political gravitational force grows over time.

Much discussion revolved around assessing the evolution of Saudi views toward the U.S. alliance as Saudi Arabia increases engagement with China. Many argued that the country remains strongly committed to the U.S. alliance and that China's involvement is not supplanting U.S. influence. Instead, Saudi Arabia is supplementing its sources of strategic and economic support, bringing new powerful allies into its tent. Chas Freeman, former ambassador to Saudi Arabia, has advocated this view in recent speeches in which he has argued that Saudi Arabia is taking on another wife in the Chinese rather than divorcing the United States. Moreover, Beijing has no interest in being drawn into military and strategic entanglements in the Gulf; China is content to let the United States play that role and pay the heavy human and diplomatic costs while China quietly builds growing energy and commercial interests. Beijing does not want to see its relationship with Washington in the region in zero-sum terms. Both China and Saudi Arabia are dependent on the United States for energy security. Alternatively, some participants argued that Saudi Arabia has been increasingly frustrated and disillusioned with U.S. relations as far back as the Clinton administration; the Bush administration added to that frustration and the Saudi government now sees the shift toward China and Asia as a robust strategy for the future. This incorporates a concern that the long-term future financial and economic decline of the United States and the inevitable weakening of the U.S.

dollar on which Saudi Arabia depends are convincing the country that its financial and economic future increasingly lies with Asia and with China in particular.

Iran

Hormoz Naficy, an oil industry consultant based in London, reviewed the main points of his paper on Iran's views toward the new energy silk road. Naficy argued that Iran has been pragmatic and has turned increasingly to relying on oil and gas investment from Asian NOCs, as it faces the tightening constraints of the Western, U.S.-led investment sanctions. China has clearly been the most active player in the country. Iran has signed major investment agreements with Sinopec, including for development of the large Yadavaran oil field, as well as more recent deals with China National Petroleum Corporation (CNPC) for development of the North Azadegan field. Both Sinopec and China National Offshore Oil Corporation (CNOOC) have signed MOUs to negotiate further deals for large LNG supplies and upstream LNG investments in gas development offshore Pars field. India's ONGC has also been increasingly active in signing new contracts for oil exploration contracts and future LNG supplies. Malaysia's Petronas has also been a fixture in the Iranian energy industry since the mid-1990s.

Naficy argued that Iran would prefer that Western companies, such as the large international oil companies (IOC) and European NOCs such as Statoil and Total, were also competitors for oil and gas deals because this would allow Tehran to play East against West to negotiate better deals. Although earlier in the revolutionary period after 1979 the IOCs were banned from the energy industry, since the late 1990s Tehran has opened up the oil industry to Western companies. Iran has tried to draw in Japan, offering Japan's Inpex the opportunity to develop the huge Azadegan field, but under pressure from the United States Inpex sharply reduced its stake in the deal, eventually leaving the field to Chinese companies. The absence of Western companies has forced Tehran to offer better "buy-back" terms to the Asian NOCs in order to entice them to take on the risks of investing in the face of sanctions. Buy-back deals are essentially a risked service contract in which the companies are paid for their services in crude oil. Moreover, in general the Western companies have the best technology, some of which the Asian NOCs cannot provide. This is particularly true in LNG, where much of the best liquefaction technology is controlled by Western companies. Hence, the Iranian oil industry has to suffice with technology that is far short of world class. In sum, Naficy argued that both Iran and the United States are worse off due to the investment sanctions, with Iran's industry hobbled by investment shortages and subpar technology, while U.S. IOCs are denied the large opportunities available in Iranian oil and LNG development. The Asian NOCs will increasingly benefit from these sanctions and become the main investors in Iranian energy, which is likely to expand political and economic ties further.

Much discussion centered around whether China and India are in the future likely to continue to go along with U.S. efforts to limit energy investment. Some felt that over time the Asian firms as well as the European companies will increasingly ignore U.S. sanctions and take advantage of energy opportunities in Iran. Major resource opportunities like those in Iran are increasingly difficult to pass up in today's highly limited opportunity environment. Moreover, in energy security terms, the world market needs those extra oil and gas supplies. Others argued that even if there is greater willingness to invest, the European firms and IOCs still face extremely poor investment terms in Iran, extremely difficult negotiations, and high political risks that will make

large investments difficult to justify. Only the Asian NOCs in China and India seem willing to accept such poor returns and high risk investment conditions.

Other Key Players in the Middle East: Japan, Korea, and Russia

Kent Calder, from the Johns Hopkins School for Advanced International Studies (SAIS), led a discussion on the historic positions of Japan and Korea in Middle East energy. He argued that Japan's influence in the region is often underestimated. In the wake of the 1970s oil shocks, Japan became the largest single oil and LNG importer from the Gulf and has a long history of deep relationships with and investments in the key producers. Tokyo has maintained its closest and longest relationship with the UAE as a partner in developing large offshore oil fields as well as major Abu Dhabi LNG projects since the 1970s. Japan was also closely tied to Saudi Arabia through long-term crude supply contracts and a 30-year joint venture with ARAMCO in the Arabian Oil Company (AOC) Neutral Zone fields—by far Japan's largest oil producing position abroad. This relationship eroded with the ending of the AOC contract in 2003, which was a major setback from Japan's perspective and led Tokyo to seek new oil investment opportunities in Iran, despite U.S. discomfort. Japan has had a long and deep historic and cultural relationship with Iran, which has been Japan's largest single crude supplier in the Gulf. Tokyo hoped to recover from the lost AOC contract by gaining access to development rights for the huge Azadegan field in Iran but, after an internal battle in the Japanese government, Inpex was forced to back out of the contract as the government gave in to pressure from the United States. Japan's weakness in Gulf influence has obviously been its lack of strategic power projection capabilities, which forces Tokyo to rely on commercial and energy technology for influence.

South Korea, alternatively, arrived much later as a player in the Gulf and has focused more on niche market opportunities in oil exporters who also developed later, including Oman and Yemen. Korea was a major investor in Yemen's oil growth beginning in the late 1980s. Korea's companies have been somewhat more independent from their government compared to Japan's companies and, by and large, are less risk-averse than their Japanese counterparts. This can be seen in these firms' move into Iraq's northern Kurdistan oil development, despite Seoul's active diplomacy in Baghdad and concern that Korean companies would be less welcome in Baghdad as a result. Korean state energy companies have been more competitive and financially independent overall than Japanese state oil companies. Both Japan and Korea are increasingly concerned about what they see as China's growing investments, oil trade, and influence in the Gulf and have reacted by intensifying their own diplomacy in the Gulf to compete with China's growing presence. Japan is also concerned about China's growing influence in Central Asian energy development and in Southeast Asia and Indonesia where Japanese energy and commercial interests historically have been extremely powerful. Japan has also stepped up its energy dialogue with Russia and Gazprom to compete with China's growing energy ties with Russia. Overall, Japan and Korea are likely to remain important players in the Gulf as they continue to import the majority of their crude oil from the region. Yet given their limited strategic weight, these countries will remain less influential than the United States and China, who wield both energy and strategic power.

Paul Saunders, director of the Nixon Center, provided a discussion of Russia's perceptions of the country's strategic and energy interests and prospects in the Gulf region. He argued that Russia sees the Middle East as much closer geographically and therefore more regionally strategic

than the Asian players. Russia's most immediate concerns are on its periphery beyond Central Asia—Afghanistan, Pakistan, and Iran—but this then extends to the Arab Gulf producers. Russia's interests in the Gulf are both strategic and energy-economic. Strategically, Moscow sees the Middle East as a place where all the major powers are involved, and is intent on being at the table as a major player in the region. The Middle East is also a major arms market, and Russia remains a key supplier to the region, especially Iran and Syria. Further, Russia's fears of Islamic terrorism in southern Russia and the Caucasus make it important to work with the Gulf states, particularly Saudi Arabia and Iran, in order to prevent them from supporting Islamic terrorist groups from Tajikistan to Chechnya. Geopolitically, Russia sees Iran as its strongest ally in a region dominated by the United States and its allies, which include Turkey, Pakistan, Afghanistan, India, Saudi Arabia, Iraq, Egypt, and Israel. Although Russia does not want to see Iran develop nuclear weapons, Moscow is more concerned presently about the regional fallout from a possible U.S. or Israeli attack on Iran. Russia therefore prefers the status quo but lacks a clear strategy for the longer term since the current status quo is unsustainable. From an energy perspective, Russia believes it has vital interests in having positive relations with the Gulf oil and LNG producers, who are major potential competitors for oil and gas export markets. Gulf and OPEC oil production decisions are critical for Russia's future oil income. Russia and Gazprom are also intent on limiting the competitive threat of future natural gas exports from the Gulf to Europe, Russia's primary gas export market, especially from Iran. Moscow is seeking stronger ties with Qatar, the world's largest LNG exporter, in order to find ways to manage potential future gas export competition. This is the motive for discussions with Qatar and Algeria over the potential for establishing a natural gas organization modeled after OPEC.

Implications for the United States

A final panel including Dan Blumenthal from the U.S.-China Economic and Security Review Commission, Edward Chow from the Center for Strategic and International Studies (CSIS), and Mikkal Herberg from NBR led a discussion on assessing the long-term strategic implications of Asia's growing energy and strategic footprint in the Gulf and Middle East for the United States. There was general agreement that although Asia's energy role in the region has been significant for several decades, the region's strategic role has been quite muted. This seems likely to change dramatically, however, over the next decade as the "new silk road" fundamentally alters the terrain on which the United States has been operating for the past forty years. For energy markets, Asia is now the "swing consumer" to match the Gulf as the "swing producer," which is driving a huge shift in investment patterns, oil industry competition, oil prices, resource access, and energy diplomacy. Chinese and Indian NOCs seem likely to be much larger and more powerful players in the region than Japan's or Korea's NOCs, and Beijing and New Delhi are likely to become progressively more assertive in pursuing their regional energy and strategic interests. China seems likely to become less inclined to follow the U.S. lead on regional energy affairs as its investment and strategic interests expand.

Whether this means greater competition for regional influence for the United States depends partly on how Washington and U.S. oil companies respond to this changing terrain. The United States must find ways to draw China and India into the International Energy Agency (IEA) and other global energy management institutions if Washington expects them to become "responsible

stakeholders” in global and Gulf energy affairs. New institutions may be also needed to give these rising powers a greater stake in managing global energy issues. Moreover, Washington needs to avoid episodes such as the CNOOC-Unocal battle which sent the message to Beijing that Chinese NOCs will not be accepted on a level playing field for investment. Hectoring India on energy ties with Iran also seems likely to undermine New Delhi’s support for U.S. policy in the region. Hence, if the United States does not want to face an adversarial energy relationship with China and India that spills over into a nationalistic energy competition in the Gulf region over resource access and influence, Washington will need to adjust U.S. policies to this changing terrain.

China's Energy Role in the Middle East and Prospects for the Future

Philip Andrews-Speed

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China's international energy strategy is based on the premise that the country is set to be a substantial net importer of oil and gas for the foreseeable future. Some 50% of the country's oil consumption, or about 4 million barrels per day (mmbpd), is met by imports. Though gas imports are currently limited to a single liquefied natural gas (LNG) terminal, the scale is set to grow as new LNG terminals are commissioned and when a gas pipeline from Turkmenistan is completed.

Depending on how rapidly demand picks up as China emerges from the current economic recession, net imports of oil could double to 8 mmbpd between 2015 and 2020, which compares with total oil imports to the United States today of about 13 mmbpd and to Japan of about 5 mmbpd. Imports of gas to China could rise from 4 billion cubic meters per year (bcm/yr) today to as much as 100 bcm/yr by 2020. This compares to Japan's current level of LNG imports, which stands at about 90 bcm/yr. Thus, by 2020 China will almost certainly be one of the major oil and gas importing regions in the world, alongside the United States, the European Union, and Japan.

The Middle East (excluding North Africa) holds about 60% of the world's proven conventional oil reserves and about 40% of the world's proven natural gas reserves. Despite this abundance of resources, this region accounts for a disproportionately small share of internationally traded oil and gas (35% and 25% respectively) and an even smaller share of world oil and gas production (31% and 12% respectively). This relatively low contribution to internationally traded oil and gas is set to change over the next ten to twenty years as an increasing number of oil and gas exporters around the world become net importers as a result of declining reserves, rising domestic demand, or both.¹ As a consequence, all countries that rely on imports of oil and natural gas will unavoidably become progressively more reliant on the Middle East.

In the longer term, perhaps beyond the year 2030, new forms of energy for transport and for static uses may result in a steady decline in the demand for oil and natural gas, and unconventional sources of oil and gas may become more readily available. In such circumstances, the relative importance of the Middle East may decline. Yet even so, the role of Middle Eastern countries in world energy markets is likely to grow substantially from 2010 to 2030.

Thus, on the one hand, there is China, the world's fastest-growing major importer of oil and gas, and, on the other hand, the Middle East, a region set to dominate world oil and gas supplies for the next two decades. It is therefore no surprise that diplomatic, economic, and energy relations between China and the countries of the Middle East have systematically deepened over the last ten years.

The apparent simple logic behind this convergence of strategic energy interests is, however, illusory (at least in part) for a number of reasons. First, the international strategic importance of the Middle East means that no relationship between a Middle Eastern state and China can be a purely bilateral matter. Considerations relating to regional stability and to third-party interests and influences are unavoidable. Second, each country in the Middle East has its own political and economic characteristics and priorities that will determine the nature and direction of its relations with China. Third, even within the energy sector itself, four sets of interests may be identified: those of China's government, of China's national oil companies (NOC), of the Middle Eastern governments, and of their NOCs.

While acknowledging that the first and second sets of factors are of unarguable importance in determining the current and future nature of energy relations between China and Middle Eastern

¹ John V. Mitchell and Paul Stevens, *Ending Dependence: Hard Choices for Oil Exporting States* (London: Chatham House, 2008).

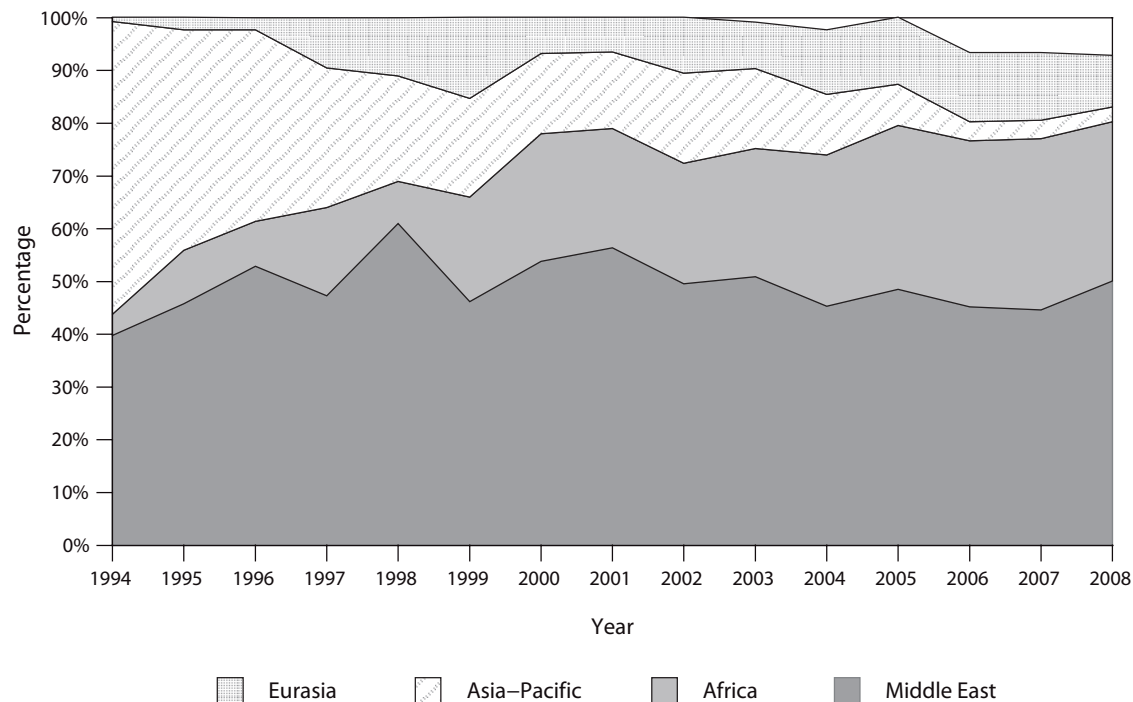
states, this essay focuses on the third set of factors, those relating directly to energy. The essay briefly reviews the nature of energy relations to date between China and the Middle East and then examines the four sets of interests driving this cooperation and how these interests may determine the future course of energy relations.

