

Stirring up the South China Sea (IV): Oil in Troubled Waters

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Executive Summary

The South China Sea's hydrocarbon resources are hotly contested though its reserves are unproven. While their potential economic benefit may be considerable, their foremost significance is political, as their division has implications for sovereignty and fundamental law of the sea principles. Exploration frictions have deepened geopolitical fault lines. Competition once framed by verbal warnings and diplomatic pressure today frequently takes the form of physical confrontation. A key factor is China's growing capability and accompanying desire to expand its own exploration while preventing other claimants' activity. In parallel, Beijing has advocated setting aside disputes and developing resources jointly, but as collaboration remains elusive, analysts in China have called for unilateral measures to pressure uncooperative parties. Better would be greater efforts to create mechanisms for preventing competition from becoming conflict, while seeking better understanding of motivations needed for eventual cooperation.

China's state-owned oil majors, known collectively as the "three buckets of oil", have grown rapidly in financial strength and technical capability, especially deep-water drilling. Driven by political zeal and internecine competition, their executives have for years pressed the government for policy and financial support to enable exploration farther from the Chinese shore and deeper into disputed waters. Vietnam, for which crude oil is vital for exports, government revenue and GDP, has made development in the South China Sea a national priority. To insulate itself from Chinese pressure, it actively courts foreign partners, some of which balk due to Beijing's warnings. The Philippines badly need new sources of domestically produced energy, as they import nearly all their crude oil and petroleum products, and their only natural gas field will soon run dry.

While each party's energy hunger could be an incentive for cooperation, joint exploration and development face obstacles. China's precondition that its sovereignty be recognised over the areas concerned raises fear that collaboration amounts to accepting its claims. Vietnam insists on defining overlapping claims pursuant to the UN Convention on the Law of the Sea (UNCLOS) before defining joint development areas. China's maps do not conform to UNCLOS principles, and it refuses to clarify the extent or nature of its claims. Compliance with Philippine law that oil and gas projects must be 60 per cent Philippine-owned, might appear to accept Manila's ownership and by extension sovereignty.

Despite the obstacles, collaboration has been tried. The most advanced partnership, the Joint Marine Seismic Undertaking (JMSU), began as a bilateral agreement between Beijing and Manila in 2004 to survey the seabed for hydrocarbon deposits in some disputed areas. Vietnam joined in 2005, as the area overlapped with its claims. The parties shared expenses and responsibilities equally and worked together. But in late 2007-2008, nationalists in the Philippines accused the government of secret, corrupt concessions that violated the constitution. When the pact expired in July 2008, Manila did not renew it.

The JMSU was conducted under particular circumstances. Most importantly, each party prioritised maintaining stable relations over asserting claims. That ingredient has been missing in recent years marked by frequent friction, heightened

tensions and volatile ties. Another promising opportunity for a joint development agreement of comparable scope is unlikely to appear soon. Beijing (political) and Manila (economic) have incentives to cooperate, but their frigid relationship, resulting from China's assertive actions and the Philippines' subsequent request for international arbitration, has made collaboration an even harder public sale for Manila, and Philippine law remains a problem. Hanoi is less constrained but also economically less motivated to collaborate with China, though they consult on joint exploration outside the mouth of the Gulf of Tonkin.

There are two key challenges. The first is to establish mechanisms to prevent current competition from escalating to the point of conflict, whether by accident or design; the second – the subject of this report – is to understand the motivations and limitations of the players in order to lay the foundations for greater collaboration, first in exploration, then in development.

To preserve the long-term prospect of collaboration and minimise the danger of clashes, parties should refrain from unilateral exploration and exploitation, particularly around land, such as islands in the Paracel and Spratly groups, whose sovereignty is hotly contested. When a more favourable regional environment is restored, steps can be taken to lower the obstacles. China's preconditions might be countered by specifying in legal terms that participation in joint exploration and development does not imply sovereignty concessions.

Misgivings about its maps could be mitigated if China were to move in the direction of framing its claims under UNCLOS, even implicitly. To incentivise Vietnam, for example, it should follow UNCLOS principles in quiet negotiations on the area of joint exploration outside the mouth of the Gulf of Tonkin. In exchange, Vietnam should refrain from trying to open negotiations on the Paracels.

