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Why China will keep importing Iranian crude, but volumes will remain limited

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On 22 July, 2019, US Secretary of State Mike Pompeo announced the US's decision to impose sanctions on a Chinese trader, Zhuhai Zhenrong, and its chief executive for 'knowingly purchasing or acquiring oil from Iran, contrary to US sanctions'.[1] While the US State Department's decision to designate a Chinese entity may be seen as a sign of further escalation in the already fraught relations between the US and China,[2] in reality, the choice of Zhuhai Zhenrong allows both the US and China to maintain opposing diplomatic stances on Iran, without further damaging the increasingly fraught bilateral relations. The US can affirm its 'maximum economic pressure' campaign while China can continue importing limited volumes of Iranian oil without exposing its largest traders to US sanctions. As a result, Chinese oil imports from Iran are set to drop slightly from their average levels of 0.45 mb/d in the first half of 2019 (H1 2019), but they are unlikely to go to zero. But as Beijing is unlikely to cut purchases from Iran (both crude oil and LPG) to zero, there is a growing risk that China's imports of Iranian crude get caught up in the increasingly fraught US-China relations.

A convenient scapegoat

Zhuhai Zhenrong is in some ways a convenient scapegoat for both sides. By designating the company, Washington can highlight that it is backing up its sanctions with clear action, sending a strong message to other importers too. But since Zhuhai Zhenrong has limited exposure to the US market, the designation is effectively meaningless. To be sure, the company will struggle to expand and develop its international business, but since its creation in 1994, as one of four licensed state importers of crude oil in China, the company has focused almost exclusively on lifting Iranian crude, accounting for more than 60 per cent of China's trade with Iran, according to its website.[3] In 2012, the Obama administration had already designated Zhuhai Zhenrong and prevented the company from receiving US export licenses, financing from the US Export Import Bank, or any loans over $10 million from US financial institutions. But that did not prevent the company from pursuing its trading activities in Iran, although term volumes have fallen from 0.24 mb/d in 2015[4]–2016[5] to an estimated 0.16 mb/d in 2018–2019, and the company's financial situation has reportedly worsened over the years.[6]

For China too, this is a face saving solution to the extent that the US has avoided designating a Chinese major such as CNPC, Sinopec, CNOOC or smaller traders such as Sinochem or Chemchina—a move that would be devastating for these global traders. Nonetheless, China's ministry of foreign affairs still issued a strong rebuke, stating its opposition to 'the US bullying behaviour of wantonly cracking down, suppressing and sanctioning Chinese companies and individuals based on US domestic law'. It went on to 'urge the US to immediately rectify its wrong behaviour, and stop imposing illegal sanctions against Chinese companies and individuals', adding also that 'China will take all necessary measures to firmly preserve the legitimate rights and interests of Chinese companies and individuals', a stronger stance than the 'strong dissatisfaction and adamant opposition' expressed in 2012.

Indeed, this time round, given the context of a tougher bilateral US-China relationship—especially given the rapid escalation following Trump's threat to impose additional tariffs effective 1 September 2019[7] and China's seeming use of its currency in retaliation—Beijing is more likely to use Iran as another factor for hardening its overall negotiating position vis a vis the US, citing concerns that the

[1] 'The United States To Impose Sanctions on Chinese Firm Zhuhai Zhenrong Company Limited for Purchasing Oil From Iran', *Press Statement, Michael R. Pompeo, Secretary of State*, 22 July 2019, https://www.state.gov/the-united-states-to-impose-sanctions-on-chinese-firm-zhuhai-zhenrong-company-limited-for-purchasing-oil-from-iran/

[2] For a broader overview of US-China relations and their impact on energy, see Michal Meidan, 'US-China: The great decoupling', *OIES Energy Insight 53*, July 2019, https://www.oxfordenergy.org/publications/us-china-the-great-decoupling/?v=79cba1185463

[3] http://zhzrgs.dlztb.com/ (Chinese)

[4] Chen Aizhu, 'China trader renews deal with Iran for 240,000 bpd crude oil in 2015', *Reuters,* 12 December 2014, 'https://af.reuters.com/article/energyOilNews/idAFL3N0TW2X620141212?sp=true

[5] Chen Aizhu, 'China's Iran specialist Zhuhai Zhenrong tips senior crude trader as head', *Reuters*, 2 August 2016, https://www.reuters.com/article/us-china-oil-zhenrong/chinas-iran-specialist-zhuhai-zhenrong-tips-senior-crude-trader-as-head-idUSKCN10D0UX

[6] 'The Mysterious Chinese-State Oil Trader Sanctioned by the U.S.', *Bloomberg*, 23 July 2019, https://www.bloomberg.com/news/articles/2019-07-23/the-mysterious-chinese-state-oil-trader-hit-by-u-s-sanctions

[7] See Michal Meidan, 'US-China Trade Tensions: Here we go again', *Oxford Energy Comment,* August 2019, https://www.oxfordenergy.org/publications/us-china-trade-tensions-here-we-go-again/?v=79cba1185463

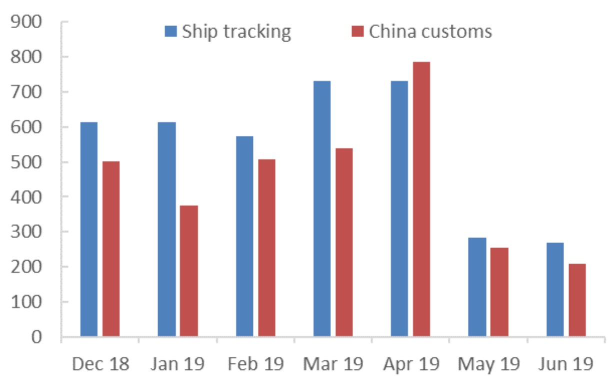
US is destabilising the Middle East,[8] and therefore putting China's own energy supplies at risk. As a result of China's diplomatic principles, and for the sake of its domestic audience, Beijing cannot be seen to be abiding by US sanctions. So, to the extent that Beijing can insulate its larger traders and refiners from US economic sanctions and still secure some supplies from Iran, it will continue to import limited volumes from Iran. But the big question remains, how much lower, and where is it all going?

