South China Sea: Security and Commercial Implications

The South China Sea (SCS) is a hotbed for competing political and military relationships between China, Southeast Asian countries and the US. China, Brunei, Malaysia, the Philippines, Taiwan and Vietnam have overlapping and competing territorial claims amid hardening rhetoric under the pretext of oil and logistical manoeuvres. However, with China increasingly isolated in its position on the SCS, smaller nations are forging new alliances and modernising their military capabilities, raising the risk of escalation.

Prognosis

- China’s rate of land reclamation activities in recent months is sparking concern among rival claimants in the SCS of its military intentions
- Non-China claimants are looking to the US for support, but the lack of unity among Association of South East Asian Nations (ASEAN) countries is allowing China to exploit divisions
- The dispute continues to hamper oil exploration in the SCS amid legal and financial risk for non-regional firms

Security Implications

China currently lays claim to roughly 90 percent of the SCS, overlapping the territorial claims of several of its neighbours. Since 2011, China’s People’s Liberation Army-Navy (PLA-N) vessels have harassed and engaged in standoffs with Vietnamese and Philippine oil exploration vessels, while in 2014, the Haiyang Shiyou-981 oil rig was installed near the Vietnamese-claimed Paracel Islands. Over the past several months, Beijing has been transforming the Subi, Fiery Cross, and Mischief Reefs in the Spratly Islands (see map, page 2) using land reclamation techniques for the construction of port facilities, radar stations, and airports as part of careful efforts to maintain a physical presence and authority without sparking direct conflict. China actually holds fewer islands than its rival claimants, having eschewed the rush for territory in the 1980s, but is now seeking to do as much as it can with the land it holds. Its neighbours remain concerned that military operations could be launched from China’s forward staging bases in the region, given its rapidly expanding armed forces. This would also give China de facto administrative control of the territories and their resources.

China’s reclamation plans are manifest of its increasingly assertive behaviour in the SCS over the past four years. It is such plans, rather than resources, that represent the greater threat to stability in the region. Countries have the ability to share resources and also to contain spats, as demonstrated by the case of the Haiyang Shiyou-981 oil rig, but diplomacy becomes difficult once sovereign control is established over contested territory. For example, China and Japan have largely avoided confrontation over resource fields in the East China Sea, but the disputed Senkaku / Diaoyu islands continue to provoke tensions in the absence of any bilateral agreement. Beijing’s apparent attempt to create a physical presence in the SCS will likely see clarification of the maximum scope of its claims within the nine-dash line (a U-shaped line that refers to the demarcation used by the government of China (PRC) for their claims to much of the SCS), which are at present legally and geographically undefined. This could lead to the declaration by China of a special Air Defence Identification Zone (ADIZ) over the SCS, possibly restricting the freedom of navigation (though the logistical capability of enforcing it remains unclear). Beijing will only press ahead once a degree of control has been exercised on the shoals and reefs it already controls, given that most of the islands and reefs that China claims within the nine-dash line are actually physically occupied by other nations.

Both China and the US appear caught in a controlled escalation strategy, albeit one that could unravel if not carefully managed. The spate of run-ins in disputed territories, whether between coast-guards and fishermen or, more worryingly, between military vessels and aircraft are reflective of the risks of miscalculation. Skirmishes between Chinese and Vietnamese vessels around the HD-981 rig in April 2014 saw the sinking of a Vietnamese fishing boat while related anti-China riots in Vietnam resulted in several...
deaths. Chinese coast guards are accused of harassing Filipino fishing vessels amid warnings of territorial infringement. Military tension in the SCS will continue over the medium-term. Vietnam and the Philippines are improving the military capabilities of their naval forces, as the US, Japan and India also engage in capacity-building to counter Chinese influence. The US will continue to navigate according to international law, but will tolerate a higher degree of risk in order to dissuade China from making further destabilising moves, such as declaring an ADIZ.

Russia does not appear to be as constrained as the US or regional nations in its bilateral relations concerning the SCS. Despite planning to hold military exercises with China in 2016, Russia is supplying Vietnam with defence equipment and vessels, as well as engaging through Gazprom in Vietnamese energy projects off that country’s coast, namely at Cam Ranh Bay. Russia’s relatively neutral security stance in the region is allowing it to operate more freely and seemingly above politically-motivated disputes.

Regional impact

The latest developments contrast with Beijing’s more recent forays in foreign policy as China seeks to soothe relations with South Korea, Japan and India, the latter two with whom China has ongoing territorial disputes. Meanwhile, perceived positive initiatives in Beijing including the Maritime Silk Road and the Asian Infrastructure Investment Bank (AIIB) are unlikely to assuage wider concerns if China’s actions in the SCS continue to raise suspicion of strategic intentions. All Southeast Asian countries are avoiding making a choice between China, as their main trading partner, and the US, their main guarantor of security in the region. However, their resolve may harden in the face of Beijing’s assertiveness, leading to an increase in regional defence spending and forcing Southeast Asian countries to make a choice between China and the US. Aggressive reclamation activity is indicative of China’s growing confidence in its regional importance and its antipathy towards perceived US interference. It is also aimed at ensuring that China meets certain stipulations of the United Nations Convention on the Law of the Sea (UNCLOS) which state that maritime territorial limits apply only from landforms and not from submersible reefs and coral outcrops. In a rare show of unity on SCS issues, the Association of Southeast Asian Nations (ASEAN) issued a statement noting that China’s reclamation activities could “undermine peace, security and stability”. For many ASEAN nations, as well as for Japan and South Korea, unfettered access through the SCS is crucial to meeting energy needs and asserting commercial power. In response, neighbouring countries are forming new and strengthening existing security relationships, especially those with links to the US. Nevertheless, ASEAN remains fractured on the SCS and many other issues. The Philippines and Vietnam have been particularly vocal on the issue, calling for a tougher ASEAN stance while working to strengthen bilateral relations with the US and Japan. Beijing has also refused attempts for it to engage with a case filed by Manila to a UN arbitration panel in 2013. However, strong nationalist sentiments periodically stoked in China may challenge efforts to calm tensions. The US says it takes no position on the sovereignty disputes, remaining concerned about the freedom of navigation, but its policy of pushing collaborative efforts is futile in the absence of unity among non-China claimants. Other Asian nations will continue to look to the US for support, but any dangerous escalation ascribed to the US will be detrimental to wider support in the region.