Energy Relations to Date

Energy relations between China and Middle Eastern states take a number of forms:

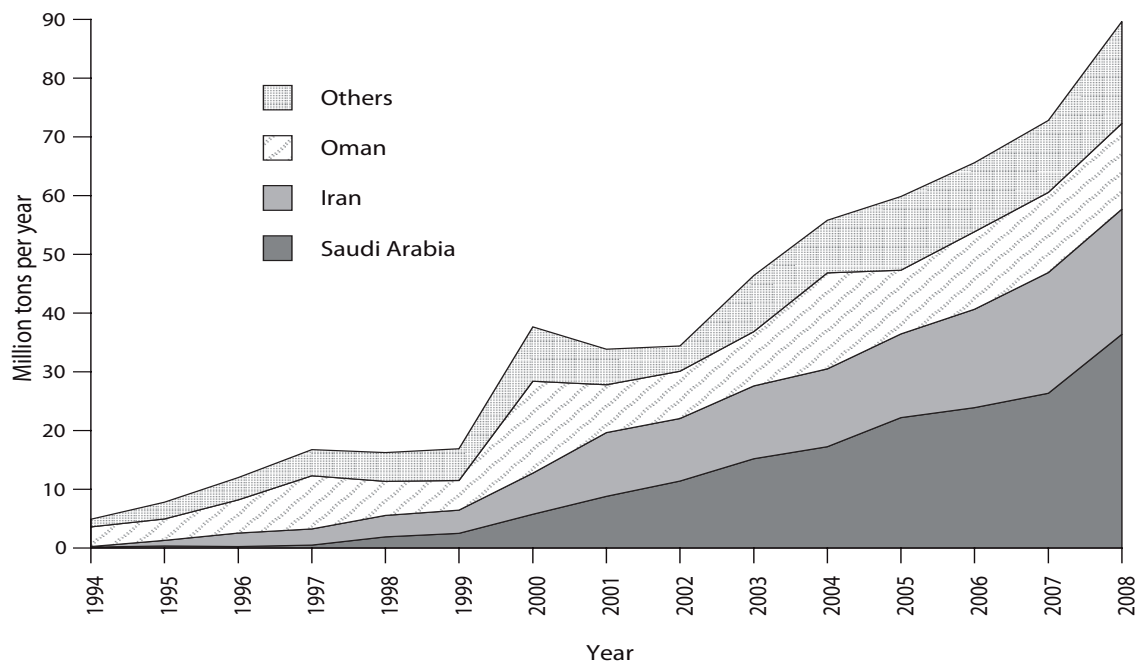
- Growing imports of oil, mainly crude oil, from the Middle East to China (**Figures 1, 2, and 3**)
- Long-term, intergovernmental agreements to supply oil or gas to China
- Investments by Chinese companies in oil and gas assets in the Middle East, mainly upstream (**Table 1**)
- Investments by Middle Eastern companies in oil assets in China, mainly downstream (**Table 2**)
- The provision of oil field and construction services by Chinese companies in the Middle East

FIGURE 1 Sources of crude oil imports to China, 1994–2008



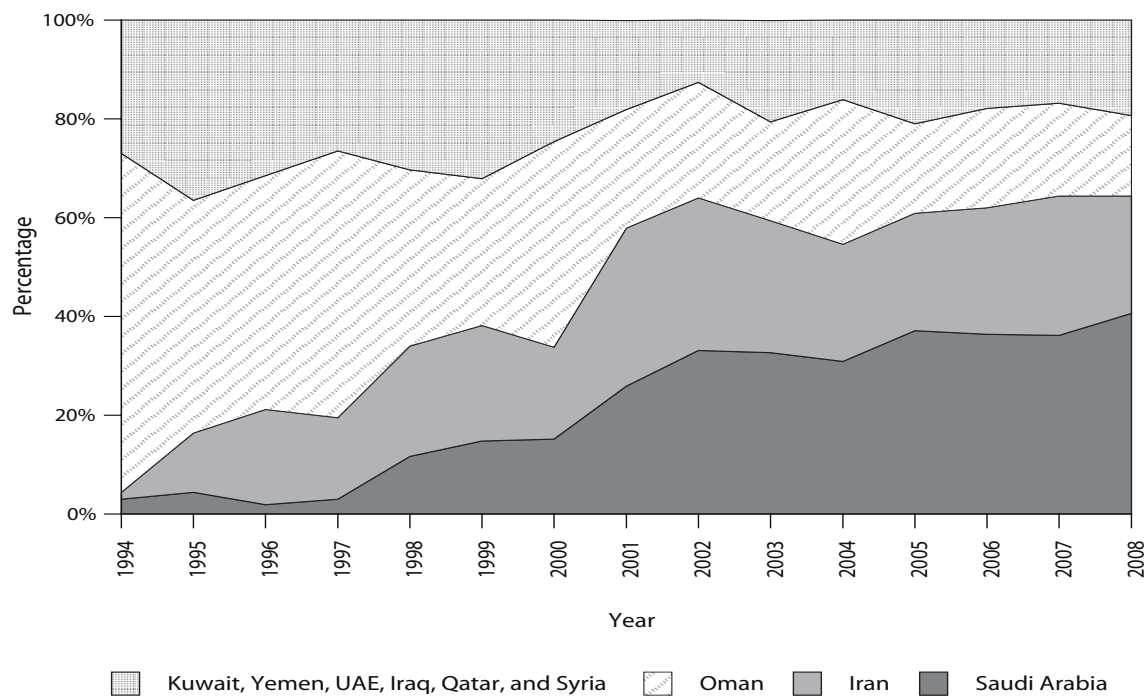
SOURCE: Chunrong Tian, "Review of China's Oil Imports and Exports in 1999," *International Petroleum Economics* 8, no. 2 (2000) (in Chinese); Chunrong Tian, "Review of China's Oil Imports and Exports in 2004," *International Petroleum Economics* 13, no. 3 (2005) (in Chinese); Chunrong Tian, "Review of China's Oil Imports and Exports in 2007," *International Petroleum Economics* 16, no. 3 (2008) (in Chinese); and Chunrong Tian, "Review of China's Oil Imports and Exports in 2008," *International Petroleum Economics* 17, no. 3 (2009): 31–39 (in Chinese).

FIGURE 2 China's crude oil imports from the Middle East, 1994–2008



SOURCE: Tian, "Review of China's Oil Imports and Exports in 1999"; Tian, "Review of China's Oil Imports and Exports in 2004"; Tian, "Review of China's Oil Imports and Exports in 2007"; and Tian, "Review of China's Oil Imports and Exports in 2008."

FIGURE 3 Relative contributions to China's crude oil imports from the Middle East, 1994–2008



SOURCE: Tian, "Review of China's Oil Imports and Exports in 1999"; Tian, "Review of China's Oil Imports and Exports in 2004"; Tian, "Review of China's Oil Imports and Exports in 2007"; and Tian, "Review of China's Oil Imports and Exports in 2008."

In the 1990s, Oman and Yemen dominated oil exports to China from the Middle East, as the crude oil from these countries had a low sulphur content, or in oil field jargon, was sweet. In contrast, most crude oil from the Middle East is rich in sulphur and is therefore sour. China's traditional refining capacity was constructed to process China's domestic crude oil, which is sweet.² As a result, China has been slowly upgrading its refineries and constructing new refineries able to process sour crude oils from the Middle East. By the end of 2008, China's capacity to refine sour crude oil amounted to approximately 1.6 mmbpd or 20% of the country's total capacity.

The proportion of oil from Saudi Arabia and Iran grew dramatically from the late 1990s, but China's ability to import the sour crude oils from Saudi, Iran, and other Middle East exporters continues to be constrained by a shortage of suitable refining capacity. As a result, the proportion of China's oil imports from the Middle East remains in the range 45%–55% of total oil imports (Figure 1), and China has put great effort into raising imports of sweet crude oil from Africa and Eurasia. A further reason for constraining the level of imports from the Middle East has been China's desire to limit, as far as possible, the country's dependence on the Middle East through diversifying sources of supply.

The years since 2000 have seen Chinese NOCs take a number of steps to gain access to investment opportunities in the Middle East, mainly in exploration and production, but also in the construction of refineries (**Table 1**). The target investments are of two types. The first type comprises a small number of large or very large oil and gas fields in the countries with major oil and gas reserves, such as Iran and, to a lesser extent, Iraq, Saudi Arabia, Kuwait, and the United Arab Emirates (UAE). Before June 2009, only the Yadavaran oil field in Iran and the al-Ahdab field in Iraq could be considered to be secure and substantial deals. The months of June and July 2009 saw Chinese oil companies secure three significant deals: China National Petroleum Corporation (CNPC) concluded an agreement with the Iranian government to replace Total in the contract to develop Phase 11 of the South Pars gas field; Sinopec launched a friendly bid for the Swiss company Addax, which has producing oil fields in the Kurdish region of Iraq; and CNPC and BP jointly won a bid to develop the giant South Rumaila oil field in southern Iraq.

The second type of investment involves a number of smaller or higher risk projects that may yield commercial profits to Chinese NOCs but are not large enough to be of strategic importance either to the large NOCs or to China's government.

Chinese NOCs will certainly continue with attempts to gain access to large and high quality reserves in the Middle East, but host governments may consider that these companies lack the technical and managerial skills for the largest and most complex projects. As a result, China's NOCs may benefit from cooperating with the major international oil companies, as Chinese oil companies already do in other parts of the world. In this context, it is significant that in April 2009 Shell raised the possibility of working with Chinese NOCs in Iraq.

China and East Asia are potentially of as great importance to the Middle East oil and gas producers, as the Middle East is to China and East Asia. Today roughly 68% of Middle Eastern oil exports flow to the Asia-Pacific region. Though only 8% reaches China, this proportion is set to rise. Further, 75% of Middle Eastern LNG goes to East Asia, mainly to Japan and South Korea. None of China's LNG imports come from the Middle East, but this is likely to change in the near future when LNG imports arrive from Iran and Qatar.

² Paul Horsnell, *Oil in Asia: Markets, Trading, Refining and Deregulation* (Oxford: Oxford University Press, 1997).

TABLE 1 Summary of exploration, production, and refining investments made, agreed, or proposed by Chinese NOCs in the Middle East

Country	Country reserves		Project name	Project type	Date signed	Company	Project status	Reserves/ production	Investment
Saudi Arabia	Oil (bn bbl)	Gas (tcm)	(O) = Oil (G) = Gas	Exploration & production (E&P)	2004	Sinopec	Exploration	? 11 TCF	<\$2.2 bn
	264	7.2	Section B (G)						
Iran	138	27.8	Block 3 (O)	E&P	2005	CNPC	Exploration		
			Masjed-I-Suleiman (O)	Acquisition	2004	CNPC	Exploration		\$150 m
			South Pars (G)	Development	2009	CNPC		50 million cubic meters per day	\$5 bn
			Yadavaran (O)	E&P	2007	Sinopec	Development	1.5-3.0 bn bbl (payment in LNG)	\$2 bn
			Zavareh-Kashan	E&P	2001	Sinopec	Failed exploration		\$160 m
			North Pars (G)	E&P	2006	CNOOC	Development	20 mtpa of LNG	\$16 bn
Iraq	115	3.2	Arak (O)	Refinery upgrade	2006	Sinopec	Construction	200 kb/d	
			Al-Ahdab (O)	Development	1997/2008	CNPC		<110 kb/d, 1 bn bbl	
			South Rumaila (O)	Development	2009	CNPC	Development	7.3 bn bbl	
			Addax assets (O)	E&P, refinery	To be finalized	Sinopec	Producing	42 mmb	
Kuwait	101	1.8	?	Development	2009	Sinopec			\$350 m
UAE	98	6.1	Uraq & Zora (G)	Acquisition	2003	Sinochem	Exploration		
Oman	5.6	0.7	Blocks 36 & 38	E&P	2004	Sinopec	Exploration		
			Blocks 17 & 40	Acquisition	2003	Sinochem	Exploration		
			Block 5 (O)	E&P		CNPC		1.5 mmb	
Yemen	2.8	0.5	Block S2		2001	Sinopec			
			Block 69 & 71		2005	Sinopec			
Syria	2.5	0.3	Qubibe (O)	Development	2004	CNPC	Development		
			Al Furat Prod Co (O)	Acquisition	2005	CNPC	Producing	58 kb/d, 24 mmb	\$570 m
			Two PSAs (O)		In negotiation	Sinopec	Producing	6 kb/d, 185-660 mmb	\$2 bn
			Al Zour (O)	Refinery	2008	CNPC			
			Block 10 (O)	Acquisition	2008	Sinochem	Producing	6.7 kb/d	

SOURCE: FACTS Global Energy, "An Update of China's Overseas Oil and Gas Investment," China Energy Series, Oil Edition, December 2008.

As a consequence, certain national oil companies in the Middle East have been seeking opportunities to invest in China. The first of these was Saudi Aramco, which entered negotiations with Sinopec as early as 1993 to construct new refining capacity at Qingdao in Shandong Province. This project only came onstream in 2008. Saudi Aramco's second refinery project with Sinopec, in Fujian Province, was commissioned in 2009. Another Saudi company, SABIC, plans to build a cracking plant in Tianjin, while the Kuwait Petroleum Corporation and the Qatar Petroleum Company also plan to build refinery and petrochemical plants (**Table 2**). In addition, these companies plan to be involved in the construction of oil storage facilities as well as to participate in the retail of oil products.

In many respects the energy strategies China pursues in the Middle East resemble those the country pursues in other parts of the world. The distinguishing features of China's energy relations and activities in the Middle East include:

- The large-scale and long duration of the diplomatic effort expended by China in the Middle East³
- The consistently large proportion of oil imports from the Middle East and the apparent importance of long-term supply agreements
- The very small number of exploration and production contracts of substantial size that have been concluded by China's NOCs, and the patience displayed by China's NOCs in negotiating large exploration and production deals
- The growing size of inward investment from the Middle East to China's oil sector

TABLE 2 Inward investment by Middle Eastern NOCs into China

Company/ Country	Project	Capacity	Location	Partners	Date signed	Completion date
Saudi Aramco	Refinery	240 tbpd	Fujian	Sinopec, ExxonMobil	2001	2009
Saudi Aramco	Refinery	<400 tbpd	Qingdao	Sinopec	2005?	2008
SABIC	Cracker	240 tbpd	Tianjin	Sinopec	2007	2009
Saudi Aramco	Oil storage		Hainan		2006	2009
Saudi Aramco	Retail stations	600 stations				
Kuwait Petroleum Corp	Refinery and petrochemicals	260 tbpd	Guangdong	Sinopec	2006	2011
Kuwait Petroleum Corp	Oil storage	1.9 mmb	Guangdong	CNAF	2007	2009
Qatar	Refinery and petrochemicals	?	?	PetroChina, Shell	MOU 2008	

SOURCE: Various press reports.

³ See, for example, John Keefer Douglas, Matthew B. Nelson, and Kevin Schwartz, "Fueling the Dragon's Flame: How China's Energy Demands Affect Its Relationships in the Middle East," U.S.-China Economic and Security Review Commission, Report, September 14, 2006, http://www.uscc.gov/researchpapers/2006/China_ME_FINAL.pdf; and Daojiong Zha, "China's Energy Security: Domestic and International Issues," *Survival* 48, no. 1 (Spring 2006): 179-90.

In addition, China's long-term dependence on Middle East oil has driven Beijing to take steps to protect sea lanes in South and East Asia⁴ and also, more recently, in the seas off Northeast Africa. The decision to invite the participation of Iran as an observer to the Shanghai Cooperation Organisation further emphasizes China's interests in energy cooperation with that country.

Motivating Factors

The nature, scope, and rate of development of China's international oil and gas strategy are remarkable even in today's economically integrated world. In part this development can be explained by the convergence of four sets of interests: those of China's government, of China's NOCs, of the Middle Eastern governments, and of Middle Eastern NOCs. This section examines each set of interests.

China's Government

China's government has many reasons for the scale and scope of the effort Beijing is devoting to the nation's international oil and gas strategy, though the primary motivation is to enhance the security of international supplies of oil and gas. In this respect, China's government has specific concerns relating to physical interruptions of supply and to price, triggered by the country's increasing reliance on imported oil and gas.⁵

As is the case for all oil importers, China is subject to the vagaries of international market prices. Regardless of how China regulates its domestic markets and regardless of much oil it refines, an importing nation is obliged to pay the prevailing market price for imports of crude oil. The concerns of China's government relating to international oil markets have three components. First, Beijing dislikes the volatile and unpredictable nature of the market. Second, the government distrusts what is perceived as the undue influence that a few producers, and especially the United States, have on the market. Third, Beijing resents the premium that China and other East Asian countries must pay for every barrel of oil imported from the Middle East.

In the 1990s and early 2000s, China's government appeared to be taking what was variously called a "strategic"⁶ or "neomercantilist"⁷ approach in addressing the challenges of securing oil and gas supplies. A belief existed in the Chinese government and its circle of advisers that security of supply could be enhanced both by owning rights to oil and gas in the ground around the world and by producing this oil and gas. The NOCs would be instruments of this policy. Such resources would be secure, and the equity oil produced would be cheaper than oil bought on the open market. Given that the world's remaining oil and gas reserves appeared to be limited, it was vital for China to move quickly to gain the country's fair share of what remained.⁸ The security of international oil and gas flows to China would be further enhanced by signing long-term supply agreements with

⁴ See, for example, Ian Storey, "Securing Southeast Asia's Sea Lanes: A Work in Progress," *Asia Policy*, no. 6 (July 2008): 95–127; and Liselotte Odgaard, *Maritime Security between China and Southeast Asia* (Aldershot: Ashgate, 2002).

⁵ Philip Andrews-Speed, Xuanli Liao, and Roland Dannreuther, *The Strategic Implications of China's Energy Needs*, Adelphi Paper No. 346 (London: Oxford University Press, 2002); Amy M. Jaffe and Steven W. Lewis, "Beijing's Oil Diplomacy," *Survival* 44, no. 1 (Spring 2002): 115–34; Erica Downs, "The Chinese Energy Security Debate," *China Quarterly*, no. 177 (March 2004): 21–41; Kenneth Lieberthal and Mikhal E. Herberg, "China's Search for Energy Security: Implications for U.S. Policy," *NBR Analysis* 17, no. 1 (April 2006): 5–42; and John Mitchell and Glada Lahn, *Oil for Asia* (London: Chatham House, 2007).

⁶ Andrews-Speed, Liao, and Dannreuther, *The Strategic Implications of China's Energy Needs*.

⁷ Lieberthal and Herberg, "China's Search for Energy Security."

⁸ Downs, "The Chinese Energy Security Debate."

major exporters, by building military capacity to protect sea lanes, and by constructing import pipelines where possible.

In addition to these objectives relating to security of supply, the government had other aims in supporting the overseas strategies of the oil companies. The most important of these relate to industrial and foreign policies.

