A Silk Road for Oil:
Sino-Kazakh Energy Diplomacy

Janet Xuanli Liao
Lecturer in International Relations and Energy Security
Centre for Energy, Petroleum, and Mineral Law and Policy

Central Asia is a familiar place to China, closely linked to the famous Silk Road legends, but the Chinese political resurgence in the region did not take place until the mid-1990s following the collapse of the former Soviet Union. Initially, Chinese attention focused on traditional geopolitics, and the Chinese energy search in the region was of secondary significance to grand strategy. However, with China's rapidly growing energy demands and petroleum imports, central Asia has become increasingly important to China for energy security. China's petroleum activities in Kazakhstan, one of the world's top-20 oil producers, have attracted special attention from the outside world.

Compared with their work in other petroleum-rich regions, China's petroleum development in Kazakhstan over the past few years has been largely successful, as indicated by two major achievements. One is the building of a 3,000 km (1,864 mi) oil pipeline across the China–Kazakhstan boundary after seven years of delay; the other is the successful Chinese takeover of PetroKazakhstan. Nevertheless, neither project was painless due to domestic politics in both countries and obstruction by other international oil companies operating in Kazakhstan.

China's influence in central Asia has not yet constituted a true challenge to the interests of major powers such as Russia and the United States. However, the potential future role of China in the region has catalyzed increasing concerns—especially in Western countries where worries are common that China will become "the world's other superpower," offsetting U.S. and Russian influence in central Asia. But China's future role in the area is not as obvious as many have imagined;

Dr. Janet Xuanli Liao is a lecturer in International Relations and Energy Security at the Centre for Energy, Petroleum, and Mineral Law and Policy at the University of Dundee, Scotland. Her publications include "Multilateral Energy Cooperation in Northeast Asia: Promise or Mirage?" with Philip Andrews-Speed and Paul Stevens, "Strategic Implications of China's Energy Needs," and the *Dictionary of International Politics*.

China's presence in central Asia has always been determined by an interplay between energy and diplomacy.

This paper will therefore examine China's energy diplomacy toward Kazakhstan over the past decade in order to provide a better understanding of China's motivations in central Asia and their possible implications.

NATIONAL SECURITY AND SINO-KAZAKH ENERGY COOPERATION

As the former Soviet state that shares the longest border with China and has some of the region's richest petroleum resources, Kazakhstan attracted Chinese attention in both strategic and energy terms following the collapse of the Soviet Union. China's cooperation with Kazakhstan at that early stage seems to have played a role in strengthening the strategic ties between the two countries.

Energy cooperation between China and Kazakhstan began in 1997, when the two signed an agreement to build a 3,000 km oil pipeline across their borders, running from Atyrau in Kazakhstan to the west to Altaw Pass in China in the east. This was one of the biggest investments China had ever undertaken in overseas petroleum development. However, the pipeline was not put into use until a few years later, partly due to the Asian financial crisis and the resultant collapse of oil prices in 1998, which made the pipeline economically unviable. More importantly, delayed economic cooperation was a product of the emphasis of Chinese policy toward Kazakhstan—namely, to obtain Kazakh cooperation on preventing the Uighur separatist movements from gaining ground in its Northwest province, the Xinjiang Uighur Autonomous Region.

China established its diplomatic relationship with Kazakhstan and other central Asian countries in January 1992, immediately following their independence. However, due to the Kazakh government's adopted policy of encouraging Kazakhs to migrate back "home" to bolster the domestic influence of the Kazakh population (which accounts for only 42 percent of the population within Kazakhstan), no official visits occurred between the two countries until Kazakh President Nursultan Nazarbayev paid an official visit to China in October 1993. Beijing's concerns about Kazakhstan's policy were rooted in the fear that promotion of Kazakh nationalism would inflame Uighur separatist groups in Xinjiang, which neighbors Kazakhstan and has a Kazakh population of 1.2 million. These separatist groups had been increasingly active since the late 1980s and had orchestrated a number of bus bombings in big cities, including Beijing and Urumuqi. With outside support, they became more assertive in the early 1990s and began to claim in some Kazakh newspapers that the nature of the Uighur issue was not to gain autonomy but to establish its own "motherland."[1]

