CHINA'S **ENERGY** QUEST

WITH CONTINUING INTEREST IN CHINA'S GROWTH PROSPECTS, FLORENCE EID-OAKDEN EXPLORES ITS INCREASING RELIANCE ON IMPORTS FROM THE MIDDLE EAST AND NORTH AFRICA

SHUTTERSTOCK

Since 2000, China's dependency on imported oil almost doubled from 30% to 57% and its reliance on imported crude will continue to grow. Since 2013, China has become the world's largest net oil importer, overtaking the US by as much as 1 million barrels per day (bpd) in 2014. And since China imports more than 50% of its crude from the Organization of the Petroleum Exporting Countries (OPEC), its oil dependence is enough to become a cause for concern on national security grounds.

China has sought to diversify its energy portfolio across geographical regions. Crude imports from Iraq, Oman and Russia have surged relative to those from Saudi Arabia and Iran, while China's use of loan-for-oil deals has strengthened its hand vis-à-vis OPEC producers.

China has started paying in renminbi for crude imports from two key suppliers: Russia and Iran. But it will take time before the petroyuan is accepted by the entire MENA region.

Diversification

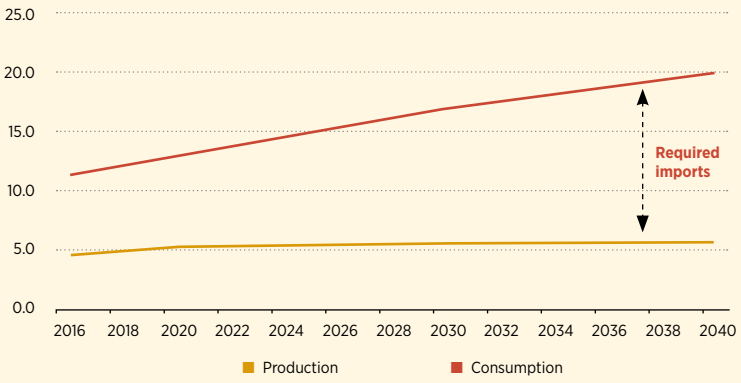
China is projected to import 8 million bpd by 2020 and 11.4 million bpd by 2030, compared with 7.6 million bpd in May 2016 (see figure 1, below).

In October 2015, OPEC's share of Chinese oil imports stood at 55%, down from 68% in mid-2012, with Saudi Arabia's share falling from 20% to 16%, and Iran's from 9% to 6% respectively. The relative decline is partly checked by the rise in imports from Iraq and Oman, which accounted for 10% and 12% of China's imported oil in October 2015, respectively. China is already the largest foreign investor in the Iraqi oil industry, holding substantial stakes in an oilfield in Kurdistan and in Al-Ahdab, Rumaila, Halfaya and West Qurna 1 in the south. In a move to further secure energy supply, China is also actively expanding Port Tripoli, Lebanon, as well as Port Said, Egypt. Port Tripoli is on the receiving end of the Mosul-Haifa oil pipeline (now defunct), whereas Port Said hosts the Damietta-Port Said gas pipeline, which is operational.

In South Sudan, Beijing has also committed diplomatic capital, including more than 700 Chinese troops as UN peacekeepers, to mediate the country's civil war, and protect its 120,000 bpd of crude supplies. China's growing interests in MENA will result in a gradual expansion of its political involvement there, but not in ways that constitute major departures from its non-interference policies, which have been the cornerstone of Chinese foreign policy.

Another noteworthy development is the dramatic rise in Russia's market share vis-à-vis Saudi Arabia and Iran. China's Russian oil imports grew 3% annually to about 810,000 bpd in the first nine months of 2015. Loan-for-oil deals are a key driver

FIGURE 1 China's projected oil demand and supply (m, bpd)



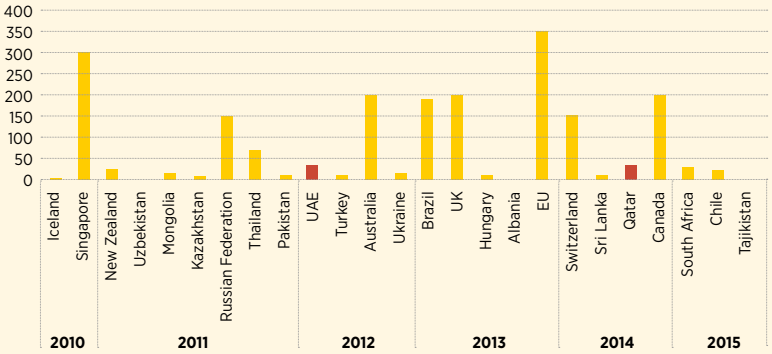
of the oil trade growth between China and non-MENA producers. From 2009, China's loan-for-oil deals with Angola, Russia, Venezuela and other producers amounted to $45bn, contributing to 30 million tonnes of crude reaching China annually.