Since the late 1990s, the government has held an official policy to protect a small number of pillar industries that remained in state hands and to promote their development into major international players. The oil industry was one of these industries.⁹ The restructuring and partial listing of the NOCs in the late 1990s confirmed that the managers shared these ambitions. Indeed, as discussed above, the very survival of the companies depended on success abroad.

Allied to this was the desire on the part of both the government and the oil companies to promote opportunities for the oil field service companies to win business overseas. This would not only keep a greater proportion of the oil companies' revenue in Chinese hands but would also provide employment for tens of thousands of oil field workers and managers. Further, as both oil companies and service companies expanded their businesses overseas, they would provide more tax revenue and foreign exchange to the government.¹⁰

Just as foreign policy can support energy policy, energy policy can be used to support foreign policy. Indeed, it has long been recognized that energy or funds to invest in energy development can be wielded in the international arena either as a carrot or as a stick. Given China's status as an energy importer, Beijing has chosen to use energy as a diplomatic carrot. The government has used energy as a starting point for building new relations, as a catalyst to renew dormant relations, and to deepen existing relations. As described above, energy has been packaged together with other instruments to achieve both political and economic gains, and in some countries energy forms a critical component of China's diplomatic strategy.¹¹

In the Middle East, the scale of the region's oil and gas resources, the potential scope for investment and services, and the internationally strategic importance of the region allow China's government to pursue a wide range of interests through involvement in the oil and gas sector. As a consequence, China's government has played a major role in helping Chinese oil companies gain access to commercial opportunities, especially in Iran, Iraq, and Saudi Arabia, which together hold the bulk of the Middle East's oil and gas reserves. In all three countries the barriers to foreign investors in the oil and gas industry have been high for many years, and government support will have been critical to China's NOCs gaining foothold ahead of other competitors.

China's National Oil Companies

Though the government may have been the main force behind diversifying oil and gas supplies and securing long-term supply arrangements, the prime movers behind the growth of overseas commercial activity by China's NOCs have been the companies themselves—not just the three main national oil companies but also their subsidiary service companies, smaller oil companies, and

⁹ Jin Zhang, *Catch-up and Competitiveness in China: The Case of Large Firms in the Oil Industry* (London: RoutledgeCurzon, 2004).

¹⁰ Xin Ma and Philip Andrews-Speed, "The Overseas Activities of China's National Oil Companies: Rationale and Outlook," *Minerals and Energy* 21, no 1 (March 2006): 17–30.

¹¹ Jaffe and Lewis, "Beijing's Oil Diplomacy."

various provincial companies. For most of these players the driving force for internationalization has been a combination of necessity and opportunity.¹²

This necessity has arisen from constraints on and threats to Chinese oil companies from within China. China's onshore areas and, to a lesser extent, offshore seas have been well explored. Though new discoveries continue to be made, the NOCs are struggling to increase production within China. The possession of oil and gas reserves for future production is a fundamental requirement for the long-term success of an oil company. With limited opportunity at home, Chinese companies have been forced to go overseas in order to secure their long-term survival. In addition to simply surviving, the commercialization and overseas listing of the NOCs in the late 1990s places on them the clear obligation to seek growth in revenues, profits, and value.

A second domestic threat arises from the manner in which oil and natural gas are priced. The government retains the right to control or set the prices of all energy products. Though producer prices for oil have risen along with international prices, producer prices for natural gas have not kept pace, and consumer prices for most forms of energy have been tightly controlled at a low level. As a result, companies that refine crude oil have been incurring massive financial losses, and those supplying gas have had their profits constrained. With tightly controlled energy markets at home, China's oil companies have clear incentives to invest abroad in such a way that they can sell their products at international prices with no restrictions.

The opportunities for these companies are multiple. First, and most importantly, overseas expansion allows them to take the first steps toward becoming truly international corporations rather than merely very large NOCs. This is the prime ambition of PetroChina, Sinopec, and China National Offshore Oil Corporation (CNOOC). To become major international players, these companies will require capital, assets, and skills. They have the capital, they are building their asset base around the world, and they are starting to develop their technical and managerial expertise to international levels, building on many decades of domestic experience.

Within this context, overseas expansion allows these companies to expand their range of activities beyond historic bases more rapidly than they could at home. Sinopec can gain oil fields to supply its Chinese refineries, CNPC and CNOOC can build their refining activities, and all three companies can expand participation in natural gas markets. For Sinochem, the firm's origins as an international oil trader could have led to the company's demise after the removal of its monopoly on the oil trade. The company's small but growing program of international investment, however, has allowed Sinochem to survive and grow.

Underpinning these opportunities is the enhanced freedom that the NOCs have enjoyed since their radical restructuring in 1998. The Chinese government has relaxed substantially the degree of operational and strategic control over both the listed subsidiaries and, to a lesser extent, the holding companies. This has allowed the companies to develop their own strategies for growth and performance, though they are still subject to approval by government and remain liable to be called on to address national priorities.

For Chinese NOCs, as for international oil companies, the Middle East is a region of key strategic importance for future investments as well as for service and construction contracts. The Chinese companies have been able to leverage government support in order to gain a modest

¹² Erica Downs, "China," Brookings Institution, Energy Security Series, December 2006; Ma and Andrews-Speed, "The Overseas Activities of China's National Oil Companies"; Mitchell and Lahn, *Oil for Asia*; and Trevor Houser, "The Roots of Chinese Oil Investment Abroad," *Asia Policy*, no. 5 (January 2008): 141–66.

advantage over their rivals, but the scale of activity in countries such as Saudi Arabia, Iran, Iraq, and Kuwait has been constrained by domestic political and legal constraints on foreign investment in natural resources.

Host Governments

The host governments play a key role in the internationalization of China's oil companies, for these governments, or their NOCs, approve the deals and award the contracts. Though many host governments treat the Chinese companies in the same way as companies from other countries, a number of governments have their own specific objectives when seeking Chinese investment in their oil and gas sectors. These objectives range from the mainly economic to the largely political.¹³

Countries such as Iran, Sudan, Myanmar, and Syria urgently require foreign investment in their energy sectors, and yet U.S. and other Western governments forbid or discourage their companies from investing there. As a result, these governments have no choice but to seek investment from countries that do not pursue the same political agenda, such as China, India, Russia, and Malaysia. Of these, China has the largest oil companies with the greatest ambitions for internationalization and the largest sources of finance, though Russia's Gazprom is taking its first steps to become a major international gas player.

There are those governments that are successful at attracting inward investment to their oil and gas sectors but that wish to reduce dependence on certain outside parties. Countries such as Libya, Equatorial Guinea, and Kazakhstan have clearly stated that they wish to diversify investment away from Western oil companies, and Kazakhstan and Turkmenistan want to break their historic dependence on Russia.

In Africa, many countries are in great need of investment both in their petroleum sectors and also in general infrastructure to accelerate economic development. The governments of Angola, Sudan, Nigeria, and other African countries have been keen to accept such assistance from China in association with oil investment because this aid has carried none of the conditions associated with aid programs from the West and has been delivered in a very timely manner.¹⁴

Governments of the petroleum-rich countries in the Middle East have objectives that relate to their search for security of demand and to the ambitions of their own NOCs. These governments know that Asia, rather than the West, will be their biggest customer in the future and therefore they must build better economic and political relations with governments in the region, and with China in particular. Thus, they are keen to sign long-term supply agreements and appear willing to allow Chinese companies to invest in their domestic petroleum sectors.

From the perspective of foreign relations, certain governments appear to be taking advantage of China's interest in their resources in order to use China as a political and strategic counter-balance to the United States or the West in general. This is likely to be the case for a number of Middle Eastern governments.

¹³ Philip Andrews-Speed, "China's Energy Policy and Its Contribution to International Stability," in "Facing China's Rise: Guidelines for an EU Strategy," ed. Marcin Zaborowski, EU Institute for Security Studies, Chaillot Paper, no. 94, December 2006, 71–81; Mitchell and Lahn, *Oil for Asia*; and David Zweig and Bi Jianhai, "China's Global Hunt for Energy," *Foreign Affairs* 84, no. 5 (September/October 2005): 25–38.

¹⁴ Linda Jakobson and Daojiong Zha, "China and the Worldwide Search for Oil Security," *Asia-Pacific Review* 13, no. 2 (November 2006): 60–73; Ian Taylor, "China's Oil Diplomacy in Africa," *International Affairs* 82, no. 5 (September 2006): 937–59; and Indira Campos and Alex Vines, "Angola and China: A Pragmatic Partnership," Center for Strategic and International Studies, Working Paper, March 2008, http://www.chathamhouse.org.uk/files/11175_angolachina_csis.pdf.

Host Country National Oil Companies

While the objectives of the host country NOCs are usually broadly consistent with those of their government, the NOC is likely to have a number of specific business goals. First, the NOC may be willing to use Chinese service and construction companies on account of their relatively cheap price and on account of the work ethic, which usually results in timely completion of even the toughest projects. This has certainly been the case in the Middle East.

Second, the host NOC may lack the cash to implement its investment program and may be keen to have a cash-rich, joint venture Chinese partner or to receive cash loans from China's government or NOCs. For example, in February 2009 the Chinese government agreed to lend \$25 billion to two of Russia's state oil companies, Rosneft and Transneft, in return for a guarantee of supply of 300,000 bpd for twenty years. That same week, the China Development Bank agreed to lend Brazil's NOC, Petrobras, \$10 billion in return for supplying between 60,000 to 100,000 bpd of crude oil to Sinopec, China's main state-owned refiner, and between 40,000 and 60,000 bpd to PetroChina. To date, the Middle Eastern NOCs have not been sufficiently short of funds to seek loans from China.

Finally, the larger NOCs of Middle Eastern countries that lack a large domestic market are keen to integrate vertically downstream into refining, petrochemicals, and retailing in a large market such as China. This strategy mirrors, to a certain extent, that of the Chinese NOCs and may help Middle Eastern NOCs to develop into major, internationalized companies.

Constraints on Deepening Energy Relations

The highly politicized nature of energy relations between China and the Middle East along with the global strategic importance of the Middle East mean that the course of the development of energy relations between China and a particular Middle Eastern state will depend on a variety of factors and interests. These include, on the one hand, general global or regional trends and events and, on the other hand, factors that relate directly to the specific interests of the four parties described above.

China's ability to deepen energy relations with Middle Eastern states will be highly dependent on the political stability of the region and on the policies and actions of other outside parties in the region. Any favorable or unfavorable trends in this respect may be ameliorated or exacerbated by relations between China and the West concerning the Middle East. At one extreme, China might choose to cooperate with the West in the development of energy relations with the Middle East. Depending on the circumstances at the time, this might result in an acceleration or a deceleration of energy activities in the region. At the other extreme, China might decide to set itself up against the West in respect of its approach to the Middle East and so seek a rapid deepening of energy relations. In this context, Iran and Iraq are likely to be test cases. For China will continue to make vigorous efforts to gain access to the rich oil and gas reserves in these countries while at the same time balancing its contradictory policies of both seeking to act as a counterweight to the United States in the region and maintaining effective working relations with its largest trading and investment partner.

With respect to the interests of the four main parties, a number of potential sources of tension may be identified that could constrain the progress of energy relations and these can be viewed in a hierarchy starting with intergovernmental relations.

The relations between Middle Eastern governments themselves and the Chinese government have been critical to the development of energy relations, especially in the case of those countries with large petroleum resources, such as Iran, Saudi Arabia, Iraq, and Kuwait. A change of government or of policy approach by the host government could constrain a deepening of energy relations, as could a sustained failure by either party to deliver on its commitments. Such failures might include a substantial decline in oil deliveries to China, a major delay or shortfall in promised investment by China into the Middle East country or vice versa, or the erection or maintenance of barriers to investment by either party. One example of the latter is the constant complaint of Middle Eastern NOCs that China's domestic pricing policy for oil products undermines the commercial viability of their refinery projects in China.

Given the heavy involvement of the respective governments in building the activities of China's NOCs in some of the Middle Eastern states, the relations between the host governments and the Chinese NOCs will be highly dependent on the cordiality of intergovernmental relations. In addition, the attitude of the host governments to the Chinese NOCs may well be colored by other factors, such as the technical performance of the Chinese NOCs as well as their track record in addressing wider responsibilities relating to economic development, environmental protection, and community relations. Further, host governments may grow reluctant to become, or to be seen to become, overdependent on Chinese oil companies.

Conversely, the Chinese NOCs themselves may lose interest in certain countries, at least temporarily, if the security situation deteriorates significantly or if the ease of access to investment opportunities deteriorates (or, in certain cases, fails to improve).

The cordiality of relations between the Middle Eastern NOCs and Chinese NOCs will depend to a great extent on higher-level relations but will also depend on the specific commercial or strategic objectives of the respective companies. Such objectives may be diverging or may be in direct competition with each other. A case in point is the desire of both sets of NOCs to become major international producers of petrochemicals. Experience in West Africa has shown that the provisional agreements between Chinese NOCs and host country NOCs to build oil refineries are frequently abandoned. Of possible greater concern is the current dispute between China and Saudi Arabia concerning alleged "dumping" on to international markets of methanol by SABIC.¹⁵

Finally, the relationship between a given Chinese NOC and the Chinese government is also of critical importance to that NOC's ability to invest in the Middle East, or, indeed, anywhere else in the world. In particular, China's government is likely to be less generous in its support for the overseas activities of Chinese NOCs if they start to incur substantial financial losses or if their behavior damages China's international reputation.

Outlook

The political and economic relationships between China and the oil- and gas-rich countries of the Middle East are destined to deepen over the next ten years on account of the extreme complementarity between these partners with respect to energy supply and demand. The majority of the world's remaining conventional reserves of oil and gas lie in the Middle East, and China is set to become one of the world's largest importers of these two fuels.

¹⁵ "Riyadh and Beijing in Talks over Claims of Saudi Methanol Dumping," *Financial Times*, July 6, 2009, 7.

As a result of the economic growth of China and of other Asian nations, the proportion of oil and gas flowing eastward from the Middle East is increasing in comparison to that flowing westward. This growth of the oil and gas trade has been supplemented by a steady increase in inward investment to the Middle East by Chinese NOCs and, to a lesser extent, by investment into China by oil companies from the Middle East. Although such overseas oil and gas activities form only part of a much wider international strategy followed by China's government and NOCs, the long-term significance of China's involvement in the Middle East is greater than for most other regions on account of the high level of oil and gas reserves.

Within this overall trend of increasing interactions and interdependencies, individual bilateral relationships will be highly heterogeneous in nature, scope, intensity, and pace of development. This heterogeneity arises from the array of interests involved, which includes those of the Chinese government, the different Chinese NOCs, the various host governments in the Middle East, and the Middle Eastern NOCs. Likewise, the diplomatic and economic impacts of China's engagement in the Middle East will vary greatly from country to country and will fluctuate over time.

The two countries with the largest reserves of oil and gas are Iran and Saudi Arabia. Iran has been the country to attract the greatest attention from China's government and NOCs. Iran is already a significant supplier of oil and has granted Chinese companies access to oil fields. Agreements covering gas resources are imminent and these will lead to the supply of natural gas to China in the form of LNG. This potentially strong economic engagement in Iran's energy sector is counterbalanced by the highly charged political context in which Iran operates at present, both in the domestic and international arenas. The short-term outlook for any foreign oil company operating in Iran is highly uncertain and fraught with risks and challenges. This will be the case for China's companies as well, despite the relatively favorable treatment they receive. In the wider international arena, China's deepening involvement in Iran will necessarily influence the government's diplomacy when addressing concerns relating to Iran. Thus, the future path of China's energy engagement with Iran, though probably very favorable in the long-term, may encounter obstacles and delays over the coming years. Regardless, in the wider international context, China's relationship with Iran is and will continue to have more political significance than its relationships with other oil and gas producing states in the Middle East.

In contrast, China's energy relationship with Saudi Arabia is relatively straightforward. To date this has been restricted to oil exports to China and limited cross-investment. Saudi Arabia's tight restrictions on inward investment in the oil sector and the high degree of competence for Saudi Aramco are likely to limit the engagement of China's NOCs in the country, except in the gas sector, which to date has proved to be of little interest. Likewise, the growth of Saudi Aramco's investments in China's refining industry will be constrained for as long as China's domestic pricing policy for oil products is unfavorable to refiners. Though any relationship with the holder of the world's largest reserves of oil is bound to have a significant political dimension, China's future energy engagement with Saudi Arabia is likely to be considerably more limited in scope and more straightforward than that with Iran.

Next down the ranking come four countries: Iraq, Kuwait, and the United Arab Emirates, each holding reserves of more than 100 billion barrels of oil, and Qatar, which has a significant quantity of gas. For political and historical reasons, the only large investment opportunities at present lie in Iraq, where large reserves remain to be produced. Yet the rate at which these reserves can be evaluated, developed, and brought to market is highly unpredictable, given the risks and

uncertainties relating to domestic politics, the legal and fiscal framework, and physical security. The involvement of China's oil companies in Iraq could become disproportionately significant over a relatively short time and is likely to cover a wide range of activities from exploration and development to construction and oil field services. This would arise not from political bias on the part of the Iraqi government but rather from the greater willingness of China's NOCs to take greater risks and accept lower rewards in the short term compared to most international oil companies.

Although Kuwait has yet to take positive steps to open up its oil sector to foreign investment, Kuwaiti investment into China is growing slowly. Imports of oil to China from the UAE and Kuwait continue to grow rapidly, and Qatar is set to become a significant supplier of natural gas to China's coastal LNG terminals.

At the bottom end of the scale lie Yemen, Oman, and Syria. These countries have little significance for China's international energy strategy but do provide modest commercial opportunities for China's NOCs as well as substantial supplies of oil in the case of Oman. The political implications of China's energy relationships with these three states are likely to be limited except in the case of Syria.

