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Mr. Chairman, Members of the Commission, my name is Gal Luft. I am executive director of the Institute for the Analysis of Global Security (IAGS), an energy security think tank which for the past three years has followed and analyzed China's foreign, economic and security policies, which stem from its growing energy consumption, and their impact on global security. I would like to thank you for inviting me to brief you on China's energy policy and its effects on U.S. interests.

Since it became a net oil importer in 1993, China has traversed the globe in a relentless quest for energy sources to fuel its booming economy. In recent years its state owned energy companies concluded oil and gas deals in close to 30 countries. There is no doubt that China's robust economic growth has already been felt on the global energy scene and contributed substantially to this year's spike in oil prices. In some cases, China's pursuit of oil has caused considerable irritation in Washington. The latest of these is the decision of China National Offshore Oil Corporation (CNOOC) to bid for Unocal, America's ninth largest energy company.

The Unocal affair brought to the fore the debate whether or not China's pursuit of oil is a threat to U.S. national security. Many of those who decry scrutiny of this deal see no harm in a proxy of China's Communist government gaining foothold in the U.S. economy. *Newsweek Magazine* called the concern "over the top"; the *Economist* called the response by Congress "farcical" and the *Wall Street Journal* said: "The fact that a Chinese oil company wants to buy American is a sign of progress, not concern." But at a time of short supply of oil, when oil prices reach a historic high of $60 per barrel, a Chinese attempt to buy a piece of America's energy is not a trivial matter. It should invoke a serious discussion about the future of America's energy and economic security in light of China's rise.

Though there is always a chance that China's pursuit of energy could present an opportunity to enhance cooperation, integration and interdependence with the U.S., I believe that it is more likely that aggressive competition over access to energy sources will ensue. With global reserves of cheaply recoverable oil and gas being depleted China is already competing with the U.S. over the same oil reserves in some of the world's most unstable areas. Former Secretary of State Henry Kissinger warned recently that the global battle for control of energy resources could become the modern equivalent of the colonial disputes of the 19th century.

Energy is the main driver of China's recent international behavior. In a lecture at Beijing University in March 2004, its deputy foreign minister, Wang Yi, admitted that Chinese foreign polices are "at the service of China's economic development." Our independent analysis has confirmed just that. I would like to focus on four regions where China's energy expediencies affect its international behavior to the detriment of the U.S.: the Middle East, the East China Sea, Central Asia and the Western Hemisphere.

The Middle East:

Close to 60 percent of China's oil imports come from the Middle East and its imports from there are projected to grow by more than 500 percent by 2030. China is already making its presence felt with money, arms and diplomacy, moving to fill the widening post-September 11 fissures between the U.S. and countries like Saudi Arabia and Iran.

A recent manifestation of how China's approach to oil puts it in conflict with vital U.S. interests is its partnership with Iran. China is the number one oil and gas importer from Iran. The two countries are bound by energy deals reaching a total value of $120 billion and growing. While the U.S. and the EU are trying to forge a diplomatic strategy to halt Iran's nuclear program, China's October 2004 energy deal with Iran brought it to block any American attempt to refer Iran's nuclear program to the UN Security Council. This indicates not only that China is interested in a militarily strong, even nuclear Iran that could challenge U.S. domination of the Persian Gulf but also that for China, energy security considerations trump international cooperation on critical global security issues.

Anther example is Sudan, which supplies seven percent of China's oil imports. The Chinese have invested billions of dollars in joint exploration contracts in this country, including the building of a 900-mile pipeline to the Red Sea. China deployed thousands of military personnel disguised as oil workers and provided arms to the Sudanese government to support it in the country's 20-year civil war. Last September, the UN Security Council passed resolution 1564, threatening Sudan with oil sanctions unless it curbed its support for belligerent militia groups in Darfur. To protect its oil interests in Sudan, Beijing stated very clearly that it would veto any bid to impose such sanctions. This case, again, shows that China assigns greater weight to lucrative supplies of crude oil than it does to efforts to halt a government sponsored genocide.

Without doubt the biggest prize in the Middle East is Saudi Arabia, home of a quarter of the world's oil reserves. Since its 1999 pronouncement of a Sino-Saudi "strategic oil partnership," Saudi Arabia became the largest supplier of crude to China. The Saudis have recently demonstrated their intention to strengthen the bond with China even further, deciding in 2004 to allow Chinese firms to explore Saudi natural gas fields while negotiations between Riyadh and U.S. companies failed to bear similar fruit. This month Saudi Arabia's national oil company Aramco became a 25% investor in the biggest refinery and petrochemical integrated project China has ever entered with a foreign entity. China would like to see a gradual Saudi shift of allegiance from Washington to Beijing. The Saudis, for their part, still rely on the U.S. for their security but further

deterioration in U.S.-Saudi relations—for example in the case of another terror attack by Saudi nationals against the U.S.—combined with growing Chinese military buildup could eventually bring the House of Saud to the open arms of the Chinese. In order to guarantee a market in China the Saudis have interest in building capacity to process their heavier Arabia crude. To this end, Saudi Arabia has been investing in China's refining industry, projected to expand by nearly 30 percent within the next five years.