Beijing/Hanoi/Manila/Brussels, 26 January 2016

Stirring up the South China Sea (IV): Oil in Troubled Waters

I. Introduction

The South China Sea is often said to be rich in hydrocarbon reserves, though most deposits are unconfirmed, due in part to the barriers that multiple claims by several coastal states put in the way of exploration.¹ The significance of the potential resources, therefore, is first and foremost political, as entitlement to them derives from sovereignty over land according to principles of the UN Convention on the Law of the Sea (UNCLOS).² Disputes over oil and gas prospecting thus have ramifications that extend well beyond division of resources.

Friction has escalated in recent years into confrontations at sea.³ In 2011-2012, Chinese law enforcement vessels and fishing boats confronted Vietnam's seabed survey ships, three times severing their seismic cables.⁴ In May 2014, Beijing deployed a deep-water drilling rig in waters disputed with Hanoi, triggering a two-month standoff involving dozens of vessels and violent anti-China protests in Vietnam.⁵ The intensity of Hanoi's pushback was substantially due to the fact that the drilling was adjacent to the Paracel Islands, which China occupies and both claim. Beijing's action touched a raw nerve, a government-affiliated analyst in Hanoi said, since Vietnam sees the island group "as being long under illegal occupation, and the government is under public pressure to take it back".⁶

Tensions cooled after China withdrew the rig, but despite the resumption of diplomacy, relations have yet to recover fully, a status described as "the new normalcy" by a senior analyst in a think-tank affiliated with Vietnam's foreign ministry: "Normal, because official exchanges returned to the pre-[rig deployment] situation. New, because there is lower trust in the relationship even though it appears nor-

¹ For additional reporting, see Crisis Group Asia Reports N°s 267, *Stirring Up the South China Sea (III): A Fleeting Opportunity for Calm*, 7 May 2015; 229, *Stirring up the South China Sea (II): Regional Responses*, 24 July 2012; 223, *Stirring Up the South China Sea (I)*, 23 April 2012; and on other maritime disputes, Asia Reports N°s 258, *Old Scores and New Grudges: Evolving Sino-Japanese Tensions*, 24 July 2014; and 245, *Dangerous Waters: China-Japan Relations on the Rocks*, 8 April 2013.

² Generally, under the UNCLOS, coastal states can claim a territorial sea and contiguous zone, an exclusive economic zone (EEZ) and a continental shelf. Within its EEZ and the continental shelf, a coastal state is entitled to a range of economic rights, including to explore, exploit, conserve and manage living and non-living natural resources. 1982 UN Convention on the Law of the Sea, 1833 UNTS 3; 21 ILM 1261 (1982), 10 December 1982, Articles 56 and 77. All South China Sea claimants are parties to the UNCLOS.

³ For history of hydrocarbon-driven frictions in the South China Sea, see Bill Hayton, *The South China Sea: The Struggle for Power in Asia*, (New Heaven and London, 2014), pp. 121-150.

⁴ *Stirring Up the South China Sea (II)*, op. cit., pp. 14-16. "May 27 2011 Press Statement", Petro Vietnam. "Vietnam urged to stop sovereignty violation", *China Daily*, 6 June 2011. "Dispute Flares Over Energy in South China Sea", *The New York Times*, 4 December 2012.

⁵ *Stirring Up the South China Sea (III)*, op. cit., pp. 4-13, 20-23.