Therefore, on his visit to Kazakhstan in April 1994, Premier Li Peng tried to convince the Kazakh government of the need for a policy change and succeeded in gaining its cooperation.[2] President Narzabayev was subsequently invited for a state visit to China in 1995, during which he signed a few agreements with his Chinese hosts, including an agreement on the utilization of the Lianyungang Port for handling Kazakhstan's transit freights and a memorandum of cooperation between the defense ministries of the two countries. In April 1996, China signed an agreement in Shanghai with Russia, Kazakhstan, Kyrgyzstan, and Tajikistan in order to enhance mutual trust through military contacts among those bordering states. Being a non-aligned country, it was an unusual move for China to sign such an agreement in its own territory, one which President Nazarbayev characterized as "the most substantial political move in the Asia–Pacific region of this century."[3]

During the following few years, China reinforced political cooperation with Kazakhstan. In addition to the "Shanghai Five" mechanism, China settled its 1,930 km border with Kazakhstan by signing a joint communiqué on the issue on 23 November 1999. Top leaders from the two countries also met frequently to discuss combating separatism, terrorism, and religious extremism.[4] With China's western border secure and the "Shanghai Five" mechanism in place, the energy factor had become seemingly less important in China's foreign policy toward central Asia. Therefore, little progress was made on the oil pipeline until a few years later.

A Greater Role for Energy in Sino–Kazakh Relations

China resumed its interest in Kazakhstan's petroleum resources after Japan stepped in to compete over the Russian oil pipelines. Therefore, 2003 witnessed a remarkable acceleration of petroleum activities at China's state-owned oil company, China National Petroleum Corporation (CNPC), in Kazakhstan.

In May 2003 CNPC's subsidiary, China National Oil & Gas Exploration & Development Corp. (CNODC), successfully purchased 25.12 percent of stock shares held by the Kazakh government in Aktobemunaigas Corp. (CNPC Aktobe), which increased CNODC's share in the company to 85.42 percent and thus provided it with absolute decision-making authority. Its annual equity production also increased by more than 1.2 million tons (mts). Between June and October, CNPC signed an agreement with British Nimir Petroleum Ltd. (BNP) on purchasing the total interest of Nimir Petroleum Bars Holding BV (and subsidiary), and thus acquired the 100 percent interest of the block. In addition, CNPC made more purchases of stock shares from BNP and Chevron Texaco North Buzachi Inc

(TNBI), making TNBI the basis of CNPC International Ltd. (North Buzachi).[5]

China also recommenced its effort to construct the 2,800 km cross-border oil pipeline. On 3 June 2003, CNPC and Kazakh's state oil company, KazMunaiGaz (KMG), signed an agreement concerning joint investment evaluation on section-by-section construction of a crude oil pipeline between Kazakhstan and China. CNPC also signed an agreement with the Kazakhstan Ministry of Finance's Committee on State Assets and Privatization concerning the expansion of CNPC's investment in Kazakhstan's oil and gas sectors. Prior to the agreements, CNPC and KMG had jointly completed the building of the westernmost section of the pipeline in March 2003, running 448 km from Atyrau to Kenkiyak in Kazakhstan, which began operating in March 2004.

Map courtesy of the Asia Times

On 17 May 2004, during President Nazarbayev's four-day official visit to China, CNPC and KMG signed an agreement to construct the easternmost part of the oil pipeline, between Atasu and Alashankou. The pipeline runs 988 km and involved an investment of $700 million. It was completed according to schedule and put into operation on 15 December 2005 by President Nazarbayev in Astana. The pipeline will initially transport ten million tons of oil to China annually, and that capacity is expected to double by 2011.[6] The date for construction on the middle section of the pipeline between Kenkiyak and Atasu is not yet decided, but once the eastern part of the pipeline starts to operate, China's oil imports from Kazakhstan, which currently rely on rail and amount to only 1.19 million tons annually, will be greatly enhanced. In addition, CNPC has planned to build a 246 km pipeline in Xinjiang, linking Alashankou and a refinery in Dushanzi.[7]