East Asia:

In the East China Sea, China is involved in territorial disputes with Japan over energy resources in the Senkaku Islands. The tiny archipelago, which was a U.S. territory before it was handed to Japan, is still used by the U.S. military as practice grounds for bombing runs. China has already begun the exploring process for gas reserves on its side of the East China Sea. The Japanese government claims that some of the reserves are actually on its side of the demarcation line and has accused China of attempting to extract hydrocarbons from its water. It also allowed its own oil firms to drill in the disputed territories—a move considered a provocation by China. The situation in the East China Sea is explosive. In November 2004 a Chinese nuclear submarine illegally penetrated Japanese water. In response, in February 2005 Tokyo took formal possession of Senkakus, provoking harsh Chinese rhetoric. On April 14, China sent an official warning to Japan to back off or "take full responsibility." Japan's defense ministry drew up contingency plans to deploy 55,000 troops in the event of a Chinese invasion of the disputed islands. This dispute is exacerbated by tension between Japan and China over access to Russian oil. For many months, China and Japan have been involved in a bidding war over a major pipeline deal to deliver Russian oil from Eastern Siberia. China's plan calls for a pipeline running to the Manchurian city of Daqing, while Japan is insisting on a pipeline that would run to Nakhodka, the Russian coastal area opposite to Japan.

This tense atmosphere is feeding popular and political animosity that has already resulted in a wave of violent anti-Japanese demonstrations in April 2005, and is likely to deepen over time. A survey last year found that 58% of Japanese see China as an emerging threat. There are other sources of tension between Japan and China, unrelated to energy. But continuous resource competition would surely exacerbate long-standing Sino-Japanese tensions even further and hence disrupt the delicate regional balance that has been maintained by the U.S. since the end of the Second World War.

Central Asia:

In Central Asia, a major reservoir of oil and gas, China has had a long-standing interest in ensuring that it enjoys unfettered access to natural resources. The two countries of particular importance for China are Kazakhstan and Uzbekistan, both important allies of the U.S. in the war on terrorism and both important sources of energy. China and Kazakhstan have formed a strategic partnership primarily focused on linking the two nations with oil and gas pipelines. So far Kazakhstan has been skillful in balancing the interests of both the U.S. and China.

The same cannot be said about Uzbekistan, where the U.S. has an air force base which serves U.S. military operation in Afghanistan. In May 2005, Uzbekistan's President Islam Karimov massacred hundreds of his own citizens in Andijan. While most of the world denounced the killing, calling for international investigation, China immediately announced its steadfast support for Karimov in his so called "war on terrorism" and rejected international investigation of the massacre. A few days later a $600 million energy deal between China and Uzbekistan was signed. China was quick to capitalize on the crisis in Washington's relations with Karimov. In this month's meeting of the Shanghai Cooperation Organization it was a leading force behind the effort to rid the region of American military presence and curb U.S. influence in Central Asia.

The Western Hemisphere:

China's oil thirst has already resulted in a series of deals stretching from the southern tip of South America to the Caribbean, areas which constitute America's backyard.

- In January 2005, China and **Peru** signed a memorandum of understanding allowing China to promote investments and technical cooperation in the exploration and export of oil and gas.
- In the same month China Petroleum & Chemical Corporation, or SINOPEC, signed a production contract with **Cuba**.
- While U.S. energy companies have grown increasingly disenchanted with the corruption and volatile politics of **Ecuador** and its energy company Petroecuador, the Chinese seem to be undeterred from investing more than $100 million into drilling and exploration work there.
- **Argentina** and China signed cooperation deals that could lead to up to $5 billion in investments over the next decade oil and gas exploration.
- In **Brazil**, the Chinese President signed 11 bilateral agreements, including planned investment of $10 billion in energy and transportation in the next two years.
- In January 2005 the Wall Street Journal reported that trade officials in **Mexico** said they see China as a potential growth market for their oil exports.
- Chinese state-owned oil companies pursue ambitious deals in **Canada**, the top petroleum supplier to the U.S. Canada has emerged as the second largest oil reserve in the world due to the drop in price in the recovery of crude from the vast reserve of Alberta's tar sands. Chinese companies are negotiating the acquisition of Canadian tar sands companies and have already bought stakes in few of them. The Chinese PetroChina International signed an agreement with Canada's giant pipeline company Enbridge to build a $2.5 billion pipeline from Alberta to the Pacific coast from where 200,000 barrels of crude a day will be shipped to China. The two countries signed the Canada-China Statement on Energy Cooperation in the 21st Century, promising to work closely in the areas of oil, gas, oil sands, energy efficiency, environment, and related ventures. Analysis conducted by IAGS shows that if China succeeds in acquiring portions of Canada's energy industry up to a third of Canada's potential exports to the U.S. could eventually be lost to China.

