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Looking West: China and Central Asia

1. What is the state of China's current energy investment activities in Central Asia?

Central Asian states, notably Kazakhstan, are large sources of overseas oil and natural gas production for China's national oil companies (NOCs). Over the past two decades, China National Petroleum Corporation (CNPC) established itself as a major foreign producer in Kazakhstan and the dominant foreign company in Turkmenistan. CNPC currently accounts for about one quarter of Kazakhstan's oil output. Meanwhile, Kazakhstan was the second largest source of overseas production for CNPC (and all of China's NOCs) behind Iraq in 2013. The 600,000 barrels of oil equivalent per day (boe/d) that CNPC pumped in Kazakhstan in 2013 accounted for one quarter of the company's overseas production of 2.46 million boe/d in that year. CNPC occupies a more privileged position in Turkmenistan, where it is the only foreign company to have been awarded an onshore production sharing contract (for the Bagtyyarlyk region in eastern Turkmenistan). In addition, CNPC currently has a technical services agreement to help develop the world's second largest natural gas field (Galkynysh). That said, concerns in Central Asian states, especially Kazakhstan, about China's NOCs becoming too dominant in their oil and gas industries is likely to limit the extent to which Chinese firms will be able to buy more assets.

2. What are the major Chinese institutions involved in Central Asia's energy sector?

The Chinese oil company with by far and away the biggest presence in Central Asia as a producer of oil and natural gas and a builder of pipelines is CNPC, which is China's largest oil and natural producer by volume. Other Chinese companies invested in oil and natural gas exploration and production in Central Asia on a much smaller scale include Sinopec (another national oil company), CITIC Group (a state-owned investment vehicle), China Investment Corporation (China's sovereign wealth fund) and Guanghui (a private company).

The Chinese financial institution that has been the largest source of capital for Central Asian energy producers and projects is the China Development Bank (CDB), a wholly state-owned bank with a mandate to advance China's national interests as understood by China's leaders at any given time. During the 2000s, one of those interests was gaining access to the energy and minerals China needed for its resource-intensive phase of economic growth. CDB helped finance the Kazakhstan-China oil pipeline and the Trans-Asia Gas Pipeline (TAGP), which runs from Turkmenistan to China via Uzbekistan and Kazakhstan. The bank has also provided debt financing to Chinese firms acquiring assets in Central Asia, such as CITIC's purchase of the Kazakhstan oil assets of Canada's Nations Energy. In addition, CDB has extended at least $8 billion in natural gas export-backed loans to Turkmenistan, which appears to have helped secure a role for CNPC in the development of Galkynysh.

The new financial institutions that Beijing is involved in creating – the multilateral Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB, also known as the "BRICS Bank") and the

China-operated Silk Road Fund (SRF) -- will probably emerge as new sources of capital for oil and natural gas projects in Central Asia for Chinese firms. Beijing seeks to forge greater economic connectivity between China and the rest of Eurasia through the construction of a "Silk Road Economic Belt," stretching from China to Europe. The SRF is the new financial institution most closely associated with this endeavor. However, financing projects aimed at delivering more oil and natural gas to China probably will not be as high a priority for Beijing as helping Chinese companies in industries hard hit by China's economic slowdown (such as rolling stock, iron and steel, cement and other construction-related sectors) find new business opportunities abroad.

3. How do Chinese leaders hope Central Asian energy resources will alleviate China's energy insecurity? How likely is it that this will come to pass?

Beijing views the Kazakhstan-China oil pipeline and the TAGP (and oil and natural gas pipelines from Myanmar and Russia) as enhancing China's security of supply by diversifying not only the countries from which China imports oil and natural gas but also the routes by which those imports reach China. Moreover, the Chinese government undoubtedly regards overland imports as safer than seaborne ones because countries like Russia and Kazakhstan are unlikely to yield to any political pressure from the United States to stop deliveries to China.

While both Central Asian pipelines have furthered China's import diversification, the TAGP has contributed more. China imported 26,000 barrels per day (b/d) of oil from Kazakhstan in 2004, the year before the pipeline went into operation. Last year, the Kazakhstan-China oil pipeline shipped 240,000 b/d to China (approximately 100,000 b/d of Kazakh oil and 140,000 b/d of Russian oil), accounting for just 4% of China's total crude oil imports of 6.2 million b/d. For comparison, China imported 997,000 b/d – 20% of its total crude imports -- from Saudi Arabia, its largest crude oil supplier. In contrast, the TAGP, which went into operation in December 2009, has transformed Turkmenistan into China's largest supplier of natural gas, delivering 25.8 billion cubic meters (bcm) -- 44 percent of China's imports -- last year. Guanghui, a private energy company, also operates a very small natural gas pipeline that runs from Kazakhstan to China.

However, Beijing is less worried about energy supply security today than it was in the late 1990s and 2000s. Not only is China's oil demand growth decelerating, but Chinese officials appear to be more comfortable with reliance on the world oil market than they were even just ten years ago. Moreover, the US shale revolution has eased concerns in China about competition for energy resources.

4. How does China's energy engagement with Central Asia impact regional and global energy markets and other countries in the region?

The Kazakhstan-China oil pipeline has helped Kazakhstan, a landlocked country far from the open ocean, to better align its oil exports with the shifting geography of oil demand growth from west to east. The majority of Kazakhstan's oil exports flow to Europe, where oil demand growth is in a long-term structural decline. In contrast, China's demand for oil is continuing to grow, albeit at a slower rate than in the 2000s. Overland pipeline deliveries are currently the only way for Kazakhstan to deliver sizeable volumes to China.