Map courtesy of the U.S. Department of Energy

The pipeline deal was believed to be driven by China and involved greater political motives than economic concerns. According to Laurent Ruseckas, a Caspian analyst, "China will be paying a premium for the Kazakhstani oil because it will be more expensive to transport east." Indeed, China seemed to be willing to pay this high price in exchange for its energy security, and Russia's impending decision over the Siberian pipeline might have strengthened Beijing's determination over the building of the China–Kazakhstan oil link. According to Yin Juntai, deputy general-manager of CNODC, "The construction of the transnational oil pipeline signifies that the energy cooperation between China and Kazakhstan has stepped into a new phase." The oil pipeline was also seen as serving Kazakhstan's aspirations to become a major oil exporter and helping "make China Kazakhstan's closest partner," as claimed by President Nazarbayev.[8]

Energy-Rooted Conflicts Between Chinese and Western Companies

The rapid expansion of Chinese petroleum activities in Kazakhstan has obviously been regarded as a potential threat to the Western oil companies who have a longer history of operation in the country. Western oil companies have thus responded defensively to Chinese advances. For example, China faced a major blow from Western oil majors when it attempted to buy into the British Gas (BG) Group's 16.6 percent stake in the Kazakhstan Agip KCO group in mid-2003, only to be coldly rebuffed.

Formed in 1997 and expected to begin commercial production in 2007–08, the Agip KCO was composed of Eni-Agip (with 16.67 percent operator), TotalFinaElf, ExxonMobil, BG, Shell (each with 16.67 percent), Inpex, and Phillips (each with 8.33 percent). The consortium signed a 40-year production sharing agreement in the Kashagan field, which holds an estimated 7 to 9 billion barrels of recoverable oil and total geological reserves of 38 billion barrels. When the BG Group announced that it was selling its stake in Agip KCO, the China National Offshore Oil Corp. (CNOOC) and the China Petrochemical Corp. (Sinopec) showed interest in jointly purchasing the shares. This was the first attempt by the two companies to acquire oil assets in Kazakhstan.

In March 2003, Sinopec and CNOOC reached an agreement with BG to buy the latter's 16.7 percent stake (8.33 percent each) in Agip KCO's project to develop the huge Kashagan field. The value of the deal was estimated at $1.23 billion. Nevertheless, the Chinese offer was blocked by other partners within Agip KCO, who exercised their right to preempt the deal and announced their intent to absorb the shares themselves. The reason offered was that the KCO Consortium would prefer to have fewer members facilitating its decision making and that BG's departure was an opportunity to streamline the process. Meanwhile, since Kashagan was thought to be the fifth-largest oil field in the world, where the oil should be sent was an important issue for Agip KCO to decide once the field started commercial production. There were three proposed routes for potential pipelines: one through Russia to the Black Sea, one through Turkey to the Mediterranean, and one through Iran to the Persian Gulf. If the Chinese partners were allowed to join, a fourth potential route would be added to the already complex situation.[9]

In addition to the above concerns, KCO's refusal to admit the Chinese companies was also related to its reluctance to see China become a stronger competitor in central Asia's energy sector. Chinese oil companies were not yet compatible with their Western counterparts, yet they were seen as having strong government support in energy-hunting projects overseas. Consequently, whether to allow Chinese companies to enter a competition was often a question that spilled into the political sphere, beyond the pure business realm of Western oil companies.

Indeed, KCO's blockage of the BG deal not only disappointed the Chinese in their overseas petroleum development, but it also allegedly upset Kazakhstan's government, which desired closer linkage with Beijing for political reasons and to maintain access to China's huge oil markets. The Kazakh government therefore invoked a legal preemption, asking the Agip KCO partners to sell 50 percent of BG's share to KMG.[10] Probably due to similar concerns, the Kazakh government offered stronger support to Beijing with its attempt to overtake PetroKazakhstan in mid-2005.