- Last but not least is **Venezuela**, U.S.' fourth largest oil supplier. Since April 2002, U.S. relations with Venezuela have become increasingly acrimonious. Venezuela's President Hugo Chavez warned the U.S. against any interference with Venezuela's internal affairs threatening that Venezuela "has enough allies on this continent to start a 100-year war," and that "U.S. citizens could forget about ever getting Venezuelan oil." This threat is not being ignored. Secretary of State Condoleezza Rice remarked in her confirmation hearing that two of her chief worries with regards to Venezuela are U.S. dependence on Venezuelan oil and whether Chavez will continue to supply it. The fissure in the relations enables China to step in and reduce Venezuela's dependence on selling oil to the U.S., which currently buys 60 percent of Venezuela's crude. A series of oil agreements signed in early 2005 allow Chinese companies to explore for oil and gas and set up refineries in Venezuela. Chinese companies agreed to invest $350 million in 15 oil fields in eastern Venezuela, along with $60 million in a gas venture, and to import 120,000 barrels of Venezuelan fuel oil a month. For now Venezuela's ability to become a major oil supplier to China is limited. China's refineries are not equipped to refine Venezuela's crude. Geography is also a constraint. Venezuela has no access to the Pacific shore and the Panama Canal cannot accommodate the biggest tankers. But China and Venezuela are trying to resolve these problems. In July 2004 Venezuela signed a contract with Colombia to build a crude oil pipeline connecting its oil fields with a port on Colombia's Pacific coast sparing Chinese tankers the need to traverse the Panama Canal.

The single most important thing to remember about China's energy acquisitions in the Western Hemisphere is that they will eventually make the U.S more dependent on the Middle East and other volatile areas. With half of its oil imports coming from the Western Hemisphere, and with oil imports projected to surge 60 percent during the next two decades due to demand growth and a decline in domestic crude production, the U.S. cannot afford to lose chunks of Western Hemispheric crude. Every barrel of oil China buys in the Americas essentially means one less barrel available for the U.S. market. This means that the U.S. will have to look for this oil elsewhere and become more reliant on oil from more remote and less stable regions, primarily West Africa, the Caspian and, above all, the tumultuous Middle East. This is contrary to President Bush's pledge to make the U.S. less dependent on "countries that don't particularly like us."

Politically, China's foothold in the Western Hemisphere could reach a stage in which it infringes on the long standing principle in U.S. foreign policy of nonintervention in the Western Hemisphere by foreign powers. Furthermore, control of energy assets by a Communist government could expose U.S. neighbors to Chinese pressure to part ways from the U.S. on issues regarding China like human rights abuses, arms sales and mainland's relations with Taiwan. Chinese penetration into Latin and Central America could also strengthen the voices of Marxism and anti-Americanism in a part of the world critical to U.S. national security.

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China’s drive into the world’s energy market has already added a degree of agitation to Sino-American relations and may continue to create occasional friction, as its state owned companies dig deeper and wider in areas where the U.S. has strategic interests.

The U.S. deploys forces and provides military assistance in the Persian Gulf, Central Asia, and West Africa--all of them are oil rich domains, yet all of them are also critical for America's war on terrorism. China's creation of a foothold in these areas, enabled by its energy relations, could compromise U.S. strategic posture and complicate its campaign against terrorism.

However, this does not necessarily mean that a superpower conflict over oil is inevitable. Energy security is but one of several issues, such as trade, human rights, weapons proliferation and Taiwan, that will affect future Sino-American relations. Each of those issues in itself could strain relations between the two powers. It is also unclear how other large energy consumers like Japan, India and Europe will position themselves on the global chessboard as *their* demand for oil grows.

Whether an oil conflict will develop depends on three major factors. The first is the sustainability of China’s astonishing economic growth. China has all the ingredients of rapid growth: its per capita income is still relatively low, so it has huge potential to improve efficiency and grow; it is a drawing ground for foreign direct investment; its labor force is cheap yet hard working and capable; and its admission to the WTO enables it to reap the benefits of globalization. If China continues to grow at breakneck speed, as it has so far, following the growth trajectory of other Asian nations such as Japan, South Korea and Taiwan, aggressive U.S-China competition over oil will be almost certain. On the other hand, if for whatever reason China’s economy will slow down, its high rates of energy consumption will decline and the resources problem will be somewhat mitigated.