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Prospects for India's Energy and Geopolitical Roles in the Middle East

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The Indian economy has emerged as one of the fastest-growing economies in the world in recent years. The end of the Cold War in 1991 coincided with a serious balance-of-payments crisis in India. In the midst of this crisis, the government of Prime Minister Narasimha Rao, together with then minister of finance Manmohan Singh, launched a series of structural reforms that introduced a new industrial policy and also led to the opening up of India's financial sector. The net effect of these changes was the jettisoning of India's model of socialist and autarkic economic development. After 1991, India began to embrace the open market and opened its economy to the wider world. In the period 1988–2006, the Indian economy has registered an average growth rate of 6.3% (including growth in excess of 8% per annum over the past six years).¹

At the same time, with a population of 1.1 billion, India is the second-largest nation in the world and is projected to become the world's largest over the next four decades or so.² As a result, India faces daunting challenges to sustain rapid economic growth and pursue a strategy of poverty alleviation.³ The elasticity for energy (i.e., percentage change in per capita energy for every percentage change in per capita GDP) in India is close to unity for total commercial primary energy consumption as well as for electricity.⁴ According to Prime Minister Manmohan Singh, "The quest for energy security is second only in [India's] scheme of things to food security."⁵ To further highlight the significance of energy to India's foreign and security policies, Singh mentioned that the quest for energy security had "become an important element of Indian diplomacy and...[was] shaping...[India's] relations with a range of countries across the globe."⁶

Currently, the Middle East accounts for more than two-thirds of India's oil imports.⁷ Similarly, India is dependent on the Persian Gulf region for most of its imported gas (in the form of liquefied natural gas, or LNG). Comprising more than 40% of India's total primary energy consumption, oil and gas are the two most important sources of energy for India after coal.⁸ Coal is likely to remain India's principal source of energy for the foreseeable future, given that India is home to the fourth-largest reserves of coal in the world. India's dependence on oil and gas is also expected to grow, however.⁹ Extrapolating from current trends, India's dependence on oil imports is estimated to account for 91%–93% of the country's oil consumption by 2031–32, while also being dependent on imported gas for more than 10%–11% of total gas needs.¹⁰ The Middle East will probably continue to provide the bulk of India's oil imports (supplemented by imports from Africa and Central Asia),

¹ Though piecemeal reforms were implemented in the 1980s, the 1991 reforms were more comprehensive and structural in nature. For details, see Arvind Panagariya, *India: The Emerging Giant* (New York: Oxford University Press, 2008).

² "India Population 'To Be Biggest,'" *BBC News*, August 18, 2004, <http://news.bbc.co.uk/2/hi/3575994.stm>.

³ Manjeet S. Pardesi and Sumit Ganguly, "Energy Security and India's Foreign/Security Policy," in *Indian Foreign Policy in a Unipolar World*, ed. Harsh Pant (New Delhi: Routledge, 2008).

⁴ This measure emphasizes the relationship between changes in per capita GDP and changes in per capita energy consumption. See "Draft Report of the Expert Committee on Integrated Energy Policy" Planning Commission, Government of India, December 2005, 21–26, <http://planningcommission.nic.in/reports/genrep/intengpol.pdf>.

⁵ Edward Luce and Quentin Peel, "Prime Minister Dr. Manmohan Singh's Interview with Financial Times," Ministry of External Affairs, May 11, 2004, <http://meaindia.nic.in/interview/2004/11/05in01.htm>.

⁶ Manmohan Singh, "The New India," *Wall Street Journal* (eastern edition), May 19, 2005.

⁷ "Draft Report of the Expert Committee," 63.

⁸ India's total primary energy consumption for 2007 was as follows: coal (51.43%), oil (31.78%), gas (8.95%), nuclear energy (0.99%), and hydroelectricity (6.85%). See "BP Statistical Review of World Energy," BP, June 2008, http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/downloads/pdf/statistical_review_of_world_energy_full_review_2008.pdf.

⁹ R.K. Pachauri, "Living With Coal: India's Energy Policy in the 21st Century," *Journal of International Affairs* 53, no. 1 (Fall 1999): 101–16.

¹⁰ These estimates assume 8% GDP growth per annum. See "Draft Report of the Expert Committee," 47.

and the Persian Gulf region will fulfill most of India's imported gas needs, even as India is looking toward Bangladesh, Myanmar, and Central Asia to fulfill gas import requirements.

Given these conditions and trends, this essay will analyze how this quest for energy imports from the Middle East (including the Persian Gulf region) is affecting India's foreign and security policies. At the same time, the essay also attempts to understand the impact of India's foreign and security policy on the country's energy security. Importantly, this essay does not address India's overall energy strategy, which has domestic, foreign policy, technological, environmental, developmental, and economic dimensions, among others. The focus of this essay is on the two-way links between India's energy security and foreign/security policy vis-à-vis the Middle East.

The next section will briefly discuss India's foreign policy toward the Middle East including India's energy needs from this region. This will be followed by a discussion of the strategies being pursued by India to meet its energy security and foreign/security policy goals in this region. The final section discusses the strategic and military implications of the strategies India is pursuing. The paper concludes by arguing that while economic imperatives, including energy needs, are driving India's engagement with the Middle East, India is slowly emerging as an important naval power in the emerging strategic architecture of the Persian Gulf region.

India's Policy toward the Middle East

Politics as the Driving Force (1940s–1960s)

In the first two decades after independence in 1947, India adopted a “political approach”¹¹ toward the Middle East. One of the primary factors driving India's early engagement with this region was the desire to cultivate good relations with the Muslim states of the Middle East to counter any Pakistani influence as a consequence of shared Muslim sentiments between Pakistan and the Arab states. This was deemed especially significant because of New Delhi's concerns about Pakistan's efforts to woo the Middle Eastern states on the Kashmir question.¹² At the same time, India chose not to establish full diplomatic relations with Israel until after the end of the Cold War and began supporting the Palestinian cause to earn the goodwill of the Muslim states of the Middle East as well as its own domestic Muslim constituency.

India's adoption of a policy of non-alignment also shaped its policies toward this region.¹³ The creation of the Baghdad Pact (later, the Central Treaty Organization) in 1955 that included several Middle Eastern states and Pakistan tied to the United Kingdom enhanced India's anxieties. India feared that Pakistan might exploit this military alliance to put pressure on India over the Kashmir dispute. Most importantly, energy security did not play an important role in India's engagement with the Middle East during the country's first two decades after independence. Though India was dependent on the Middle East for oil imports during this period, its energy requirements were relatively small. Furthermore, most of its refineries were then owned by Western oil companies as a consequence of the country's colonial past. These firms imported oil primarily from Saudi Arabia and Iran.¹⁴

¹¹ Prithvi Ram Mudiam, *India and the Middle East* (London: British Academic Press, 1994).

¹² On the Kashmir dispute and India-Pakistan conflict, see Sumit Ganguly, *The Crisis in Kashmir: Portents of War, Hopes of Peace* (Cambridge: Cambridge University Press, 1997); and Sumit Ganguly, *Conflict Unending: India-Pakistan Tensions since 1947* (New York: Columbia University Press, 2001).

¹³ Mudiam, *India and the Middle East*.

¹⁴ Biplab Dasgupta, *The Oil Industry in India: Some Economic Aspects* (London: Frank Cass, 1971).

Economics as the Driving Force (1970s–1980s)

From the 1970s onward economic factors and energy needs began to replace India's "political approach" to the Middle East. To begin with, India nationalized its Western-owned oil refineries in the 1970s.¹⁵ This was a consequence of Prime Minister Indira Gandhi's efforts to systematically implement her socialist agenda.¹⁶ Furthermore, the "oil shocks" of the 1970s and the economic boom in the Gulf that followed caused India to "look west" diplomatically toward the oil-rich countries of the Middle East.¹⁷ During the 1973–74 oil crisis, Iraq came to India's help by agreeing to supply oil to India at a reduced price.¹⁸

Strategic factors also began to enter into India's calculations for engagement with the Middle East during the 1970s. India became deeply concerned with Iran's efforts to play the role of a regional power in South Asia.¹⁹ Iran had emerged as the single-largest source of foreign investments in the subcontinent in the early 1970s.²⁰ Furthermore, in 1972 the Shah of Iran declared that any attack on Pakistan would be tantamount to an attack on Iran, and that Tehran was committed to the territorial integrity of Pakistan.²¹ Iran also permitted Pakistan to station fighter aircraft on its territory, thereby providing Islamabad with "strategic depth" vis-à-vis India.²² Iran's quest to play the role of a South Asian power directly challenged India's status as the preeminent power in the subcontinent.²³ However, given India's relatively poor economic performance and limited politico-military options in the extant Cold War environment, India was unable to strategically engage the Middle East to offset Pakistan's temporary advantage during this period.

Strategic Engagement with the Middle East After the End of the Cold War

After the end of the Cold War, India's slow but gradual embrace of the market since 1991 has introduced a definitive strategic component into India's policies toward the Middle East. The first signs of a dramatic reappraisal of India's Middle East, and indeed global, policies came during the first Gulf War. Under Prime Minister V.P. Singh's National Front government (1989–90), India allowed U.S. aircraft to refuel in Bombay on their way to the Persian Gulf. His successor, Prime Minister Chandra Shekhar (1990–91), agreed to continue refueling U.S. aircraft even after U.S.-led military action against Saddam Hussein's Iraq began in the 1991 Persian Gulf War.²⁴ Importantly, New Delhi did not publicize this decision and most of India's politicians and the media were unaware that U.S. planes were refueling in India. This was significant because India had heretofore enjoyed close relations with Iraq, which was a major supplier of oil to New Delhi and unlike most

¹⁵ See Dinshaw Mistry, "Domestic and International Influences on India's Energy Policy, 1947–2008," in *India's Foreign Policy: Retrospect and Prospect*, ed. Sumit Ganguly (New Delhi: Oxford University Press, forthcoming).

¹⁶ On Indira Gandhi's economic policies, including the nationalization of several key sectors of Indian economy, see Panagariya, *India: The Emerging Giant*, 47–77.

¹⁷ Raju G.C. Thomas, "Energy Politics and Indian Security," *Pacific Affairs* 55, no. 1 (Spring 1982): 32–53.

¹⁸ B.M. Jain, "India-Pakistan Engagement with the Greater Middle East: Implications and Options," in *The Greater Middle East in Global Politics*, ed. M. Parvizi Amineh (Leiden: Brill, 2007).

¹⁹ Bhabani Sen Gupta, "Waiting for India: India's Role as a Regional Power," *Journal of International Affairs* 29, no. 2 (1975): 178–80.

²⁰ *Ibid.*, 179.

²¹ *Ibid.*, 178–79.

²² Ben Sheppard, "India and Pakistan's Military and Security Relations with the Middle East," in *The Middle East's Relations with Asia and Russia*, eds. Hannah Carter and Anoushiravan Ehteshami (London: Routledge, 2004), 129–30.

²³ India emerged as the leading South Asian power after it vivisected Pakistan, its primary South Asian rival, in the 1971 Bangladesh War.

²⁴ Dennis Kux, *India and the United States: Estranged Democracies, 1941–1991* (Washington, D.C.: National Defense University Press, 1992), 440–41. Due to domestic political considerations, India withdrew this support a day or so before the end of the hostilities against Iraq.

other Middle Eastern states had backed India on Kashmir on a number of occasions in various international forums.

The Indo-Israeli relationship. A year later, in 1992, India established full diplomatic relations with Israel. There were a number of factors that went into this decision.²⁵ The end of the Cold War and the United States' emergence as the sole global superpower meant that the establishment of a close relationship with the United States was important for the success of India's foreign policy goals.²⁶ A close partnership with U.S. friends and allies, including Israel, was thus deemed important in establishing closer ties with the United States. Furthermore, the 1991 Madrid Conference and the initiation of the Arab-Israeli peace process made an Indo-Israeli rapprochement more palatable to India's Muslim citizenry.

At the same time, India was shocked and dismayed about the ease with which Western military technology had destroyed Iraq's Soviet-built weaponry during the first Gulf War. Most of India's military hardware at the end of the Cold War was of Soviet origin. Consequently, India turned to Israel as a source of high quality and advanced military systems. While Russia still remains India's main source of weaponry, Israel has emerged as the second-largest source of military hardware for India.²⁷ In fact, Israel also supplied India with military hardware and critical military supplies during the 1999 Kargil War and during the 2001–02 Indo-Pakistani crisis.²⁸ In 2004, Washington announced its willingness to approve India's request to purchase the Israeli-built Phalcon radar system, a sale that was earlier denied to China.²⁹ Israel is also believed to have trained 3,000 Indian Special Forces to fight separatist militants in Kashmir.³⁰

The Indo-Israeli relationship was particularly strengthened after the rise of the Bharatiya Janata Party (BJP) to power in India (1998–2004). The then Indian home minister L.K. Advani's and foreign minister Jaswant Singh's visits to Israel in 2000 intensified Indo-Israeli cooperation on counterterrorism. Israeli prime minister Ariel Sharon's visit to India in 2003—the first Israeli prime minister to visit India—symbolized the growing Indo-Israeli strategic partnership. During these high-level visits, the two countries agreed to intensify their efforts to share intelligence and to counter Islamic terrorism.³¹

The Indo-Iranian relationship. Ironically, along with Israel, India's relationship with Iran has emerged as the other critical partnership in India's strategic engagement with the Middle East. The 1979 Islamic revolution in Iran and India's neutral stance during the Iran-Iraq War (1980–88) had significantly strained Indo-Iranian relations. Prime Minister Narasimha Rao's 1993 visit to Tehran, however—the first Indian prime ministerial visit to Iran since the revolution—was welcomed by the then Iranian president Hashemi Rafsanjani as “a turning point in bilateral relations.”³² On his

²⁵ Efraim Inbar, “The Indian-Israel Entente,” *Orbis* 48, no. 1 (Winter 2004): 89–104; see also Nicolas Blarel, “Indo-Israeli Relations: Emergence of a Strategic Partnership,” ed. Ganguly, *India's Foreign Policy*.

²⁶ Sumit Ganguly, “The Start of a Beautiful Friendship? The United States and India,” *World Policy Journal* XX, no. 1 (Spring 2003); and C. Raja Mohan, *Impossible Allies: Nuclear India, United States, and the Global Order* (New Delhi: India Research Press, 2006).

²⁷ Neal Sandler, “A Boom in Israel's Exports to India,” *Business Week*, August 28, 2008, http://www.businessweek.com/globalbiz/content/aug2008/gb20080828_867715.htm.

²⁸ Prithvi Ram Mudiam, “Indian Power Projection in the Greater Middle East: Tools and Objectives,” in *The Greater Middle East*, ed. Amineh, 423.

²⁹ Yaakov Katz, “India to Finally Receive Phalcon AWACS,” *Jerusalem Post*, May 9, 2009, <http://www.jpost.com/servlet/Servlet?page=JPPost/JPArticle/ShowFull&cid=1241773214057>.

³⁰ Armand Cucciniello and Pramit Mitra, “India and Israel Move Closer Together,” *South Asia Monitor*, no. 63, October 1, 2003.

³¹ Cucciniello and Mitra, “India and Israel Move Closer Together.”

³² Subramanian Swamy, “An Iranian Sister,” *Frontline*, April 12, 2002, <http://www.hinduonnet.com/fline/fl1907/19070560.htm>.

return visit to India in 1994, Rafsanjani was greeted by a crowd of thousands in the northern city of Luknow,³³ a major center of Shia learning in the subcontinent.³⁴

India and Iran began collaborating in the mid-1990s when the two countries joined other nations, including Russia, in supporting the United Front (now reorganized as the Northern Alliance) against the growing influence of the Taliban in Afghanistan.³⁵ After the start of the U.S.-led war against the Taliban regime in Afghanistan, India again looked to Iran in order to provide diplomatic and material support to the Northern Alliance. Since Pakistan continues to deny India overland access to Afghanistan via Pakistani territory, India has cultivated Iran as an alternative route for supplies to Afghanistan.³⁶

Earlier in 2009, India handed over a \$150 million road to the Afghan government that it had constructed from Delaram in the Nimroz Province of Afghanistan to Zaranj near the Iranian border, which connects to the Iranian port of Chahbahar.³⁷ India is also upgrading the Iranian port of Chahbahar, and it is widely believed that Indian naval forces may be allowed to use these facilities in the future.³⁸ It is also believed that Iran has agreed to permit India to access Iranian military bases in the event of another India-Pakistan war.³⁹

Iran is also a very important source of energy imports for India. Iran supplies more than 10% of India's total imported oil.⁴⁰ In 2005, Iran entered into a \$22 billion deal with India to supply LNG for a period of 25 years beginning in 2009.⁴¹ The challenge for India's Middle East policy is to maintain close relations with both Iran and Israel without antagonizing either, given the conflictual relationship between Iran and Israel. India has already shown some finesse in this regard. India voted with the majority (including the United States) at the International Atomic Energy Agency in September 2005 and February 2006 after finding Iran in non-compliance with its international obligations to the Nuclear Nonproliferation Treaty (NPT).⁴² However, India continues to build a relationship with Iran centered on energy and common strategic interests in Afghanistan, much to the chagrin of the United States.

The Middle East and India's Energy Security Strategy

There are several dimensions to India's energy security strategy. India has stepped up the search to tap domestic oil and gas reserves. However, there have been no major oil discoveries in India since the offshore Bombay High fields were found roughly three decades ago.⁴³ The outlook for gas in India looks more promising with new gas fields being found offshore in the

³³ Jonah Blank, *Mullahs on the Mainframe: Islam and Modernity among Daudi Bohras* (Chicago: The University of Chicago Press, 2001), 186.

³⁴ India is home to the second-largest Shia community in the world after Iran.

³⁵ Sheppard, "India and Pakistan," 123.