Commercial Implications

The SCS has vast potential oil and gas reserves, but territorial disputes will delay exploration and production for some years.

The US Energy Information Administration estimates that the SCS holds around 11 billion barrels of oil and 190 trillion cubic feet of natural gas of which the majority is located within uncontested territory close to the various countries’ shorelines; Malaysia has an estimated 5 billion barrels in
its waters, followed by Vietnam, Brunei and China. By comparison, the US is estimated to have proven oil reserves of 30.5 billion barrels and Russia to have proven natural gas reserves of 47.6 trillion cubic meters. However, the geological and technological challenges to drilling a deepwater well (including adverse weather and other factors) mean that extraction is extremely costly. Though this may not dissuade all investors, the risk of becoming mired in a political dispute could.

The SCS has a dearth of international oil companies operating due to divestment and downscaling of operations as they move to Africa and the Americas. This has left space for national oil companies to become the dominant players, along with a smattering of independent exploration and production companies. In 2006, Chevron signed a deal with Malaysian state-owned firm Petronas for exploration in Block 122 in disputed waters east of Vietnam. However, a strong rebuke from China saw Chevron cease operations, despite assurances of protection from Vietnam. Chevron now works within undisputed territorial waters. In 2014, Houston-based Harvest Natural Resources Inc. divested from the SCS after securing rights from China to drill in a block that had been awarded by Hanoi to another company. Other firms with less exposure in China are willing to test Beijing’s resolve. Murphy Oil Corp., which has no operations in China, agreed in 2014 to move ahead with exploration off Vietnam, while ExxonMobil has already worked with PetroVietnam in the SCS. UK-based Forum Energy announced that it would stop its exploration activities after the Philippines’ Department of Energy cited the historic claims case that the Philippines have filed against China.

**Commercial dialogue**

Despite ongoing diplomatic and security tensions, for many years, Philippine-listed energy exploration company Philex Petroleum Corporation and the China National Offshore Oil Company (CNOOC) have engaged in talks over possible joint exploration and the development of the Sampaguita Field in Reed Bank. Stalled Philex-CNOOC talks suggest political interference, but there remains scope for cooperation between Chinese and Southeast Asian firms. Fosun, a private Chinese conglomerate, has acquired Australian energy company Roc’s contracts with Petronas, which include the development of the Balai Cluster fields off the coast of Sarawak. The fields first started production in May 2014 meaning Fosun has de facto acknowledged Malaysia’s jurisdiction, which may have a negative impact on the conglomerate’s domestic operations. The avenue of least risk for international firms is to engage in activities in uncontested areas, but until China clarifies its scope of claims in the SCS, the operating environment will remain uncertain due to the potential for legal risks and political disputes. A longer-term option could see the establishment of Joint Development Zones, which would lower risks due to the economic implications at stake and initial willingness to compromise, opening the way for more rational negotiations.

**Impact on shipping**

Concerns about disruption to shipping in the SCS are pertinent in Washington and Japan, whose vast energy shipments pass through the sea lanes. However, around 60 percent of Chinese oil imports come from countries whose oil exports use the SCS to reach China, giving a mutual interest in protecting shipping lanes. Furthermore, historical precedents for blockades against commercial shipping in open seas are few, with the most effective methods targeting ports, as seen in the Arabian Gulf during the Iran-Iraq War from 1980-1988. The geography of the region also offers an alternative, if expensive option, used by many larger oil tankers, i.e. to divert south through the Java Sea and east of the Philippines.

### Scenarios

**Highest impact:** A skirmish or standoff between vessels from China and rival claimants escalates into isolated live-fire exchange. Relative self-restraint of other claimants emboldens China to act belligerently. The declaration of an ADIZ over the SCS results in commercial airlines forced to file flight details with Chinese authorities, prompting the US to harden its position against China’s activities by sending US naval vessels close to disputed islands.

**Most likely:** An intensification of China’s land reclamation activities leads to further flight incursions by US surveillance aircraft over Chinese-claimed islands. China remains alert to possible flashpoints, with Washington keen to avoid those that could trigger the declaration of an ADIZ. Beijing continues to refuse to engage in bilateral discussions with rival claimants.

**Best Case:** China engages with other claimants, either bilaterally or with ASEAN, who also present a united front over territorial claims. China clarifies its claims in the SCS, allowing oil exploration firms to be more confident in engaging with regional national oil companies.