The second predictor of future Sino-American relations is the ability of the world energy market to provide enough cheaply recoverable oil to satisfy global demand. Petroleum reserves are undoubtedly limited and there are only so many places to seek them. No one can precisely determine how much low-cost petroleum is stored in our planet. The world uses about 85 million barrels of oil per day. According to the International Energy Agency, this amount is projected to grow to 120 mbd by 2030. This means adding to the oil market four Saudi Arabias or twenty Nigerias worth of oil in just 25 years. I am doubtful that fulfilling such demand at reasonable prices is geologically feasible. For some years many geologists have been warning that the world's ability to produce oil is approaching its peak, meaning reaching the point in which half of the world’s oil endowment is depleted. How far we are from peak production is a matter of intense debate. The US Geological Survey (USGS) states that reserves of recoverable oil stand at about three trillion barrels and that peak production will not come for about 30 years. The International Energy Agency (IEA) believes that oil will peak between "2013 and 2037." But a growing number of geologists claim that peak production will arrive much sooner. For years, these “depletionists” have been warning that the huge “super fields” that supply most of the world’s oil were discovered in the 1950s and 1960s and the recent oil discoveries have been significantly smaller. Even the industry’s confidence in its ability

to provide the market's needs is waning. "The time when we could count on cheap oil and even cheaper natural gas is clearly ending," Dave O'Reilly, chief executive of ChevronTexaco admitted recently. Surely a world awash with cheap oil will eliminate grounds for dispute among consumers, but it is less clear what will be the impact of shortage and high prices. On the one hand it could increase the likelihood of aggressive competition between the heavily dependent U.S. and other major consumers spearheaded by China. On the other hand, high oil prices are likely to slow down economic growth in China and the world at large and therefore reduce energy demand.

The third predictor of whether China and the U.S. are bound to clash over oil is the relationship between the two countries and OPEC members, especially in the eventuality that shortage does occur. When it comes to control over reserves the balance of power between OPEC and non-OPEC producers is tilting toward the former. Non-OPEC nations now pump close to two thirds of the world's supply but in relation to their reserves their production rates are nearly twice as great as OPEC's. In other words, they produce far more than they discover. According to Exxon Mobil Corporation, non-OPEC production will start to decline within five years or so while OPEC producers will still be going strong. Consequently, OPEC's share of the pie will increase - and with it its control of the market - to over 90% of world oil reserves and over 60% of production in 2030. At this point, those countries with the strongest ties to OPEC members will enjoy a strategic edge.

While it is true that oil is a fungible commodity and its prices and supply levels are determined by the international markets, ownership of oil assets and good relations with the governments that own them give the consuming country considerable advantage. Nine of the world's top ten oil companies, together holding over 75% of the world's oil reserves, are owned by governments, not publicly traded companies. If U.S. relations with major OPEC producers such as Saudi Arabia, Venezuela and Iran continue to deteriorate while China succeeds in courting them, OPEC's oil will be more readily available for the Chinese market while supply to the U.S. will be increasingly compromised.

Conclusion

Despite the many tell tale signs of China's oil-driven international behavior, Washington has not yet turned its focus to the implications of 1.3 billion Chinese gradually abandoning their bicycles for cars on U.S.-China relations. Neither U.S.' foreign policy nor its energy policy currently address the possibility that global demand might outstrip supply. The best demonstration of this complacency is the energy bill currently deliberated in Congress. The bill proposes a modest goal of reduction of U.S. oil dependence of 1 million barrels by 2015 while U.S. demand by this time is projected to grow by 4 million barrels per day. As a consumer of a quarter of the world's oil supply and holder of merely three percent of global reserves, the U.S. cannot afford to sit on its hands and hope that the world's energy problem resolves itself. In addition, with one of the worst fuel efficiency standards in the industrialized world the U.S. lacks the moral authority to preach to the Chinese about the need to address *their* oil problem. Nor can it

ask them to deny their people the high standard of living that Americans have been enjoying for decades.

While there is an urgent need for a comprehensive energy strategy to deal with China's energy needs such strategy cannot be based on seeking ways to block China's access to oil. The U.S. should look inward and begin to seriously address its growing addiction to oil and more broadly assign a larger role for energy policy in its global strategy. This can only be done through multinational cooperation on energy and a joint commitment by the U.S., China and the other consuming countries to work toward reducing global oil dependence through efficiency and development of alternative energy sources. Both the U.S. and China are not rich in oil but they are both well endowed with a wealth of other energy sources that can be used to displace petroleum in the transportation sector, which accounts for two thirds of U.S. oil consumption and the bulk of the growth in oil consumption in the developing world. Both China and the U.S. are rich in coal; both have large cities that generate huge amounts of garbage and both have massive agricultural sectors that generate billions of tons of biomass. Technology can convert all of these resources into transportation fuel. Were the U.S. and China to collaborate on advancing such technologies and improving efficiency they could gradually curb their demand for oil and hence reduce the likelihood for conflict.

Thank you, Mr. Chairman.