⁶ Crisis Group interview, Hanoi, September 2014.

mal”.⁷ Mistrust of Beijing has fuelled calls among the public and foreign policy intelligentsia for the leadership to overcome its ideological suspicion of the West and seek closer economic and security ties with the U.S.⁸

China has taken a similar stance toward the Philippines. In March 2011, two of its law enforcement vessels forced a survey ship doing seismic studies away from the Reed Bank, near the uncontested Philippine island of Palawan. Manila explored legal recourse and in January 2013 began arbitration proceedings against China at the Permanent Court of Arbitration in The Hague under UNCLOS Annex VII.⁹ It asked for a finding that “China has unlawfully interfered with” the Philippines’ exercise of sovereign rights with respect to resources of its exclusive economic zone (EEZ) and continental shelf.¹⁰ It also requested the tribunal to rule illegal the “nine-dash line”, which according to official Chinese maps loops down from the coast to take in most of the South China Sea.¹¹ Beijing has refused to participate and pressured Manila to withdraw the suit.¹²

Beijing, however, has tolerated Malaysia, some of whose natural gas fields are within Chinese-claimed waters, not objecting to its agreement with Brunei to jointly develop energy resources in an area all three claim.¹³ The difference likely reflects appreciation that Malaysia and Brunei downplay their differences with China, while Vietnam and the Philippines seek to rally international support.¹⁴

China’s seeming flexibility partially reflects asymmetry in the economic significance the claimants attach to hydrocarbon resources. Vietnam and Malaysia rely heavily on oil from the South China Sea for export.¹⁵ The Philippines count on domestically produced natural gas to escape what otherwise appears a future of dependence on polluting coal or expensive liquefied natural gas (LNG) imports.¹⁶ China, though energy hungry, has access to diversified sources of imported fuel, some of which arguably are less politically costly to obtain than the South China Sea’s unproven, disputed reserves.

⁷ Crisis Group interview, Hanoi, August 2015.

⁸ Crisis Group interviews, Vietnamese foreign policy analysts and foreign ministry officials, Hanoi, September 2014 and August 2015; Beijing, April 2015.

⁹ “Philippines halts tests after China patrol challenge”, BBC, 8 March 2011. *Stirring Up the South China Sea (III)*, op. cit., pp. 14-19.

¹⁰ “Arbitration between the Republic of The Philippines and the People’s Republic of China”, press release, Permanent Court of Arbitration at The Hague, 29 October 2015.

¹¹ Based on the definition by the International Hydrographic Organization of the South China Sea, bordered, clockwise from the north, by China, Taiwan, the Philippines, Malaysia, Brunei, Indonesia, Singapore, Thailand, Cambodia and Vietnam, the U.S. Department of State estimates the nine-dash line encompasses 62 per cent of the South China Sea. “China: Maritime Claims in the South China Sea”, *Limits in the Sea*, no. 143, U.S. Department of State, 5 December 2014, p. 4. “Limits of Oceans and Seas”, International Hydrographic Organization, 1953, pp. 30-31. Media reports often refer to estimates of 80 to 90 per cent. See, for example, “Analysis, China’s nine-dashed line in South China Sea”, Reuters, 25 May 2012.

¹² *Stirring Up the South China Sea (III)*, op. cit., pp. 17-19.

¹³ *Stirring Up the South China Sea (II)*, op. cit., p. 16.

¹⁴ Crisis Group interviews, Chinese analysts, Beijing, August and October 2014.

¹⁵ See Section III for analysis of Vietnam’s energy profile. Malaysia’s energy sector accounts for about 20 per cent of its GDP. It holds estimated reserves of five billion barrels of crude oil and liquids and 80 trillion cubic feet of natural gas in the South China Sea, the largest of the coastal states. “Malaysia: International energy data and analysis”, U.S. Energy Information Administration (USEIA), updated 29 September 2014.

¹⁶ See Section IV for analysis of the Philippines’s energy profile.

Beijing's apparent flexibility also reflects the elasticity of its claims. It declares "China has indisputable sovereignty over the islands in the South China Sea and the adjacent waters, and enjoys sovereign rights and jurisdiction over the relevant waters as well as the seabed and subsoil thereof". But it defines "adjacent waters" or "relevant waters" vaguely, offering only a rough delimitation within the nine-dash line, an area that significantly overlaps EEZs asserted by Brunei, Malaysia, the Philippines, Vietnam and Indonesia.¹⁷ It has deliberately maintained "strategic ambiguity" by clarifying neither the coordinates and legal basis of that line, nor the sovereign rights and jurisdiction it intends to enforce within it.¹⁸