³⁶ Rahul Bedi, "India's Secret War Against the Taliban," *Jane's Intelligence Review* 14, no. 6 (June 2002): 19.

³⁷ Jonathon Burch, "Afghanistan, India Unveil Strategic Road," Reuters, January 22, 2009, <http://www.alertnet.org/thenews/newsdesk/ISL347705.htm>.

³⁸ Donald L. Berlin, "India-Iran Relations: A Deepening Entente," Asia-Pacific Center for Security Studies, Special Assessment, October 2004, <http://www.apcss.org/Publications/SAS/AsiaBilateralRelations/India-IranRelationsBerlin.pdf>.

³⁹ C. Christine Fair, "India and Iran: New Delhi's Balancing Act," *Washington Quarterly* 30, no. 3 (Summer 2007): 150.

⁴⁰ This figure is for the year 2004–05. See "Draft Report of the Expert Committee," 63.

⁴¹ "Welcome LNG Agreement," *Hindu Business Line*, June 15, 2005.

⁴² K. Alan Kronstadt and Kenneth Katzman, "India-Iran Relations and U.S. Interests," Congressional Research Service, CRS Report for the Congress, RS22486, August 2, 2006, <http://fpc.state.gov/documents/organization/70294.pdf>.

⁴³ India has onshore oil fields in Assam and recently the British firm Cairns Energy discovered oil in Rajasthan.

Krishna-Godavari basin, the Bay of Bengal, the Andaman Sea, and onshore in Rajasthan. In spite of this, India has become a net importer of LNG since 2004 and its dependence on imports is likely to increase, especially since the share of natural gas is expected to increase in the country's energy matrix.⁴⁴ Consequently, India's overwhelming dependence on the Middle East is likely to continue for reasons of geography and cost. Currently, just four Middle Eastern states supply more than half of India's total oil imports—Saudi Arabia (24.96%), Kuwait (11.85%), Iran (10.03%), and Iraq (8.69%).⁴⁵ In addition to spot purchases of LNG, India has already been importing LNG through a long-term contract with Qatar, and discussions to do the same from Iran and Oman are underway.⁴⁶

India is also actively seeking equity oil and gas abroad. The Indian government has already invested in excess of \$3 billion in acquiring oil and gas fields abroad and has further plans to invest \$1 billion per annum until 2015 “with a view to meet 15% of its demand.”⁴⁷ ONGC Videsh Limited (OVL), the overseas arm of India's state-owned Oil and Natural Gas Corporation (ONGC), has purchased exploration and production blocks in a dozen countries in the Middle East, the Asia-Pacific, Africa, and Latin America.⁴⁸ The production of oil and gas from these blocks, if successful, is likely to provide India with a far cheaper source of energy than the prevailing international market price.

India is also contemplating the import of gas through pipelines from gas-rich states in India's immediate and extended neighborhood, including Iran. Since a pipeline traverses through several countries, it entails a complex contractual framework and has an important bearing on geopolitics. One of the most important of such projects is the Iran-Pakistan-India pipeline. However, since this pipeline will need to traverse through Pakistani territory (including the insurgency-hit Baluchistan region of Pakistan), very little progress has been made on this project to date.⁴⁹ Furthermore, the United States has expressed reservations regarding this pipeline because of Iran's pariah status in the West and controversial nuclear program.⁵⁰

Finally, India's energy security strategy also has a growing military component. The Indian Air Force and Navy are likely to play a critical role in ensuring energy security for the country. In 2006, Indian Air Chief Marshall S.P. Tyagi stated that the Indian military was poised to play a crucial role in providing energy and trade security to ensure the country's economic resurgence.⁵¹ He also called for the expansion of the Indian Air Force to guarantee the country's energy security and added that India's expanded reach would be “strategic and defensive in nature.”⁵²

⁴⁴ “India: Natural Gas,” Energy Information Administration, March 2009, <http://www.eia.doe.gov/emeu/cabs/India/NaturalGas.html>.

⁴⁵ “Draft Report of the Expert Committee,” 63.

⁴⁶ Arijit Barman, “India Strikes LNG Import Deal with Qatar,” *NDTV Profit*, September 23, 2003, <http://www.ndtvprofit.com/homepage/storybusinessnew.asp?id=15342&frmsrch=1&txtsrch=LNG%2CQatar>; “Iran Wants to Renegotiate 5-mt LNG Deal with India,” *Hindu Business Line*, August 5, 2006; and “Ratnagiri Gas: India looks to Oman for fuel supply,” *Hindu*, January 28, 2006.

⁴⁷ “India to Invest US\$1bln in Foreign Oil Equity,” *Asia Times*, http://www.atimes.com/atimes/South_Asia/FE25Df03.html.

⁴⁸ The details of OVL's operations in these countries can be found at Oil and Natural Gas Corporation Limited's (ONGC) company website, <http://www.ongcvidesh.com>, under “Operations.”

⁴⁹ Gal Luft, “Iran-Pakistan-India Pipeline: The Baloch Wildcard” Institute for the Analysis of Global Security, Energy Security, 2005, <http://www.iags.org/n0115042.htm>.

⁵⁰ Kronstadt and Katzman, “India-Iran Relations.”

⁵¹ For a report on Air Chief Marshal Tyagi's views about the role of the Indian military in the country's security environment, see Shashindra Pal Tyagi “India's Strategic Environment and the Role of Military Power,” Carnegie Endowment for International Peace, August 22, 2006, <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=908&&prog=zgp&proj=zsa>.

⁵² Sanjeev Srivastava, “India's Air Force ‘Needs to Grow,’” *BBC News*, April 18, 2006, http://news.bbc.co.uk/2/hi/south_asia/4919420.stm.

Similarly, in its first-ever maritime doctrine published in 2004, the Indian Navy explicitly highlighted energy security of the country as a context that required the application of maritime power in both offensive and defensive operations conducted to protect the country's maritime trade.⁵³ India's maritime doctrine also highlights the importance of the Gulf region and Central Asia for India's energy security.⁵⁴ The doctrine further mentions the "[s]afeguarding [of] Indian energy assets outside territorial India" and the preservation of "international SLOCs through the Indian Ocean on a permanent basis" among several scenarios of conflict in which the Indian Navy may find itself embroiled.⁵⁵

India is now in the process of taking some initial steps to boost its military presence in the Persian Gulf region. In 2008, India signed defense pacts (including provisions for maritime cooperation) with Qatar and Oman.⁵⁶ According to the agreement with Qatar, which is also home to a U.S. naval base, India will provide assistance whenever Qatari assets need protection. The defense pact with Qatar reportedly includes the possibility of stationing Indian troops in that country.⁵⁷ The defense pact additionally enables the two countries to share intelligence and makes provisions for India to train Qatari defense personnel.⁵⁸ India and Qatar also signed a security and law enforcement agreement that paves the way for the two countries to share information related to terrorism and to check other non-traditional security threats such as money laundering and transnational crime.⁵⁹ With Oman, India is providing training to Omani military officers in its premier military institutions. Oman recently provided India with berthing facilities for naval vessels in support of the Indian Navy's anti-piracy operations off the shores of Somalia.⁶⁰ India had deployed warships in the Gulf of Aden in late 2008 to protect Indian commercial shipping from pirates operating off the coast of Somalia.⁶¹

Strategic Implications of India's Energy Strategy in the Middle East

India's foray into the Middle East for energy security has brought the country face to face with an important competitor, the People's Republic of China—Asia's other rising power with an enormous appetite for imported oil and gas.⁶² The vast foreign exchange reserves available to China's state-owned oil firms have enabled China to undercut India's efforts to acquire energy assets overseas in Angola, Nigeria, Ecuador, and Kazakhstan. In each of these instances, the Chinese firms ended up acquiring oil and gas blocks only after substantially increasing their proposed bids.⁶³ However, India and China have made efforts to reduce the commercial and financial aspect of

⁵³ "Indian Maritime Doctrine," INBR 8, Integrated Headquarters, Ministry of Defence, Navy, 2004, 93.

⁵⁴ Ibid., 63–68.

⁵⁵ Ibid., 59.

⁵⁶ Vinod Matthew, "Security Pact with Qatar Gives India Gulf Toehold," *Indian Express*, November 12, 2008; and Sandeep Dikshit, "India, Oman to Step Up Defence Ties," *Hindu*, November 10, 2008.

⁵⁷ Vivek Raghuvanshi, "India, Qatar Discuss Defense Cooperation," *Defense News*, November 10, 2008, <http://www.defensenews.com/story.php?i=3812947>.

⁵⁸ Matthew, "Security Pact."

⁵⁹ Sandeep Dikshit, "India Signs Defense Pact with Qatar," *Hindu*, November 11, 2008.

⁶⁰ Dikshit, "India, Oman to Step Up Defence Ties."

⁶¹ "India 'To Guard Somalia Waters,'" *BBC News*, October 17, 2008, http://news.bbc.co.uk/2/hi/south_asia/7675251.stm.

⁶² Michael T. Klare, *Rising Powers, Shrinking Planet: The New Geopolitics of Energy* (New York: Metropolitan Books, 2008).

⁶³ "China and India: A Rage for Oil," *Business Week*, August 25, 2005, http://www.businessweek.com/bwdaily/dnflash/aug2005/nf20050825_4692_db016.htm?chan=gb.

their competition over energy security. In 2005, the two countries signed several memorandums of understanding (MOU) to promote energy cooperation.⁶⁴ These MOUs have essentially been guided by tactical financial and commercial logic, and thus far cooperation between the two countries has been limited in nature and scope, even as they have jointly bid for oil assets in places such as Syria and Colombia. In fact, ONGC has suffered far more setbacks at the hands of China's state-run energy corporations compared to Western oil firms.⁶⁵ As far as energy is concerned, India is in a fundamentally competitive if not a conflictual relationship with China.⁶⁶

Finally, India is also building up military might, especially naval assets, to project power into the Middle East to safeguard the country's energy interests. India is constructing a naval and navel-air base in Karwar in southern India on the Arabian Sea that, when completed, is slated to be Asia's largest.⁶⁷ India is building the Karwar base, and to a lesser extent Chahbahar in Iran, in response to Chinese naval activities in Pakistan near the Persian Gulf region.

China is funding the construction of a deep-sea, warm-water port in Gwadar along the Makran coast in Baluchistan Province in Pakistan.⁶⁸ Once linked to the trans-Karakoram highway that connects Pakistan's northern areas with China's Xinjiang province, Gwadar will emerge as a hub for the transportation of oil and gas from the Persian Gulf to China. Given the Sino-Pakistani entente,⁶⁹ it is very likely that China will deploy its naval power in Gwadar to protect the country's energy assets in the Persian Gulf. The growth of Chinese naval power in the Indian Ocean region will further complicate the Sino-Indian rivalry.⁷⁰ That China already considers India a major rival in the Indian Ocean region was revealed as early as 1993 when a senior People's Liberation Army officer proclaimed that China could "no longer accept the Indian Ocean as an ocean only of the Indians."⁷¹

To counter China's growing influence in the Persian Gulf, to enhance its own energy security, and to pursue its broader national security objectives, New Delhi is pursuing a two-pronged strategy to enhance India's strategic profile in the Middle East. The first component of this strategy is defense diplomacy, which can be seen in India's maritime and defense cooperation with several states in the Persian Gulf region, primarily Iran, Qatar, and Oman. At the same time, India is also projecting military power in the region to signal to the Middle East states that India has the capacity, as well as the will, to play a larger role there. This second strand of Indian strategy was most visible during the 2008 anti-piracy operations of the Indian Navy off the coast of Somalia. Even before that, however, India demonstrated its strategic reach in 2006 when it evacuated its own citizens together with the citizens of Nepal, Sri Lanka, and Lebanon during the crisis in

⁶⁴ Richard McGregor, Jo Johnson, and Carola Hoyos, "China and India Forge Alliance on Oil," *Financial Times*, January 12, 2006; and John Larkin, "India and China Forge an Energy Tie; National Oil Companies To Work Together to Bid For Select Assets Abroad," *Wall Street Journal* (eastern edition), August 18, 2005.

⁶⁵ Ricardo Soares de Oliveira, "India's Rise and the Global Politics of Energy Supply: Challenges for the Next Decade," Vasant J. Memorial Foundation, Eleventh Vasant J. Sheth Memorial Lecture, December 2008, 10.

⁶⁶ Sumit Ganguly, "Energy Trends in India and China: Implications for the United States" (testimony before the U.S. Senate Foreign Relations Committee, Washington, D.C., July 26, 2005), http://www.indiana.edu/~isp/media/sfr_7-26-05.doc.

⁶⁷ Donald L. Berlin, "India in the Indian Ocean," *Naval War College Review* 59, no. 2 (Spring 2006): 81.

⁶⁸ Robert D. Kaplan, "Pakistan's Fatal Shore," *Atlantic*, May 2009, <http://www.theatlantic.com/doc/200905/kaplan-pakistan>.

⁶⁹ For an early view of the Sino-Pakistani entente, see Anwar Hussain Syed, *China and Pakistan: Diplomacy of an Entente Cordiale* (Amherst: University of Massachusetts Press, 1974).

⁷⁰ See "China Turns to the Indian Ocean," in James R. Holmes, Andrew C. Winner, and Toshi Yoshihara, *Indian Naval Strategy in the Twenty-First Century* (London: Routledge, 2009), chap. 8.

⁷¹ Quoted in Robert D. Kaplan, "Center Stage for the 21st Century," *Foreign Affairs* 88, no. 2 (March–April 2009): 16–32.

Lebanon.⁷² With a growing economy, rising energy needs, and military engagement with the Middle East, India is in the process of establishing itself as an important player in the emerging strategic architecture of that region.

Conclusion

The pursuit of energy security in the Middle East will require India to tread a fine line between Iran and Israel (as well as the United States). India's quest for energy security is also likely to lead to an intensification of its strategic rivalry with China for access to oil and gas in the Middle East. In India's efforts to ensure national energy security, the country is also in the process of emerging as a significant naval power in the Persian Gulf region. Promoting energy security is crucial for India as the country could increase its annual GDP growth rate by 2% per annum if the energy sector were to reach international levels of performance.⁷³ Consequently, energy security may be India's Achilles' heel in the country's economic resurgence and in its path to becoming an Asian and global player.

⁷² On this operation codenamed Operation Sukoon, see Andrew C. Winner, "India as a Maritime Power?" in *Asia Looks Seaward: Power and Maritime Strategy*, eds. James R. Holmes and Toshi Yoshihara (Westport: Praeger, 2007), 142.

⁷³ The Energy and Resources Institute (TERI), *Defining an Integrated Energy Strategy for India: Ensuring Security, Sufficiency, and Sustainability* (New Delhi: TERI, 2002).

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Energy and Trade Relations between China and Saudi Arabia: A Continuing Evolution

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Relations between Saudi Arabia and China have been increasing dramatically over the past ten years. The king of Saudi Arabia travelled to China in January 2006, the first Saudi monarch to do so and his first state visit as king. The Chinese president reciprocated by visiting Saudi Arabia in April 2006 and again earlier this year. There are important Saudi investments in refining in China, and Sinopec was chosen over U.S. firms as one of the oil companies charged with finding dry gas in Saudi Arabia. Trade with China is increasing very rapidly, up 77% in 2008 alone.¹ Between 2002 and 2004, Saudi imports from China rose by 160%. In 2007, China was the second largest exporter to Saudi Arabia and the fifth-largest buyer of Saudi exports. China is the country's third largest trading partner after the European Union and is almost at par with the United States, after starting from almost zero in the mid-1980s.

China's growth and ability to export to the rest of the world, and the United States in particular, are very much linked to its ability to obtain crude oil for its refineries and feedstock for its chemical manufacturing. China needs about 7 million barrels per day (b/d) to fuel its economy. According to the Energy Information Administration (EIA), oil production in China averaged 3.973 million b/d in 2008, whereas imports were 3.957 million barrels per day. This deficit has led the country to embark on a worldwide search for crude oil. China has become the largest investor and oil producer in Sudan and has made expensive deals for offshore oil in Angola. Beijing is negotiating large deals with Tehran. China has built a one million b/d pipeline in Kazakhstan to tap into that country's production, and is even negotiating with Russia to ensure that the trans-Siberian pipeline to Vladivostok for supplying Japan with oil is built with a branch through Manchuria for supplying Northern China. Of course, for China the simplest, cheapest, and quickest way to get oil is to buy it from the national oil companies (NOC) of the Gulf Cooperation Council. The Arab NOCs, especially Saudi Aramco, are known to be reliable suppliers less subject to political variables. Hence, over the past ten years Saudi Arabia has become the largest supplier of crude oil to China, shipping over 500,000 b/d in 2007 and 700,000 b/d in 2008.

China's appetite for resources partly explains the increase in contacts with Saudi Arabia. However, it does not fully explain why Saudi Arabia decided to intensify relations with a country that had previously been seen as an adversary. After the 1950s Saudi Arabia saw China as a Communist, heathen country like the Soviet Union, eager to spread its ideology and seeking the downfall of the traditional regimes in the Persian Gulf. Further, at this time the Gulf had no need for China, which was seen as being too distant and lacking products needed by the Gulf that could not be provided by the West. The Western countries, and the United States in Saudi Arabia in particular, were responsible for the discovery of oil, economic development, and military protection of the region against the potential aggression of the Communist world through its client-states of South Yemen, Syria, and, until President Sadat, Egypt.