As the oil price remains sluggish, loan-recipient countries are required to export more crude to China in order to repay the given amounts of loans. Nonetheless, MENA oil producers can take comfort from the fact that Chinese enthusiasm for loan-for-oil deals has been somewhat dented, as credit risks loom large for its loans to Venezuela and Angola.

China's strategic petroleum reserve boasted 400 million barrels in total in June 2016, still 200 million barrels short of its 2020 target. While Chinese diversification will remain a potent force in the oil market, we expect the Middle East to remain China's top choice in the short to medium term at a time when the pie of Chinese demand is growing. In May 2016, Saudi Arabia, Iran and Iraq's crude exports to China soared by 33.6%, 19.5% and 56.6% year-on-year respectively, albeit against Russia's 52.4%.

One major factor is that Beijing has been actively substituting coal with oil and gas as part of its environmental drive to cap coal use at 62% of total energy consumption by 2020. In addition, Chinese refineries' preferences for the Gulf Cooperation Council's medium to heavy grade, to which their production lines are catered, will mean China's demand for Saudi oil will remain inelastic for some time to come. More broadly, Chinese diversification will not imply its absence in the Middle East and North Africa. Combined, the two regions are home to half of Chinese companies' overseas oil production, a showcase of the country's continued interest in oil trades with these regions.[1]

FIGURE 2 Bilateral swap agreements (renminbi, bn)



Crude to China, yuan to MENA

Being the world's largest trading nation and net importer of crude oil, China would also naturally desire to make at least part of its oil payments in renminbi. Beijing hopes that the rise of the petroyuan will provide a stable anchor to the value of the renminbi, thereby establishing the renminbi as a global reserve currency. China has already been paying part of its purchase of Iranian oil in renminbi as early as 2012, as Iran sought to get around Western financial sanctions.

In 2015, Qatar became MENA's first hub for clearing transactions in renminbi, following a $5.7bn currency swap with the People's Bank of China in 2014 (see figure 2, above). Concurrently, China and the United Arab Emirates (UAE) renewed their currency swap agreement in December 2015, leading to a swap line totalling $5.2bn. The petroyuan would not be aided by Qatar and the UAE, however, as evidence suggests; renminbi clearing is likely to first start with non-oil trades.

In the wake of Western sanctions, Russia has also accepted selling oil to China in renminbi. While sanctions only target individuals and businesses, Russian officials are vigilant to the risk that they could one day be shut out of the dollar-based international financial system. Gazprom Neft, Russia's third-largest oil producer, has reached the stage of selling all of its China-bound crude in renminbi from mid-2015, whereas Rosneft, the largest producer, has received renminbi credit from Russian state banks. Russian embrace of the renminbi largely contributed to its capture of Chinese oil market share at the expense of Saudi Arabia for the second time, in the first five months of 2016. However, Saudi Arabia retook the top spot in June, as it intensified price competition and, for the first time, sold a spot crude cargo of 730,000 barrels to an independent Chinese refiner.

The fight for market shares on the currency front will continue, although Russia would not wholeheartedly underwrite the rise of the petroyuan should Western sanctions be relaxed.

Far from being content with making oil payments in renminbi, China also wants to launch its own crude futures benchmark later this year in the Shanghai International Energy Exchange, in its bid to rival Brent and West Texas Intermediate. China has long complained about the so-called 'Asia premium' caused by the Middle East's formula-based pricing, which results in Asian countries paying on average $1.20 per barrel more than Europe and the US since 1988.[2]

Currently, the price of Asia-bound crude is determined by the average of Platts Dubai Crude and Oman Crude benchmarks, which do not accurately reflect Asian crude supply and demand.[3]

With limited convertibility, renminbi-denominated crude futures contracts are unlikely to be popular among oil traders, although perceptions might change upon further financial liberalisation of China. Overall, although China's thirst for imported crude continues to grow on the back of rapid economic growth, the ascent of renminbi-denominated oil will take time unless renminbi develops sufficient appeal as a global reserve currency.

In the short to medium term, Beijing envisages the renminbi as a regional currency in Southeast Asia and Central Asia, knowing full well that the petroyuan will not have enough allure among MENA countries at this stage. Looking into the future, Beijing aims to establish the renminbi not against the dollar, but alongside it as part of a global multi-currency regime. This implies that China will be content to pay MENA countries in both the petroyuan and the petrodollar in the long term.

1 US Energy Information Administration
2 Arabia Monitor; People's Bank of China
3 S&P Global

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