CNPC's Takeover of PetroKazakhstan

PetroKazakhstan (PetroKaz) was an international petroleum company registered in Canada, but with all of its assets in Kazakhstan. It owned 12 oil fields and exploration licenses in six blocks in Kazakhstan, including full ownership of the oil field Kumkol South, and a joint ownership of Kumkol North with Russia's Lukoil through a 50/50 joint venture, Turgai Petroleum.[11] PetroKaz also owned the Shymkent refinery, the largest refinery in Kazakhstan to meet modern industrial standards. The company's proven reserves were equivalent to 390 million barrels of oil. Faced with a series of legal conflicts with Lukoil as well as pressure from the Kazakh government regarding environmental concerns caused by its gas fire, PetroKaz confirmed on 27 June 2005 that it was considering a sale with an estimated market capitalization of $3.5 billion.

Soon after, CNPC, Sinopec, Lukoil, and India's state-owned Oil & Natural Gas Corp. (ONGC), showed interest in the acquisition. But it was said that the interests of the two countries were incompatible. As an article in *People's Daily* stated, "Facing a similar situation as China in its reliance on Middle East oil imports, India was keen to diversify the sources of supply as well." Since ONGC lacked connections with the Kazakh petroleum industry, it submitted an offer to PetroKaz through ONGC-Mittal Energy Ltd., a joint venture between ONGC and the world's largest steelmaker, Mittal Investments Sarl. Mittal was said to have enjoyed much goodwill in Kazakhstan, so its involvement was expected to ensure that the Kazakh government would not exercise its right of preemption if the ONGC bid were to emerge triumphant.[15]

To enhance the chance of winning the deal, an Indian delegation made a two-day visit to Astana in mid-August. Headed by Deputy Foreign Minister Rajiv Sikri, the delegation included representatives of ONGC, and the talks with their Kazakh counterparts allegedly centered almost exclusively on energy issues. Despite the potential difficulties facing the Indians against a stronger Chinese position in Kazakhstan, Sikri appeared optimistic: "Chinese companies are already here. They are undoubtedly strong. But we are strong too."[16]

According to the *Times of India*, ONGC-Mittal's original offer was around $3.9 billion against a $3.6 billion bid from CNPC. But while CNPC revised its bid to $4.18 billion, the ONGC-Mittal combination was neither given a chance to match the bid nor was it allowed to re-bid.[17] On 23 August, three weeks after

CNOOC withdrew its bid for Unocal due to political pressure from the U.S. government, CNPC signed an acquisition agreement with PetroKaz. Although the Indians complained that the process was unfair, observers believed that there were legitimate reasons why the Chinese were allowed to raise their original bid price: they were ready to proceed without any conditions, whereas the ONGC-Mittal bid was conditional, and the CNPC offer included a large cash component. Therefore, PetroKaz preferred this offer to the Indian bid.

Nevertheless, the signing of the agreement was not the end of story. CNPC soon found itself facing more obstacles. One was from the Kazakh government, which had passed a law declaring for itself the right to preempt the sale of any oil property in the country in order to ensure that strategic control of PetroKaz would stay with the state. Another problem came from Lukoil, which threatened to use its preemptive right to buy the shares in the Turgai Petroleum joint venture between Lukoil and PetroKaz. Besides, the agreement would only come into effect with the approval of two-thirds of PetroKaz shareholders.

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The proposal raised by the Kazakh government required that "an appropriate share" be controlled by KMG "for the sake of national economic security." At an oil and gas exhibition in Almaty, Kazakh Energy Minister Vladimir Shkolnik claimed that "[t]he question of the sale of PetroKaz to CNPC is very serious—we are talking about a strategic project. What shape the deal will take has not been decided, but the government of Kazakhstan will do everything possible to ensure that strategic control remains with the state." Kazakhstan was also reportedly wary of allowing a Chinese company to take over strategic oil assets so close to the frontier. According to a Moscow-based oil analyst, Dmitri Loukashov, "The 600 km between Kumkol and the Chinese frontier is an empty space. Kazakhstan believes it would be dangerous to allow the Chinese to create a stronghold in the area."[18]

Some lawmakers further urged the government to withdraw PetroKaz's oil exploration license for alleged violations of environmental laws and price-fixing. On 28 September, the Kazakh government submitted legal amendments to the local parliament to give the cabinet a priority right to purchase shares and assets of companies extracting oil in the republic. On 12 October, both houses of Kazakhstan's parliament ratified a bill to give Astana the right to intervene in the sale of foreign-held oil companies, which became effective after President Nazarbayev signed it a few days later.[19]