This essay will present why Saudi Arabia has decided to forgo its long-standing dislike of Communist regimes and the implications of this evolution on the relations between Saudi Arabia and the United States in particular. The essay will argue that there are three major causes to the Saudi evolution:

- First, Saudi Arabia wants to become a major world power but cannot do so by relying on military power. Instead, the kingdom is seeking to become an indispensable economic power, based on the natural advantage of low-cost energy and plentiful capital. Saudi Arabia is slated to be the largest

¹ "Improved Trade Relations between Saudi Arabia and China, SABB Reports," *Zawya*, February 23, 2009, <http://www.zawya.com/Story.cfm/sidv52n08-3NC27/Improved%20Trade%20Relations%20Between%20Saudi%20Arabia%20And%20China,%20SABB%20Reports/>.

producer of chemicals in the world by 2020. The Saudi Arabian government is developing a new paradigm of international relations, replacing military might with economic might. Even though Beijing is increasing China's relatively weak military machine, the Chinese government seems to have a similar view of the world in pushing economic ties over military domination.

- Second, Saudi Arabia can only achieve this objective if the country can develop extensive relationships with its main clients in the world. China, because of its population and policies, is viewed as the country's main client in the future not only for oil but increasingly for energy-based products such as chemicals, cement, steel, and fertilizers.
- Third, the increase in Saudi-China relations allows Saudi Arabia to become less dependent on the United States. There is a widespread belief in the U.S. press and government that Saudi Arabia has an "oil for security" pact with the United States. It appears, however, that the Saudis do not necessarily share this view. Indeed, the oil for security paradigm does not appear in the Saudi press or speeches of leaders and citizens. From the elites to the average taxi driver, the people of the Gulf do not necessarily reject U.S. protection but are nonetheless very wary of it. There is strong and widespread disapproval of U.S. policies in the region, particularly regarding the Israeli-Palestinian conflict and the war in Iraq. There are tremendous worries that the United States will cave in to pressure from Israel and Israeli lobbies in the United States and bomb Iran or allow Iran to be bombed, thus opening the region to Shia uprisings. There is a general lack of respect for all U.S. administrations when it comes to their inability to contain or resist these pressures and serve as an effective mediator in the region. Hence, the Saudi leadership probably decided some time ago to slowly but surely move away from the embrace of the bald eagle and look elsewhere for support. Although China may not replace the United States in terms of military force in the Gulf, it is part of the new silk road and a multipolar world that will suit the Saudis better.

The New Saudi Paradigm: Economic Domination over Military Power

Undoubtedly Saudi Arabia is in the midst of a major industrial revolution. Although no longer the world's main oil producer, having surrendered this role to Russia, Saudi Arabia is still a major global supplier of oil. The kingdom is the leader of the Organization of the Petroleum Exporting Countries (OPEC) and thus has an immense impact on the dynamics of the global energy supply. Possessing a more flexible spare production capacity than any other country, Saudi Arabia can increase production rapidly and depress prices. Riyadh successfully used this production increase technique in 1998 to enforce production quotas and provide for price recovery by 2000. In other words, the government can strike the fear of oil minister Ali al-Naimi into the heart of every OPEC oil official. Using its access to very low cost oil and gas, Saudi Arabia has also become the fastest-growing chemical producer in the world. The country's main chemical companies, SABIC, Sipchem, and SIIG, are producing over 60 million tons per year of products based mostly on ethane and methane. Additionally, Saudi Arabia is developing indigenous technologies for new products. When the country does not have the technology required, Saudi Arabia buys the companies that

do.² The NOC Saudi Aramco is also entering the fray, seeking to produce chemicals based on Naphtha and liquefied petroleum gas (LPG) from crude oil refining operations. Saudi Aramco's joint venture with Sumitomo, PetroRabigh, has started production using refined products from the newly refurbished Rabigh refinery. The investment amounted to over \$10 billion and has begun producing all manners of chemicals mainly for the Far East (and China in particular). Saudi Aramco is also pushing forward with a venture of over \$20 billion with Dow Chemical to use feedstock from a new refinery at Ras Tanura on the Gulf, which would make it the largest chemical complex anywhere in the world.

Saudi Arabia is not seeking to be just a major producer of chemicals and other energy-based products such as fertilizers, cement, aluminum, or steel, the country is seeking to be the largest, at least in chemicals and fertilizers, as well as a dominant player in the other categories. This effort requires major cash investments in the hundreds of billions of dollars and changes in education and society, which the leadership is both aware of and supporting. King Abdullah is strongly encouraging new industrial-energy based industries. He is supporting the massive investments of Saudi Aramco, SABIC, and Maaden. The king inaugurates with much fanfare most new plants opening in Saudi Arabia, whether by the private or public sector. He has ordered that five new large industrial cities be developed to match the growth of industry. Emaar, the largest developer in Dubai, is currently developing the biggest of the five cities, King Abdullah Industrial City.

King Abdullah is also pushing for major reforms in education. The new King Abdullah University (KAUST), north of Jeddah, which opens in the summer of 2009, seeks to be a major world center for scientific research, sparing no efforts or expense to achieve this. The king has named a Singaporean scientist as president and has arranged for MIT to be involved in structuring the curriculum; teachers are being hired from all over the world and teaching will be solely in English. Quite significantly, women will be accepted equally with men and classes will be mixed. Foreign students will also be permitted admission. King Abdullah seems to view this new university as the new Baghdad, which was the capital of the Abbasid Caliphate during Islam's golden age from the eighth to thirteenth centuries, and in which luminaries from all over the world established a civilization that was among the most advanced in the world.

KAUST and the new economic cities are indicative of where King Abdullah and his advisors want to take Saudi Arabia. On many occasions the leadership has said that the country seeks to develop a knowledge-based economy. Such an approach is meant to reorient the kingdom from being merely a producer of oil to being a major industrial power. While the leadership seeks to exploit Saudi Arabia's comparative advantage in oil and gas, the goal is to maximize return by adding "knowledge." In other words, when a barrel of oil sold on the world market brings \$50 to the Saudi treasury, the same barrel sold after having been processed into chemicals will bring between \$200 and \$1,500. The more advanced the chemical, the higher the value added. This implies that the kingdom will sooner or later start decreasing oil production to maximize its return and retain most of it in the ground for use in value-added products over multiple years of oil production.

Not everyone in Saudi Arabia, however, shares this vision. Some of the more conservative religious elements are quite opposed to any development that will remove students from learning

² SABIC bought jointly with Süd Chemie of Germany a major producer of catalysts in New Jersey. It also bought the ethylene-producing assets of DSM of Holland and those of Huntsman in England and Ireland. This has given SABIC the Naphtha-based technology, which the firm previously did not have and made it the largest producer of ethylene in Europe. SABIC also bought the advanced plastics division of GE, which manufacture technologically advanced plastics mainly for the car industry. In the present recession all of these assets appear to be substantially losing value, but when the economy rebounds SABIC will be a major world leader in petrochemicals as well as more advanced chemicals.

their particular view of religion or bring women into the work force and permit them to mix with men. The religious establishment is divided on these issues. The religious establishment, often referred to as the *Sahwa* (reawakening), was given significant control over social and religious issues by King Fahad for supporting his government after the infamous attack on Mecca of 1979.³ The *Sahwa* is a coalition of *Ikhwan* (Muslim Brotherhood) refugees from Egypt and traditional *Makhdalites*, who are from the most conservative Wahhabi tradition.⁴ Yet the king has been co-opting the various factions within the *Sahwa*, sometimes rewarding the *Makhdalites* with minor cabinet posts, sometimes rewarding the *Ikhwan* with access to media or cash payments. In the past three years King Abdullah has severely curbed the influence of the *mutawain* (the religious police). He is reforming the educational system and has placed a woman in the position of minister at the Ministry of Education and more liberal presidents in the main universities in Saudi Arabia, in addition to putting Saudi Aramco in charge of KAUST and the King Fahd University of Petroleum and Minerals (KFUPM) engineering school in Dhahran. Though there still seems to be a long way to go, the king, against the advice of the conservatives, has now arranged for dialogue among the various factions of Islam and between Islam and other religions. He has made some effort to assuage the Shia in the Eastern Province. King Abdullah and his major advisors act as if they can push the kingdom into the 21st century, whether the kingdom likes it or not. Judging by the king's popularity, however, one can reasonably conclude he has the backing of most Saudis, despite the wishes of the more conservative elements of society.

The Saudi leadership has actually been taking such steps for quite a while. In the late 1970s, the civil service and a much younger King Fahad made the decision not to export natural gas. All the gas that until then had been flared began to be gathered and used solely to produce electricity, desalinate water, and make fertilizers and chemicals. The civil service also structured the financial system of the country so that banks could only lend to local entities or to the state and its industrial ventures,⁵ relieving Saudi Arabia from a dependency on foreign bank loans or the edicts of the International Monetary Fund in Washington. The kingdom spent a lot of money building infrastructure, and with the increases in oil income after 2000, all the elements were in place to trigger the major industrial development that is occurring today.

The amount of effort, money, and personal risk taken by the king and his advisors in pushing to develop Saudi Arabia point to a vision of the country, the scope of which is beyond seeking mere economic wealth. The elites want to create wealth on a long-term, sustainable basis in order to fulfill a view of the country as having the potential to be a world leader. Although Saudi Arabia does not have the population of China, India, or the United States, it has enough of the world's basic goods to play a major role, and the leadership wants this role to be recognized.

³ F. Gregory Gause III, *Oil Monarchies: Domestic and Security Challenges in the Arab Gulf States* (New York: Council on Foreign Relations Press, 1994).

⁴ Stephane Lacroix, "The 'Madkhalis' vs. the 'Sahwa': Making Sense of the Salafi Debate on Politics in Saudi Arabia" (paper presented at George Washington University, Washington, D.C. April 20, 2009).

⁵ See, for example, Jean-Francois Seznec, "Financing Industrialization in the Arab-Persian Gulf" (paper presented at the conference of Center for Contemporary Arab Studies, Georgetown University, Washington, D.C., March 2008, to be published in 2009 as part of the proceedings of the conference); Jean-Francois Seznec, "WTO and the Dangers of Privatization," in *Institutions, Globalization and Empowerment*, eds. Kartik Chandra Roy and Jorn Sideras (Cheltenham: Edward Elgar Publishing, 2006); and Jean-Francois Seznec, "The Politics of the Financial Market in the Arab-Persian Gulf" (unpublished dissertation, 1994).

Saudi-China Commercial Ties

China's growth requires energy and feedstock. Since Deng Xiaoping, China has decided to develop a modern, high-growth economy to provide a higher standard of living to the country's billion-plus citizens. China could offer increasingly skilled labor at a fraction of the cost of the West and Japan and has already become the manufacturer of choice for the rest of the world, especially the United States. It could be argued that this was done in concert with U.S. authorities, who did not seem to notice that they were transferring a great deal of the U.S. manufacturing base to China to then import products of quality at low prices back into the United States. This allowed for low inflation in the United States, an improved standard of living over the past twenty years, the minimization of labor problems, and a focus on services. Chinese manufacturing growth was further enhanced by the Central Bank's ability to keep the renminbi low in spite of the country's economic success and double-digit economic growth rates. The growth of Chinese exports, which has fueled economic development, is fully dependent, however, on China's access to basic resources such as iron ore, bauxite, oil, and feedstock for the chemical industry. China, as one of the largest countries in the world, has access to many natural resources but is no longer self-sufficient (for example, the country is now dependent on large imports of ores from Australia).⁶ Until the present recession of 2009, China's energy needs increased rapidly and were met by coal-fired generation plants as well as by oil.⁷ Even during the present global financial and economic crisis, China is still growing, though now only in single digits.⁸ The Chinese oil fields are mature and production remains quite stable. In February 2009, with the international crisis hurting China's ability to export products, crude oil demand was down to 5,975 million b/d.⁹ Imports of crude oil and oil products have declined accordingly to 2.2 million b/d from 3.1 million b/d in early 2008. It is likely, however, that China will continue to grow more dependent on energy imports once the global economy has rebounded.¹⁰ For example, many Chinese people are buying cars, thereby increasing the need for refined products and ultimately for crude oil.

China's export industry is also very dependent on its ability to produce plastics. Most products exported from China include some type of plastic component. One key to China's success in selling overseas has been the country's ability to transport goods without damage. Hence, plastic toys and hard electronics alike are dependent on being packaged properly. Chinese products require large inputs of polystyrene, high density polyethylene (HDPE), low density polyethylene (LDPE), polypropylene (PP), and numerous other products needed for packaging or making toys, electronic casings, tools, and all manners of products. China is a net importer of many of these products and is the second-largest consumer of plastics after the United States. In 2007, China consumed 12.4 million tons of polyethylene, of which nearly 50% was imported.¹¹ Saudi Arabia

⁶ In fact, Chinese companies are now trying to buy controlling interest in some of the main mines of Australia by acquiring large portions of Rio Tinto, the second-largest mining firm in the world with extensive assets in Australia.

⁷ In 2008, China was putting on-line one coal fired electricity plant per day.

⁸ *BBC World News*, May 12, 2009.

⁹ See the Joint Oil Data Initiative (JODI) database available at <http://www.jodidb.org/wds/ReportFolders/reportFolders.aspx>. JODI was established in Riyadh by the producer and consumer nations.

¹⁰ China is not as dependent on oil imports as the United States, which remains by far the very largest importer of crude oil and products. The United States was importing about 15.5 million b/d in December 2007 before the recession and was importing about 14 million b/d in February 2009. Computed from the JODI database of production and consumption, <http://www.jodidata.org>. These figures are about 10% higher than the figures published by *Oil & Gas Journal*, which presents the figures for the United States for February 2009 as 9.028 million b/d of crude oil imports and 3.495 million b/d of product imports. See *Oil & Gas Journal* 104, no. 12 (March 2006): 66.

¹¹ "World Petchem in Slump on China Plastic," *Alibaba*, September 25, 2008, <http://news.alibaba.com/article/detail/analysis/100007842-1-world-petchem-slump-china-plastic.html>.

has become a dominant supplier of these products as well as feedstocks such as naphtha and other basic oil products including propane, butane, and heavy fuel oil. Therefore, China does appear to have major reasons to develop its business and political relationship with Saudi Arabia.¹²

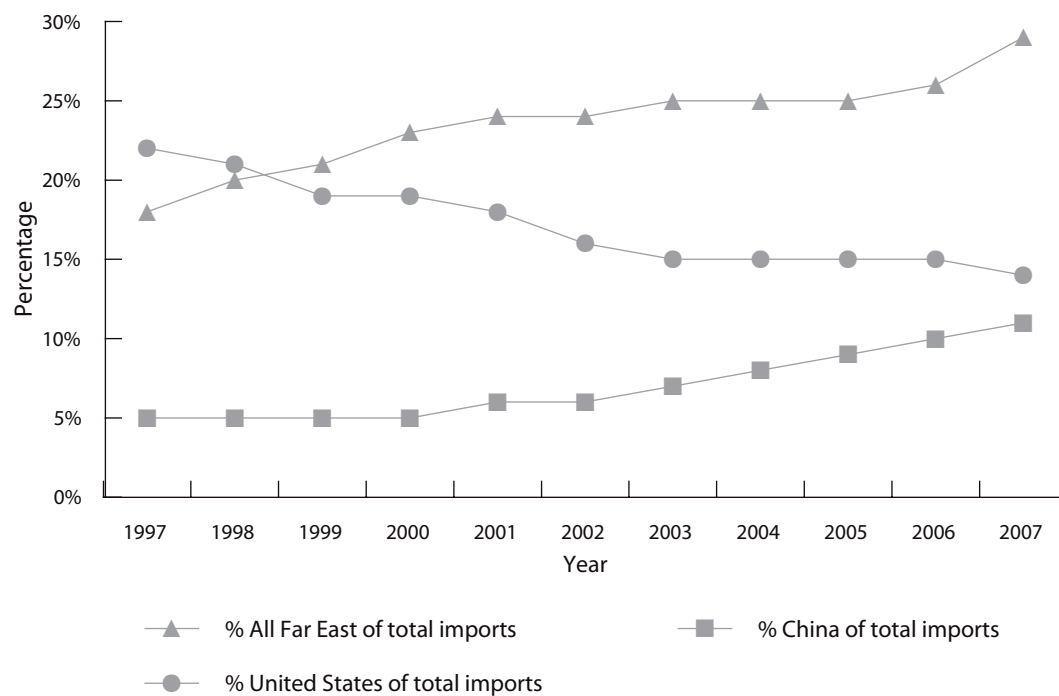
Saudi Arabia–China and the United States

The rise of China in world affairs and its huge economic weight in the world were not lost on Saudi Arabia. Indeed, the Saudis saw that their main export could have a huge, almost endless market in China and that China could serve as an important counterweight to U.S. influence in Saudi foreign policy. The Bush years were a major turning point for Saudi-U.S. relations. After September 11, the Saudis witnessed a very strong anti-Saudi sentiment in the United States, the distinct tilt of the administration in favor of the rightist movements in Israel, and the U.S. intervention in Iraq, of which they very strongly disapproved. There were also other minor but nevertheless important disagreements. For example, the effort by the Bush administration to isolate Saudi Arabia and try to break up the Gulf Cooperation Council (GCC) by signing free trade agreements with Bahrain and Oman or the U.S. stonewalling of Saudi Arabia's effort to join the World Trade Organization (WTO) were two developments that soured the relationship. Only a personal visit by King Abdullah to President Bush in Crawford, Texas, in 2005 was able to convince the president that Saudi Arabia's membership in the WTO would help the country become a 21st-century economy and thus would be good for the United States. Altogether, the relationship was impaired enough for the Saudi leadership to start revising its traditional friendship with Washington. Naturally, Saudi Arabia would not just kick the United States out; rather, the country is subtly and slowly but relentlessly switching away from the United States. In public there are constant reminders of the Abdel Aziz–Roosevelt meeting at Bitter Lake in 1945. There are reminders that Saudi Aramco was originally a U.S. company and that U.S. companies are often favored in the kingdom. It is quite evident, however, that no U.S. oil company was chosen to look for dry gas in the kingdom after ExxonMobil spent tens of millions of dollars and four years trying to start a program. On the other hand, Sinopec, a company with very little access to proper technology, was chosen and became a partner to Saudi Aramco. Perhaps important is the growth of China's market share in Saudi Arabia. Saudi Aramco and Sinopec just began operating their 200,000 b/d joint venture refinery in China. Despite their religious ideology, Saudi Arabia has chosen to not make an issue of the fate of the Muslim Uighurs in China.