Similarly, the TAGP has helped Turkmenistan, another landlocked country, adapt to the shifting geography of natural gas demand from east to west. Europe's natural gas demand has been slow to recover since the global financial crisis. In contrast, China is likely to be a major driver of global demand growth at least through 2020 despite the slowdown in Chinese gas demand growth last year. The importance of China to Turkmenistan's economic livelihood is underscored by the ongoing cutbacks in Russian and Iranian imports of Turkmen gas. Russia's Gazprom, whose purchases from Turkmenistan peaked at 40 bcm in 2008, announced it would reduce its imports this year from 10 bcm to 4 bcm.

China's involvement in Central Asia's energy sector has been negative for Russia because it has contributed to the erosion of Russian influence over Central Asian states by providing them with non-Russian export routes and sources of financing. Moreover, Central Asian states, notably Turkmenistan, have a first-mover advantage in the competition for shares of the Chinese natural gas market. The TAGP has been operating for more than five years, while the Power of Siberia pipeline is not scheduled to begin delivering natural gas from Russia to China until 2018-2019 barring any sanctions-related delays. In addition, China appears to have successfully used the price it pays for Turkmen gas to drive a hard bargain with Russia for the price of the gas it will import through the Power of Siberia pipeline. Although Gazprom has declared the pricing formula to be a commercial secret, a back-of-the-envelope calculation indicates a price closer to what CNPC pays Turkmenistan at the Chinese border and below the price level sought by the Russians. China will also attempt to leverage the price it pays for Turkmen gas in negotiations for a second gas pipeline from Russia (the Altai line) to China.

5. To what extent do Chinese and U.S. companies operating in Central Asia complement or compete with each other?

The shale revolution in the United States has diminished competition between Chinese and US companies for oil and natural gas assets in Central Asia by easing concerns about oil scarcity and providing US companies with a more attractive investment destination. In recent years, US oil companies have increasingly focused their upstream investments on the United States, which is a much less risky place to operate than many other countries because of its political stability, strong rule of law and low tax and royalty rates. This trend towards "onshoring" is unlikely to go away as a result of one or two years of slower shale growth due to lower oil prices. Consequently, acquiring exploration and production assets in Central Asia is not as high a priority as it was for US oil companies before 2008.

Take the case of Kazakhstan. Even before the US shale energy revolution, there was much frustration among US and European oil companies operating in Kazakhstan because of Astana's high level of involvement in the oil industry, resource nationalist practices, delays and cost overruns. But the companies stayed put due to the dearth of opportunities elsewhere to invest in such large fields, many of which are in countries closed to foreign equity participation. However, the US shale revolution presented oil companies with a more attractive investment destination. In 2013, for example, Conoco Phillips sold its 8.4% stake in the multinational consortium developing Kazakhstan's giant Kashagan field to Kazakhstan's state oil company, KazMunaiGaz, for $5.4 billion as part of a broader effort by Conoco Phillips to rationalize its international portfolio to focus on developing its shale assets in the United States. KazMunaiGaz subsequently sold the stake it purchased from Conoco Phillips to CNPC.

Similarly, the easing of anxieties about oil scarcity appears to have diminished concerns in the United States about China's competitive advantage in Turkmenistan, an isolated country with high levels of political risk that is home to the world's second largest natural gas field (Galkynysh). CNPC is the dominant foreign player in the Turkmen upstream, thanks in part to the largely Chinese-built and financed Trans-Asia Natural Gas Pipeline and at least $8 billion worth of natural gas export-backed loans extended by CDB to Ashgabat. As Richard Morningstar, a former US special envoy for Eurasian energy, observed in 2009: "It's easy for Turkmenistan to make a deal with China, when China comes in and says, 'hey, we're going to write a check for X amount of money, we're going to build a pipeline. That's not a hard deal to accept, and we (the United States) can't compete in that way." However, the US shale revolution has made competing with China's NOCs in Turkmenistan and other countries a less pressing issue for US oil companies more focused on investing in the United States.

6. Has the recent decline in the price of petroleum altered China's posture in the energy sector in Central Asia, and if so, how?

The current lower oil price environment is one factor that is likely to make China's oil companies more selective shoppers for overseas assets, including in Central Asia. The collapse in crude oil prices is reducing the upstream profits of China's NOCs, leaving them with less money to spend on exploration and production. Other reasons include:

The Xi administration's ongoing anti-corruption campaign: The anti-graft investigations, which have taken down more than two dozen managers at CNPC, have slowed decision making within the company and its domestic peers. Uncertain who the next target might be, management at all of the "big three" NOCs went into self-preservation mode. This reluctance to make major decisions has contributed to the slowdown in the international mergers and acquisitions of China's NOCs. Both CNPC and CNOOC are currently being inspected by teams from China's top anti-corruption body as part of a broader effort to reduce corruption and facilitate reform at central state-owned enterprises (SOEs). (Sinopec was part of the inspection round that concluded in December.) It is unclear how long the anti-graft probes will continue to constrain overseas investments.

The Xi administration's SOE reform agenda: Beijing's drive to improve the financial performance of its SOEs is putting pressure on the NOCs to make more prudent investments. The balance sheets of China's NOCs deteriorated dramatically after the global financial crisis as a result of a myopic focus on "growth at any cost." PetroChina, the internationally-listed subsidiary of CNPC, is a case on point. The company's debt-to-equity ratio surged from 9.8% in 4Q 2007 to 51.8% in 1Q 2013, while its return on assets declined from 15.30% to 5.26% over the same period. As a result, PetroChina began emphasizing a shift in the company's investment strategy from volume to value and the company announced capex cuts even well before the oil price collapse.