CNPC was reportedly under pressure from the Kazakh government to re-sell up to 50 percent of PetroKaz's shares to state-owned KMG. But the company seemed unwilling to follow the order immediately. In the words of the CNPC spokesman, "Right now, we don't have any such plan."[20] CNPC probably took this approach with the hope that strong Sino-Kazakh political ties could help solve the problem. PetroKaz was also unhappy about the situation. Bernard Isautier, chief executive of PetroKaz, argued that while the Kazakh government could preempt the sale of assets within the country, it could not block the sale of PetroKaz itself. "We are not speaking about a sale of assets where preemptive rights would apply," he said. "We don't expect any problem in that regard."[21]

However, it did not take long for CNPC to realize that it had to satisfy the Kazakh government, because no deal would be possible without the latter's blessing. Moreover, it was said that the Kazakh government had already made a substantial compromise "to give CNPC acreage so close to the border with China." CNPC then started negotiating with KMG. Following "some eleventh-hour diplomacy," CNPC signed a Memorandum of Mutual Understanding with KMG on 15 October, which stipulated that KMG would have 33 percent of PetroKaz's shares over the exploitation of mineral resources, worth $1.4 billion, as well as the right to joint management of the Shymkent oil refinery and oil products in equivalent conditions.[22] Han Xiaoping, vice president of the Falcon Pioneer Technology Co., Ltd. (an energy research firm in Beijing), argued that, legally, the decision of the PetroKaz shareholders should bear more weight than that of the Kazakh government because PetroKaz is a company registered in Canada; in practice, the approval of the Kazakh government was vital to the outcome. In this sense, CNPC's re-sell of 33 percent of share to KMG seemed to be the key to ensure the completion of the deal.

Another challenge came from Russia's Lukoil. Holding 50 percent of Turgai Petroleum, Lukoil claimed that it had the "preemptive right" to buy out the shares of PetroKaz. Lukoil's intervention was "vigorously" opposed by PetroKaz as it was "without merit." But perhaps Lukoil's claim was not only about its business dispute with PetroKaz over the sale of oil or about giving priority to the domestic market of Kazakhstan. It was likely also about geopolitics. "It's possible the Russian energy ministry might dislike seeing Kazakh oil moving 'east and not west'," says Martin Molyneaux, managing director of Institutional Research for FirstEnergy Capital Corp.[23]

On 11 October, PetroKaz received from Lukoil a notice of intention to appear at the hearing on 18 October before the Albert Court of Queen's Bench for consideration of whether or not to approve the CNPC acquisition. A week later, the Albert Court of Queen's Bench held a four-hour hearing from counsel to PetroKaz, CNPC, Lukoil, and certain shareholders, but reserved its decision as to whether to grant the final order until 26 October 2005.

Despite the delay of the court's decision, the CNPC bid was welcomed by PetroKaz shareholders. Before the court's hearing on that same day, 18 October, a special meeting of PetroKaz shareholders was held to consider CNPC's $4.18 billion acquisition. The shareholders offered overwhelming approval by a 99.04 percent vote in favor of the CNPC bid, "setting the stage for the deal to be completed after weeks of political wrangling and uncertainty."[24]

Up to this point, both PetroKaz and CNPC seemed confident about the final result of the acquisition. According to Han Xiaoping, CNPC's offer had no conflict of interest with Canada; therefore, a denial of the deal could only undermine the interests of PetroKaz shareholders and spoil Canada's investment climate. Bernard Isautier also addressed a similar point by asserting that "the transaction is in the best interest of the shareholders." They were proved correct by the final outcome: on 26 October, the court granted its order approving the arrangement involving the CNPC acquisition of PetroKaz for $55.00 cash per share, a total of $4.18 billion.[25]