Figures 1 and 2 show the evolution of Saudi imports and exports from China (which here includes Hong Kong, Macao, and Taiwan) relative to the United States. In absolute dollar terms, the United States has been increasingly selling to and buying from Saudi Arabia. Indeed total Saudi imports from the United States went from \$8.438 billion in 1997 to \$12.478 billion in 2008. The U.S. market share of imports declined substantially, however. In terms of evaluating the importance of imports on political and economic influence, the concept of market share is more important than absolute dollar figures. When U.S. imports and exports increased, China's increased much faster. Indeed, only market share shows that Saudi Arabia as a whole, not just the leadership, is placing increasing value on the Chinese trade, above and beyond the sale of oil to China. The U.S. market share declined from 22% in 1997 to 14% in 2007, while

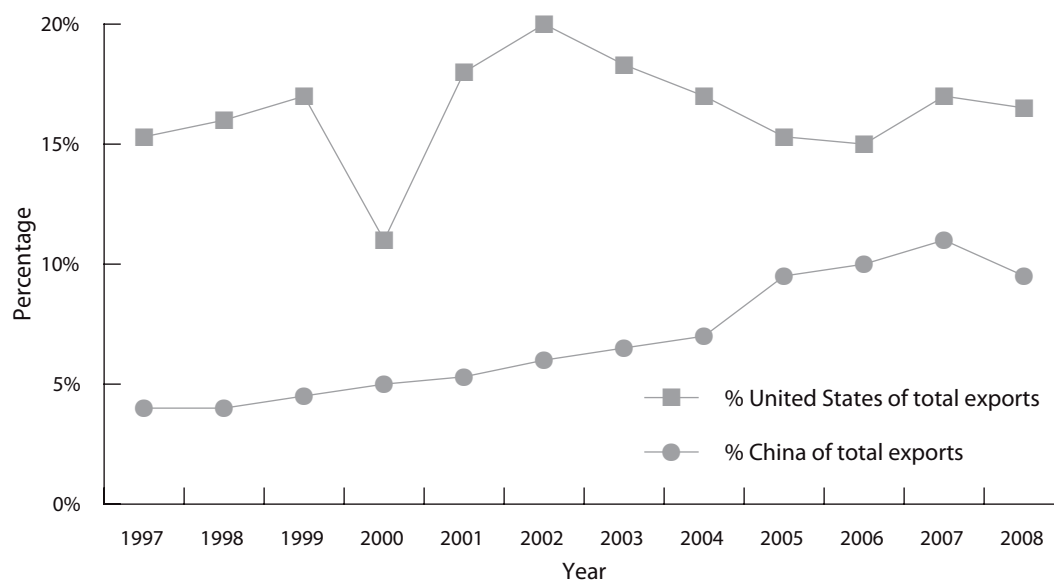
¹² The basic feedstock cost of SABIC is \$0.75 per million Btu, whereas the Chinese cost is about \$5 per million Btu, corresponding to a cost of \$45 per barrel of oil.

FIGURE 1 Market share of imports into Saudi Arabia



SOURCE: Computed from statistics available from the Saudi Ministry of Economic Planning, <http://www.mep.gov.sa>.

FIGURE 2 Market share of total Saudi exports



SOURCE: Computed from statistics available from the Saudi Ministry of Economic Planning, <http://www.mep.gov.sa>.

the Chinese share (which includes Taiwan and Hong Kong) had climbed from 5% to 11% and if all the Far East nations are included (Vietnam, South Korea, Japan, Philippines, Indonesia, and Singapore), the East Asian market share increased from 18% in 1997 to 29% in 2007. The economic influence of the United States is relentlessly declining relative to that of the Far East and China in particular.

All the indications are that in 2008 China (including Taiwan) has equaled the U.S. market share for Saudi imports, with the U.S. share dropping to about 8%.¹³ Currency fluctuation cannot explain the U.S. fall relative to China. Indeed, until 2007 the Chinese currency was basically pegged to the U.S. dollar and even now moves only very slowly as China tries to maintain its price advantage relative to the euro, the yen, and the dollar. In fact, even when the euro was increasing very rapidly relative to the U.S. dollar, the European Union only lost 1% of market share, when it should have lost much more to the United States.

It is obvious that a systematic shift away from the United States toward the Far East, and especially toward China, has been taking place, and China is becoming much more important to Saudi Arabia. China is now building the railroad between Mecca and Medina. It has been chosen as partner in a large aluminum venture in the Southwest of Saudi Arabia. As mentioned earlier, China is exploring for dry gas in the Rub al-Khali. There are also numerous Chinese engineering, procurement, and construction contractors active in Saudi Arabia, building schools, harbors, and factories. China is becoming a major buyer of Saudi crude oil and of Saudi feedstocks and chemicals.

Conclusion

These developments are indicative of three clear elements that are driving the development of this new Sino-Arabian silk road.

First, the Saudi leadership is pushing very hard to become a major industrial power in the world by 2020. Riyadh is therefore seeking to establish the best relations with those countries that will be the country's major markets for oil and gas products. The markets for Saudi Arabia are increasingly the countries of the Far East and in particular China. This is giving rise to the new silk road, which is growing in importance daily. The links with China are encouraged and developed systematically—they fit the Saudi ambition to be an economic and political major power by 2020.

Second, China needs Saudi Arabia to maintain Chinese growth even in the down times of 2009. China needs a reliable supplier of oil, but Indonesia is now a net importer of oil, Iran and Sudan are unreliable, Russia has political agendas, and Venezuela is too far away. The GCC countries and in particular Saudi Arabia are the only credible, sizable, long-term alternative providers of crude oil to China. Saudi Arabia is also a source of capital for China and can provide the chemical products that China needs to continue gaining export markets as well as the refined products and crude oil to manufacture these chemicals themselves.

Third, the constant disappointment with U.S. policies in the region is pushing Saudi Arabia to find a new paradigm to the old oil for security mantra of the various U.S. administrations. The Saudi leadership knows it does not have the military might to replace that of the United

¹³ The market share of both China and the United States dropped in 2008.

States but indeed is acting as if a very powerful economy can sway other countries to its point of view. Certainly China, viewed widely in the Gulf as the future predominant economic world power, even if not necessarily as the predominant military one, must become the next favored ally. China is willing to work with Saudi Arabia, not on the basis of military sales or exchanges but in establishing long-term economic links that could make both countries major powers to be reckoned with in international affairs.

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR CONFERENCE REPORT | OCTOBER 2009

Iran's Views on the Future of Energy Relations with China and Asia

Hormoz Naficy

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Prior to the current financial crisis there was a great deal of focus, and barely concealed concern, with what seemed like the insatiable energy demands of China, India, and to a lesser extent the smaller but also fast-emerging economies of the Far East as well as what this demand meant to the West, particularly to the United States. Following from this, and concomitantly, there was the focus and concern that some of the oil producers of the Middle East and elsewhere were responding all too positively to this growing demand in Asia. While some of the traditional oil provinces, such as Saudi Arabia, Kuwait, and the United Arab Emirates (UAE) did not offer a level playing field or remained, on the whole, out of bounds to the national oil companies (NOC) of China, India, and other Asian states, for a variety of political and commercial reasons a few were more open and receptive. This essay is intended to look at one such case—Iran—where the host country not only offered a level playing field but actively promoted the entry of the Asian NOCs (ANOC) into its upstream.

After a long, and at times tortuous, internal debate regarding the merits of FDI in the Iranian oil and gas industry, in the late 1990s Iran finally made the decision to reopen its upstream to foreign participation. Soon after this it became evident that Iran fully intended to welcome the participation of the ANOCs along with that of the international oil companies (IOC), which had been forced out of Iran as a result of the Islamic Revolution in 1979. This still fast-evolving relationship between Iran and the ANOCs will be reviewed here, and an assessment offered on the relationship's likely impact on the fierce competition between the West and the economic powers of the Far East over future supplies of oil and gas. In this connection a reminder is also appropriate that the current financial crisis, and the resultant slowing of the phenomenal growth in energy demand by the major Far Eastern economies, has afforded at most only a brief respite from that fierce competition.

New Partnerships in the Upstream Sector

The Ancient Silk Road Revisited

As ancient Asian civilizations, Iran and China had mutually beneficial trade relations dating back centuries, and equally, Iranian trade with India and Japan had flourished. Reference to “the new energy silk road” is thus entirely appropriate. Even though this trade was at times interrupted, relationships resumed whenever the land routes were secure. Political relations between Iran and these Asian countries has almost always been cordial, the invasion of India by Iran in the 18th century being the one exception. This history has meant that China and India—unlike, for example, Russia, the United Kingdom, or the United States—carried no political baggage when they entered into the Iranian oil scene. Neutrality of the flag mattered and offered these ANOCs substantial competitive advantages.

New energy partnerships between Iran and the ANOCs have been forged in the last decade or so, signifying a new chapter in the relationship between the two regions. China's Sinopec and India's Oil and Natural Gas Corporation (ONGC) were awarded exploration contracts in 2001 and 2002 respectively, pursuant to the exploration and development bidding round announced by the National Iranian Oil Company (NIOC) in 1998. Those were the first of many contracts, and it became quite apparent that these ANOCs were no longer content with being importers of Iranian oil or just buyers of oil in the open marketplace. These firms had begun to seriously invest in the upstream projects of Iran in order to become equity owners in their own right. It is stating

the obvious that this meant that the political stakes had risen substantially to correspond with the growing commercial benefits of these new partnerships. Furthermore, these two ANOCs of China and India were not the only new players from that region. The 2004 exploration licensing round saw the entry of the China National Petroleum Corporation (CNPC) and Thailand's PTTEP, both in 2005. Sinopec was also awarded a second block in 2005. Malaysia's Petronas had been in Iran even longer, since 1995, albeit as a non-operator, and Vietnam's PetroVietnam signed an exploration contract in 2007.

The signing of the most significant oil development contracts with an ANOC also occurred in 2007. The contract for the development of the Yadavaran oil field was awarded to China's Sinopec. This giant oil field, with recoverable reserves in excess of 3 billion barrels of oil, as well as some 2.7 trillion cubic feet of gas recoverable, had to be considered one of Iran's remaining crown jewels, and the award of field development to Sinopec indicated a clear willingness by the NIOC to accept the larger ANOCs as competent enough to handle major upstream projects. The initial memorandum of understanding (MOU) for this project had been signed back in 2004, and so despite the oft-reported political pressures from the United States and the long and arduous negotiations over the commercial terms, especially over the rate of return, the signing of the memorandum was hailed as a major commercial triumph by both sides. For Iran the MOU was also a major political victory. Not only was another major exploration and production (E&P) project signed, but as part of the package negotiated China agreed to explore possibilities for the eventual importation of liquefied natural gas (LNG) from Iran. Iran's long-held desire to enter the LNG export market, a desire thwarted by the United States, received a gigantic boost with this coupling of an upstream project with LNG exports.

These contracts enabled these companies to act as contractors to the NIOC and become operators and participants in Iranian E&P projects. Under the current "buy-back" contract, essentially a risked service contract, contractors will receive crude oil in lieu of a fee. Only one Far Eastern powerhouse, Japan, has continued to tow the U.S. policy of sanctions and containment of Iran. Japan's International Petroleum Exploration Corporation (INPEX) had procrastinated on a final decision regarding the development of the Azadegan oil field, with recoverable reserves in excess of 5 billion barrels—substantially larger than Yadavaran. INPEX eventually agreed to proceed with a much reduced stake in 2006, and early this year China's CNPC stepped in, at least partially, when the company reportedly won a contract for the development of North Azadegan. It should be noted that all of these ANOCs have partnered with Iranian state oil companies.

The U.S. Reaction to New Challenges

U.S. policymakers, and for the most part those whose job it is to advise these policymakers, reacted to these unfolding new challenges as if caught by surprise, followed by indignation. Yet it could be argued that there ought not to have been surprises, and further that the indignation was, and still is, unjustifiable. No apportionment of blame is intended, but there is a need to recognize that this growing partnership was actually fuelled in part by U.S. policy toward Iran. Politics aside, there is almost perfect economic sense in this matchmaking, but its pace and magnitude was forced on Iran. An Iran targeted by almost 30 years of U.S.-sponsored sanctions and containment, and forced into a disconnect with most of the West as an energy partner, has turned more eastward than Tehran would have liked. The balance in the portfolio of investors in Iran would have looked different had decisions been based on pure commercial reasons. Iran may have been less reluctant

to respond to Asian overtures had Tehran been able to play competitors against each other as part of the traditional game of playing off the East against the West. Throughout the ages, Iran has been masterful in playing that game.

The ANOCs, mandated by their respective governments to find additional secure sources of supply wherever possible—and in the case of China and India, at whatever price—took full advantage of this vacuum and gladly stepped in.

The Development of the Iranian Oil and Gas Industry

A brief review of the development of the Iranian oil and gas industry after oil was first discovered in 1908 will further assist an understanding of how Iran has arrived at this juncture and how the country's eastward turn has been affected and influenced by Western political missteps.

Before looking at the recent political history of the industry, however, it would be useful to highlight why Iranian oil and gas resources matter by offering some statistics related to reserves.

There is ample agreement within the technical circles of the industry that Iran is a resource-rich country. Iran holds the second-largest reserves of both oil and natural gas in the world. Crude oil proven reserves stand at 138.4 billion barrels, or 11.2% of the world total, which is second only to the reserves of Saudi Arabia. Increasingly there has been a sharper focus on the significance of the size of Iran's reserves in terms of natural gas. With 27.8 trillion meters (981.7 trillion cubic feet) of proven reserves, Iran holds 15.7% of the world total. Only the Russian Federation has larger reserves.

Lessons from the Proud and Turbulent History of Iran's Oil Industry

The Iranian oil industry is 101 years old, the oldest in the Middle East. Oil was first discovered in 1908. It is a proud industry with a turbulent history.

As a result of the pioneering exploration work of the Anglo-Persian Oil Company, a forefather of today's BP, oil was first discovered in a location called Masjid-e-Suleiman in southwest Iran, where the company, later renamed the Anglo-Iranian Oil Company, had gained exclusive exploration rights. In the early days, Iranian involvement in such work was limited to the supply of the blue-collar oil field labor. Abadan oil refinery, built to refine this crude for export, and at the time the largest refinery in the world, was also British-managed and controlled.

Royalties paid to Iran were a source of discord between the Iranian state and the Anglo-Persian/Anglo-Iranian Company almost from the outset. These royalties and the absence of Iranian participation in the decisionmaking process were arguably the major grievances that eventually led to the nationalization of the oil industry in 1951. During the nationalization period of 1951–53, Iran was unable to export oil, as it lacked the tanker fleet to reach markets and at any rate these markets were closed to Iran as a result of the de facto boycott of Iranian oil.

With the overthrow in 1953 of the nationalist government of Mohammad Mossadegh in a coup d'état now known to have been masterminded by the intelligence services of the United States and the United Kingdom, Iran entered an era of grudging cooperation with the IOCs. The United States, by then heavily involved in Iranian affairs, promoted an agreement between Iran and a consortium of IOCs consisting of BP (40%), U.S. oil companies (40%), Royal Dutch/Shell (14%), and Compagnie Francaise de Petrol (6%). The United States not only engineered the entry of its major oil firms into Iran for the first time but also enabled BP to retain a major interest for another

quarter of a century. This agreement and a series of joint venture agreements signed in the 1960s and the 1970s remained in force until the Islamic Revolution in 1979.

The oil agreement of 1954 enabled Iran, albeit modestly at first, to exercise its rights to participate in oil operations and in the decisionmaking process. Even though the oil consortium retained control over actual oil field operations, the state assumed ownership of physical assets. The NIOC also assumed responsibility for all non-basic facilities in the agreement area and took over the operation of the Naft-e-Shah oil field and a refinery in western Iran. Furthermore, the newly empowered NIOC began its own exploration and development activities outside the agreement area, which led to the discovery of oil and gas in central Iran. These early experiences gave Iran the foundations on which to build a robust national oil industry, both upstream and downstream, and the confidence to supervise and monitor the work of IOCs in later years.

It should be emphasized that with de facto changes to the contractual relationship with the consortium and the signing of the 1973 Sale and Purchase Agreement, followed by the enactment of a new petroleum act and the conclusion of a number of risk service contracts in 1974, Iran's cherished objective of full and complete control of its oil industry was finally achieved.

The socio-political upheavals leading up to the Islamic Revolution and the revolution itself radically changed the entire industry. All agreements with the IOCs were declared null and void, and as during the period of nationalization, Iran assumed all operations with what was left of its cadre of management. The entire senior- and mid-levels of management of the NIOC from the pre-revolution era were replaced, removed, or forced into exile abroad. The operation of a huge industry producing some five million barrels of oil a day was in new hands.

The Iran-Iraq War (1980–88) that followed the Islamic Revolution further prevented an orderly development of the oil industry. Production facilities, pipelines, refineries, and export terminals were all damaged by ground operations or by airstrikes, thereby greatly reducing Iran's ability to maintain production at pre-war levels. The early years after the war were dedicated to the repair of this extensive damage and the rehabilitation of the oil industry.

The Commercial and Political Costs of the Iran-Libya Sanctions Act (ILSA)

Following the Islamic Revolution, another significant drag on the development of the oil industry has been economic sanctions imposed on Iran as a direct consequence of the country's poor relations with the United States. These sanctions and Iran's relative isolation have forced Tehran to focus on the rapid development of domestic capabilities, whether in the manufacture of goods, the provision of required services, or the management of projects without outside technical input.