The curious incident of the missing barrels

Flows of Iranian oil to China in May and June, as reported by Chinese customs, averaged 0.23 mb/d, higher than Zhuhai Zhenrong's estimated term volumes (0.16 mb/d in 2019). This, however, represents a sharp drop from the 0.52 mb/d imported on average between November 2018 and April 2019, although this too was well above the 0.36 mb/d waiver granted to China by the US in November. But while there may be diplomatic value in raising imports from Iran, the commercial rationale is less clear cut. Iranian crude, to the extent that NIOC may be offering it at a discount to Chinese refiners and is going to the trouble of shipping it, holds some economic appeal, but China's state-owned majors and its smaller independent refiners remain reluctant to source Iranian crude directly for fear of being designated by the US. As they have become increasingly integrated in global markets and trading, their exposure to US dollar transactions is far more important than importing Iranian barrels. Moreover, they can and are securing alternative supplies. For example, flows of Saudi crude have surged y/y by 0.44 mb/d in H1 2019 (although this is in part to supply new mega refiners Rongsheng and Hengli), averaging 1.54 mb/d in H1 19, and imports of Iraqi crude have also risen by 74 thousand b/d in H1 2019 from 2018 levels.

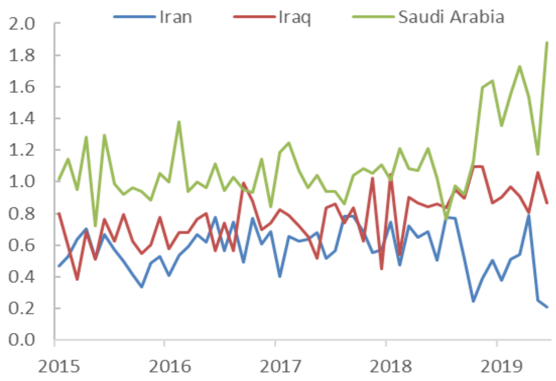
Still, for now Zhuhai Zhenrong is a useful vehicle and given that the company does not own refining or storage in China, the crude it sources from Iran is sold on to domestic refiners or placed in storage. Some of the crude has likely gone into China's Strategic Petroleum Reserve (SPR) programme, with Iranian crude estimated to have filled tanks in Jinzhou (Dalian province, adjacent to NIOC-leased bonded tank space), as well as in Zhoushan, Zhejiang province. But between 20-30 million barrels (mb)—based on the difference between tanker-tracking estimates and official customs data—have gone into bonded tanks in China leased by NIOC, allowing Chinese refiners to draw on Iranian crude and potentially remain insulated from US sanctions.

Figure 1: Iranian imports ship tracking vs customs, kb/d



Source: Bloomberg, China customs

Figure 2: Imports from Iran, Iraq, Saudi, mb/d



Source: China customs

Should overall Iranian imports into China level off or continue to fall, Washington could overlook some of the discrepancies in the data, as well as questions surrounding volumes of Iranian LPG imports into

[8] Ben Blanchard, 'Don't open 'Pandora's Box' in Middle East, China warns', *Reuters*, 18 June 2019, https://www.reuters.com/article/us-iran-nuclear-china/dont-open-pandoras-box-in-middle-east-china-warns-idUSKCN1TJ0B8

China,[9] especially given that tracking physical and financial flows is increasingly challenging.[10] That said, recurring media reports of Chinese defiance[11] will make it harder for Washington to avoid the topic, but it still remains unclear how much Zhuhai Zhenrong is lifting (and whether it is exceeding its term deal) and whether or not CNPC and Sinopec are still lifting equity barrels given that equity barrels do not represent purchases (in the narrow sense) from Iran. But if import volumes rise considerably over several months, or if the US seeks to squeeze Iran even further and decides Chinese imports should go to zero, China will face a difficult choice. Since the US has taken Chinese telecoms giant Huawei to task, it is no longer unconceivable that it would consider designating a Chinese oil and gas major.

Beijing will therefore tread carefully with its Iranian imports. Beijing's need to uphold its independent foreign policy and not be seen as bowing to US edicts suggests the now-sanctioned Zhuhai Zhenrong will continue importing crude into China, but those volumes will remain limited. Indeed, even though China views Iran as an important oil supplier and investment destination, it will want to avoid Iran's crude imports getting caught up in the broader US-China relations—mainly in light of the risk to its large energy traders—even as negotiations with the US have once again reached a dead-end.

[9] Ship tracking data suggests that China is still importing large volumes of LPG from Iran, 'China turns to Iran for LPG, ignoring sanctions', *Bloomberg*, 19 June 2019, https://www.scmp.com/news/china/diplomacy/article/3015172/china-turns-iran-fuel-its-lpg-habit-ignoring-sanctions

[10] Clyde Russel, 'Iran's crude exports are down, but estimates of how much vary wildly', *Reuters*, 1 August 2019, https://uk.reuters.com/article/uk-column-russell-crude-iran/column-irans-crude-exports-are-down-but-estimates-of-how-much-vary-wildly-idUKKCN1UR3O9

[11] Anjali Singhvi, Edward Wong and Denise Lu, 'Defying U.S. Sanctions, China and Others Take Oil From 12 Iranian Tankers', *New York Times*, 3 August 2019, https://www.nytimes.com/interactive/2019/08/03/world/middleeast/us-iran-sanctions-ships.html