CNPC's takeover of PetroKaz was viewed as "a consolation prize for China's oil industry," especially after CNOOC's failure in the Unocal deal.[26] The deal would not only add to CNPC's existing stakes in Kazakhstan's petroleum sector, but could also provide China with a better position to expand into other oil projects in the country and, ultimately, west to the Caspian Sea. Upon the takeover, CNPC became the second-largest oil company in Kazakhstan. Kazakhstan became a flagship base for CNPC, second only to Sudan, but with more geographical advantage and less political risk.[27]

Conclusions

With the steady growth of the Chinese economy and its energy demands, Kazakhstan—together with other central Asian states—has become one of the key sources for China's energy supply. In terms of absolute amounts, oil from Kazakhstan still only accounts for a small portion of China's total oil imports: in 2004, China imported 1.19 million tons (8.3 million barrels) of crude oil from Kazakhstan, compared with the country's total imports of 91million tons (636.8 million barrels), about 1.31 percent. Nevertheless, a bilateral strategic partnership underpinned by energy cooperation is believed to fit the fundamental interest of both nations. According to Xinhua during Hu Jintao's 2005 visit, "to expand and deepen cooperation in areas of oil and natural gas is of strategic importance to the economic development of the two countries." On 11 January 2006, during his four-day official visit to Kazakhstan, Chinese Vice President Zeng Qinghong signed a joint communiqué with President Nazarbayev. The two leaders praised the completion of the Sino–Kazakh oil pipeline and vowed to promote energy cooperation between the two countries as part of their strategic partnership.[28]

It seems likely that China's economic and political growth potential will support a stronger role for China in central Asia in the foreseeable future, and this has already triggered great concern among Western analysts. According to Martin Clark from the London based journal *Petroleum Economist*, the operation of the China–Kazakhstan oil pipeline is a triumph for both countries because it demonstrates "Beijing's growing influence" over central Asia and also enables a weakening of Moscow's control over Kazakh oil flow, which previously had to go through two pipelines on Russian territory.[29] William Engdahl, the author of the book *A Century of War: Anglo-American Oil Politics and the New World Order* also claims that China's close energy cooperation with Kazakhstan has not only strengthened its position over energy security, but has also produced a major loss for the United States "over the entire strategic Eurasian region with the latest developments."[30]

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This kind of concern is not groundless, but it is less likely that China will become another "superpower" in the region for three reasons. First, China stands strongly against unilateralism in international affairs. Because of its recognition of the dominant influence of former Soviet states in central Asia, China prefers to rely on the multilateral Shanghai Cooperation Organization (SCO) mechanism to maintain regional stability, and it has done so since the SCO's establishment. The settlement of boundaries between China and the central Asian countries can help China to avoid a bigger military commitment in the region. Meanwhile, despite the dispute between the petroleum companies, including CNPC and Lukoil, Sino–Russian relations in Central Asia show signs of improvement, "underlined by the ever-increasing profile of the SCO."[31]

Secondly, China does not face practical threats from any central Asian states, and its strategic partnership with Russia is working well to ensure it a collective role in dealing with central Asian affairs. Recently, some energy specialists in China have begun to appeal for "a long-term strategy" in energy cooperation with Russia and Kazakhstan. Zhou Dadi, a senior researcher from the State Development and Reform Commission, has pointed out that given the complexity of energy cooperation—which involves not only price, revenue, and industrial policy, but also diplomacy—it is necessary to consider a long-term strategy instead of focusing solely on the volume of oil imported.[32] If China follows this approach and maintains a more open and transparent strategy for its energy security, it will be able to help reduce suspicion from the outside world, especially from Western countries.

Finally, China is still a developing country and needs a peaceful environment for its modernization program. China's global energy search, including its actions in central Asia, serves the purpose of economic development and seeks to ensure a better living standard for the Chinese people. Politically, China has attempted to play a greater role on the world stage, but being a superpower does not meet the principles of China's foreign policy and will not serve China's fundamental interests either. As more oil flows from Kazakhstan to China through the Altaw Pass, the famous "Silk Road" may become a "black road," but the spirit of peace carried out for a thousand years through the "Silk Road" should remain unchanged. The influence of the United States—the only superpower in today's world—in central Asia has already caused uneasiness for many countries, and nobody would like to see another superpower emerging, not even China itself.

NOTES

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