The official government attitude toward the participation of the IOCs in Iran's oil and gas sector has shifted over the years. In the early years the more radical stance that foreign oil companies would again exploit Iran and were thus undesirable partners prevailed. After the Iran-Iraq War and during the Rafsanjani era, with the emphasis on rehabilitation, the internal debate favored those who advocated the need for acquiring foreign technical and financial involvement, regardless of the source. With the election of Mohammad Khatami as president in 1997, this debate was finally won by those advocating FDI and the full participation of the IOCs in the oil and gas industry of Iran. The formal opening toward the IOCs occurred in 1998 during a major oil conference in London, where the NIOC offered a range of projects in which the IOCs could participate and the terms and conditions of the buy-back contracts were spelled out in detail. Upstream contracts between the NIOC and its foreign partners, including the ANOCs,

that exist today all either date back to that conference or are the result of initiatives subsequently pursued by the NIOC, with the only exception being the 1995 contract for the development of Sirri A and E fields in the Persian Gulf.

The Scorecard for the Years since the Reopening of Iran's Upstream

As was mentioned, in 1998, and after a long internal debate on the merits of FDI in the oil and gas industry, the NIOC finally announced 24 buy-back development projects that would be offered to the international oil industry. Since then the IOCs, later to be followed by the ANOCs, began a gradual and grudging return to Iranian E&P. After the first wave of development projects, the NIOC turned to exploration projects, the first of which was signed in 2000. It has not been a happy return for either the NIOC or the IOCs, with both parties claiming and counter-claiming the intransigence of the other. The NIOC has not been able to fully comprehend the issues the oil companies have with the commercial terms of the buy-back. Nor has the NIOC understood other concerns relating to the vast Iranian bureaucracy, the red tape involved, and the difficulties with respect to the actual logistics of operating in Iran. The IOCs have a long list of grievances and requests for change that they consider essential for the establishment of a better investment climate. However, it has often been noted in government circles that the ANOCs are less demanding or at least less vocal about their expectations.

Since the renewed opening, the NIOC and the other state institutions involved with policy and planning related to the oil industry have created an elaborate process of vetting the foreign oil companies that wish to bid for projects in the oil and gas industry. Interested companies must convince the NIOC of their financial and technical capabilities. In terms of financial ability, ANOCs—with the full support of their respective governments—are quite capable of qualifying. Yet on the issue of technical capabilities, where the NIOC is looking for a track record of projects executed, especially internationally, most ANOCs would have had difficulties—both in the vetting process and in winning contracts—had they been in direct competition with the Western IOCs, especially the U.S. majors. In the absence of competition from the United States and given weaker competition from European companies (note that Shell is in Iran but BP has been absent since the Islamic Revolution), ANOCs are able to win contracts even though these companies are less suited for such projects. The U.S. oil services industry is also barred from operating in Iran and that further aggravates the situation as the winning European companies and ANOCs must turn elsewhere for the work that sector leaders such as Schlumberger and Halliburton do best. Like any other oil producing state, Iran wants to promote and facilitate the transfer of technology from the outside to the NIOC and other Iranian partners in these projects. With the absence of the U.S. oil and oil services companies, and furthermore due to the ban on the sale of U.S. manufactured oil industry equipment, these projects tend to use older, less bold technologies. Few firms can go the route of “state of the art technology” without U.S. input. Although Iranian and foreign contractors often bypass the U.S. ban by importing equipment from intermediary states, project costs are inevitably inflated as a result. Under the buy-back contracts, the foreign partner, as a contractor to the NIOC, executes the project on behalf of the NIOC and all project costs are reimbursed upon completion. Thus, these inflated costs are ultimately born by the state. In this scenario it could be argued that the ANOCs, which as state entities are less cost-conscious and less commercially driven than the IOCs, are not ideal partners.

Competition for Future Upstream Projects and the Challenges for the United States

The first major oil contract available after the Islamic Revolution was for the development of the Sirri A and E fields in the Persian Gulf, and it is well known that the agreement was signed with France's Total in 1995. However, the rest of the history of this groundbreaking contract may not be so well known. The original negotiation for the project was with Conoco, but the U.S. government prevented the final signature and the project went to Total instead. Iranian officials always point out that it was not Iran that prevented that rapprochement, at least commercially, but the United States. There was even speculation at one time that the development of the giant Azadegan oil field was kept in reserve for many years for the return of the United States to Iran.

In the absence of competition from the United States, the ANOCs will continue to expand their presence in Iran. As they gear up for additional international exposure and gain more upstream experience, the once undisputed U.S. competitive edge could become blunted, and the challenges associated with any re-entry by the United States could become much harder. It is entirely conceivable that we could end up with the unnecessary scenario of a once predominant U.S. oil industry calling for a level playing field.

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR CONFERENCE REPORT | OCTOBER 2009

The New Energy Silk Road: Implications for the United States

Mikkal E. Herberg

Panelists for this discussion were **DAN BLUMENTHAL**, U.S-China Economic and Security Review Commission; **EDWARD CHOW**, Center for Strategic and International Studies; and **MIKKAL HERBERG**, The National Bureau of Asian Research.

The conference papers and discussion broadly confirmed the view that the Asian energy importers, particularly China, will play an increasingly important role in the energy development of the Middle East and Persian Gulf that is also likely to drive an expanding political, economic, and diplomatic role for these states. This ultimately is bound to have major strategic and energy security implications for the United States, the dominant outside power in the region for the past 50 years. The United States is the reigning global energy superpower, the leader in establishing the global institutions and arrangements governing energy today, and the guarantor of the sea lanes of communication (SLOC) in the Gulf region. The United States is also deeply embedded in the strategic future of the region through the U.S.-Saudi strategic alliance, costly ongoing engagement over nearly two decades in Iraq, as the leader in the Western effort to isolate Iran and frustrate that country's nuclear development, and as the key power in efforts to resolve the Arab-Israeli conflict. And the Middle East is destined to remain at the center of global oil and liquefied natural gas (LNG) production capacity, markets, and prices.

Until now Asia has played only a significant energy role in the region through substantial Japanese and Korean investment as well as by providing enormous markets for Gulf crude oil and LNG, and more recently, through growing oil and gas exports to and investment from China and India. Asia's political and strategic footprint in the Gulf, however, has been quite muted. Japan and Korea, for a wide range of reasons, have neither been capable nor interested in seeking to project power and influence in the region and have been content to rely on U.S. efforts to maintain stable and reliable energy flows from the region. China's and India's more recent involvement in the region, following on their growing energy security interests, has also been modest, with neither country being interested in taking responsibility for a complex and conflict-prone region and also largely content to freeride on the United States. Nevertheless, both states have been reluctantly drawn into the region's conflicts through energy ties with Iran, forcing these countries into a difficult balancing act between their energy security interests and the risks of seriously damaging relations with the United States.

But as Asia's dependence on Gulf energy inexorably grows over the next decade and the Gulf states increasingly see their energy market and investment future growing in Asia, it seems likely that this "new silk road" is sowing the seeds of significant change in the underlying terrain on which the United States has been operating for the past 40 years. The implications span both the global energy markets and the future of regional and global geopolitics. For energy markets, while the Gulf has been and will remain the "swing producer" for world oil supplies; developing Asia, and especially China, have now become the global "swing consumer," replacing the United States in this role. This is fundamentally changing the outlook for global energy investment, resource access, oil prices, and the role of national oil companies (NOC), particularly in an era likely to be characterized by much higher energy prices and intense competition to access supplies. In particular, China's enormous and fast-growing demand for oil and petrochemicals and its burgeoning investment capacity, combined with the growing competitiveness and capabilities of the Chinese NOCs and oil services industry, suggest that China's future energy investment role and impact in the Gulf will far outweigh any role in the past played by Japan or Korea. Chinese as well as Indian NOCs are likely to be far more successful and competitive than Japan's NOCs and more ambitious in scale than Korean energy companies. This converges closely with the Gulf's, particularly Saudi Arabia's, long-term vision of transforming into a global energy and petrochemical superpower—a new stage of Saudi ambition and growth strategy in which China

and India are key huge growth markets. The energy convergence between these states and the Gulf seems therefore destined to grow enormously in scale and scope, which suggests that both China and India are likely to focus progressively more assertively on their vital interests in the Gulf. At the same time, the energy security policies of China and India are not nearly as aligned with the United States as are those of Japan and Korea. Particularly in the case of China, it seems unlikely that Beijing will be content to follow Washington's strategic lead in the Gulf in ten to twenty years, given the sharp policy differences that exist over Iran, U.S. dominance in Iraq, competitive energy diplomacy and markets, and overall Middle East policy.

Whether this trend means greater competition with the United States for regional influence and control over energy resources depends heavily on how both the U.S. government and U.S.-based international oil companies (IOC) respond to this changing and unfamiliar terrain. If, for example, Washington expects an increasingly influential China to become a partner in U.S. efforts to maintain oil market stability and increase access to Gulf oil resources, Washington must find ways to draw China into existing institutions, free markets, and industry competition for reserves. It is important to bring China and India into the International Energy Agency (IEA) and its emergency management system, but the United States has not been particularly nimble in addressing this issue. Moreover, China itself does not yet seem interested in joining the IEA and intends to use its new strategic petroleum reserves unilaterally rather than collaboratively with the IEA. This suggests the need to develop new energy institutions that give China a greater stake in contributing to global oil market management, that is, increase incentives for China to act as a "responsible stakeholder" in global energy affairs as well as in energy affairs in the Gulf region. Moreover, the U.S. political firestorm over China National Offshore Oil Corporation's (CNOOC) attempt to acquire Unocal in 2005 symbolized for China that the United States and U.S. oil companies were not interested in a level, competitive playing field in the oil investment and the global oil industry. The IOCs, including U.S. companies, also have been slow to address the growing competitive challenge from China's NOCs. The rejection by the IOC partners of a CNOOC buy-in into the offshore Kashagan consortium in Kazakhstan sent a message to China that its NOCs would not be treated equally in the international oil industry. For India, the constant U.S. hectoring over New Delhi's negotiations with Tehran to build a gas pipeline to India via Pakistan increase the risk that India will resist U.S. leadership in the Gulf as India's power and regional influence grow.

From a broader geopolitical perspective on the Gulf region, the ground is also likely to progressively shift for the United States as China's military, political, and economic power grow over the next decade. China's concerns over its future energy security are rooted in fears over continuing U.S. power and predominance in the Gulf and surrounding regions. Beijing expects the United States to remain powerfully engaged in the Gulf, Central Asia, South Asia, Afghanistan, the Horn of Africa, and the Malacca Strait, all critical areas near major oil suppliers and key transport routes and bottlenecks. Moreover, the United States will remain the region's most formidable naval power with control over the energy shipping sea lanes of the Gulf, the Indian Ocean, and the South China Sea, all vital to China's economic and energy security. Hence, while not yet possessing the capability or strong desire to become involved in the politics of the Gulf region, China remains deeply suspicious of U.S. interests and is convinced that the United States intends to use its power in the region to help "contain" China. Other strategic U.S.-China tensions tend to cascade onto energy security fears, including the risk of confrontation over Taiwan. All this is fueling China's

security dilemma in the region and driving the country toward long-term measures to protect its economic and energy interests and gradually project its own power and influence in South Asia and the Gulf region and seas. This is clearly a factor in China's rapidly developing blue water naval power (including plans to build aircraft carriers), establishing port and naval access points across the Indian Ocean from Chittagong to Gwadar, testing naval capabilities by way of a recent piracy mission off the Horn of Africa, and establishing large submarine bases in the South China Sea. China is also driving efforts to establish alternative energy pipeline transport routes overland from the Gulf through Pakistan, Central Asia, and Myanmar. Not surprisingly, these moves are causing strong reactions in New Delhi as India increasingly worries about encirclement by China and responds by accelerating India's naval development in order to maintain influence over the country's own vital energy shipping lanes.

Thus, China's strategic and ultimately political influence in the Gulf region is destined to grow as the country's dependence on Gulf energy and sea lanes increases and Chinese naval and strategic capabilities expand commensurately. Consequently, the United States needs both to develop a long-term strategy to manage the potential challenge of rising competition with China over influence in the Gulf and to find ways to forge a long-term partnership based on shared interests rather than allowing the Gulf region to become a source of greater bilateral tensions. The core regional interest shared by the United States and China is in ensuring the political stability of the Gulf area and the reliable flow of energy to China, the United States, and the world economy. Politically driven supply disruptions from the Gulf have been at the root of most of the severe oil price shocks in recent years, resulting in untold economic damage to both countries.

The United States and China must therefore construct their partnership on a foundation of an agreement to work together more closely to ensure stability in the Gulf. This will require progress in working toward greater cooperation on several key existing and potential sources of bilateral tension over the future of the Gulf. First and most importantly, stronger Sino-U.S. consensus is required on dealing with Iran's nuclear development, currently the most serious source of bilateral disagreement and distrust over the region's long-term stability. It goes without saying that such consensus will be extremely difficult to achieve. For the United States this is a touchstone, long-term strategic issue, whereas China seems to have no clear long-term strategy and is instead much more focused on avoiding the near-term risk of instability that would be potentially caused by a U.S. or Israeli attack on Iran. Moreover, as China's NOCs become major investors in Iran's oil and gas industry, apprehension will increase in Washington over China's role. Second, the United States and China need to find ways to avoid an escalating competition for influence in Saudi Arabia and the bilateral distrust engendered by growing Chinese influence in the kingdom. China's expanding engagement in Saudi Arabia risks being perceived as undermining the Saudi-U.S. strategic alliance, a fear that has already set off alarm bells among many in the Washington security community. Third, the United States and China need to find common ground on the future of Iraq and the U.S. role there. The enormous scale of new oil and gas investment opportunities in Iraq—easily the largest potential in the world—will inevitably draw China and Chinese NOCs into a large and important energy role in Iraq and will, inexorably, attract much greater Chinese diplomatic and economic attention. Beijing opposed the U.S. war in Iraq and views U.S. influence there with deep suspicion. Conversely, the United States is likely to increasingly see China as a competitor for influence with a critical U.S. ally in the Gulf. Fourth, as China's power and influence in the Middle East grows, the United States and China will need to work to find common ground on an approach

to the Arab-Israeli conflict. China has long viewed U.S. support for Israel as one-sided and Beijing, while not very active yet in the region, has been a strong supporter of the Palestinian cause.

Finally, stronger U.S.-China cooperation on pursuing their shared interest in a more stable Middle East and Gulf region as China's power and influence there grow will depend heavily on the overall tone of U.S.-China strategic relations. Collaboration will be possible and far more productive if it is in the context of improving bilateral strategic cooperation and trust on a global basis. Alternatively, to the extent that the current atmosphere of distrust and competition for influence tends to characterize the two states' future global relationship, it will be much more difficult to find common ground on the vexing issues surrounding efforts to promote stability in this key energy exporting region.

2009 Energy Security Conference

The New Energy Silk Road: The Growing Asia–Middle East Energy Nexus

CONFERENCE AGENDA

Washington, D.C.

MONDAY, MAY 18

8:30-8:40 Welcome

Roy Kamphausen, Vice President
The National Bureau of Asian Research

8:45-9:15 Keynote Address

Jonathan Shrier, Acting Assistant Secretary of Energy
Office of Policy and International Affairs, U.S. Department of Energy

9:30-10:15 “The Middle East and Asia: Oil Trade and Investment”

Fareed Mohamedi
PFC Energy

10:15-10:25 Coffee Break

10:30-12:30 Asian Perspectives on the Growing Asia–Middle East Energy Nexus

Presentation: “Asia–Middle East Energy Trade and Investment Trends”

Mikkal Herberg
The National Bureau of Asian Research

Paper: “China’s Energy Role in the Middle East and Prospects for the Future”

Philip Andrews-Speed
University of Dundee

Prospects for China's current and future energy and diplomatic role in the Middle East

Discussants:

Robert Sutter, Georgetown University

Bo Kong, Global Energy and Environment Program, SAIS, Johns Hopkins University

12:40-1:40 Lunch

1:45-2:45 Asian Perspectives on the Growing Asia–Middle East Energy Nexus (cont.)

Paper: "India's Future Energy and Geopolitical Role in the Region"

Sumit Ganguly

Indiana University

Prospects for India's current and future energy and diplomatic role in the Middle East

Discussants:

James Clad, National Defense University

Manpreet Singh Anand, Chevron Corporation

3:00-5:00 Middle East Perspectives on the Growing Asia–Middle East Energy Nexus

Paper: "Saudi Arabia's Relations with China and Asia and Prospects for the Future"

Jean-Francois Seznec

Center for Contemporary Arab Studies, Georgetown University

How do the Saudis view their future energy and strategic relations with China and Asia, especially in the context of the strategic alliance with the United States?

Paper: "Iran's Views on Future Relations with China and Asia and Prospects for the Future"

Hormoz Naficy

Petroventures Advisory Ltd., London

How does Iran view its future energy and strategic relations with China and Asia, especially in the context of its strategic conflicts with the United States?

Discussants:

Jon Alterman, CSIS

Flynt Leverett, New America Foundation

TUESDAY, MAY 19

9:00-9:30 Breakfast

9:30-10:30 Other Competitors in Energy and Diplomacy in the Gulf and Middle East

Presentation: “Japan and South Korea’s Energy Diplomacy in the Middle East and Gulf and Prospects for the Future”

Kent Calder
SAIS, Johns Hopkins University

Presentation: “Russian Energy and Strategic Interests in the Middle East and Gulf and Prospects for the Future”

Paul Saunders
Nixon Center

10:30-12:00 Roundtable Discussion: Strategic Implications for the U.S. of the Growing Asia–Middle East Energy Nexus

Roundtable Participants:

Mikkal Herberg, NBR
Dan Blumenthal, AEI
Edward Chow, CSIS



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