Vietnam has the second most expansive claim. It asserts sovereignty over the entirety of the Paracel and Spratly Islands, the most significant land features in the South China Sea. The Philippines claim the western section of the Spratlys (the Kalayaan Island Group) and the Scarborough Shoal. Malaysia claims sovereignty over a cluster of features in the Spratlys close to its coast, and Brunei claims two Spratly features.¹⁹

China has also proposed joint development as a provisional measure before settlement of sovereignty disputes. Sound in principle, this has met lukewarm responses from most other claimants, who see the presumption the nine-dash line would be the starting point of negotiations for joint development as fundamentally unfair. That line contradicts a cardinal principle of UNCLOS, to which all claimants are parties, namely that "the land dominates the sea", so a coastal state can claim maritime zones based only on land over which it has sovereignty.²⁰

The consequent failure of joint development as a confidence-building measure has had a destabilising effect, as Beijing blames rival claimants for not reciprocating its gesture for collaboration. As oil companies acquire the technology, capital and appetite for deep-water drilling, pressure has been increasing on the government to respond by undertaking unilateral exploration and development. The artificial islands under construction since early 2014 in the Spratlys could enable logistic support that enhances the capabilities of the companies and their drilling platforms, as well as surveillance vessels and coast guard ships, both to explore further into the southern part of the South China Sea and to obstruct rival claimants' activities.

This is the fourth Crisis Group report on South China Sea disputes. The first two, published in 2012, examined competition and lack of coordination among China's government agencies that drove them to stoke tensions and analysed factors that motivated other claimants, especially Vietnam and the Philippines, to assert their positions. The third focused primarily on the domestic, diplomatic, strategic and geopolitical drivers of events since late 2012 and their implications for regional security. This report studies the economic and political factors that motivate the

¹⁷ Chinese Mission Note Verbale no. CML/17/2009, to the UN Secretary-General, 7 May 2009.

¹⁸ Crisis Group interviews, Chinese scholars, Beijing, August 2014, July 2015. Some Chinese scholars have urged China to assert "historical rights within the nine-dash line ... in respect of fishing, navigation, and exploration and exploitation of resources". Gao Zhiguo, Jia Bingbing, *The Nine-Dash Line in the South China Sea: History, Status and Implications*, (Beijing, 2014).

¹⁹ Hong Thao Nguyen, "Vietnam's Position on the Sovereignty over the Paracels & The Spratlys: Its Maritime Claims", *Journal of East Asia & International Law*, V JEAİL (1) 2012, pp. 168-195. Republic Act. No. 9522, Republic of the Philippines, 10 March 2009. J. Ashley Roach, "Malaysia and Brunei: An Analysis of their Claims in the South China Sea", CNA, August 2014.

²⁰ See Crisis Group Report, *Stirring up the South China Sea (I)*, op. cit., pp. 3-4.

competition for hydrocarbon resources and the prospect for eventual joint development. China, the Philippines and Vietnam (the most active claimants) are the main subjects. It is based principally on interviews in Beijing, Manila, and Hanoi with government officials, diplomats, security and energy analysts, academics and lawyers, many of whom requested that their names be withheld.

II. China's March to the Sea

A. "Three Buckets of Oil"

China's appetite for fossil fuels in the South China Sea grew with its hunger for energy, overall foreign policy assertiveness and technical capabilities. Nicknamed the "three buckets of oil", the national oil companies (NOCs) – China National Offshore Oil Corporation (CNOOC), China National Petroleum Corporation (CNPC) and China Petroleum & Chemical Corporation (Sinopec) – have led the march, their eagerness for development driven by potential political gains as much as economic interest and intensified by competition.

The NOCs are overseen by the State-owned Assets Supervision and Administration Commission of the State Council, but the Central Organisation Department of the Chinese Communist Party (CCP) appoints their top executives, who are also the companies' leading party cadres and typically hold vice ministerial rank.²¹ It is not rare for NOC executives to ascend to prominent political positions.²² Economic and commercial interests, therefore, may not be the only determinants when NOC executives make business decisions. "They could have hoped to use achievement in the South China Sea to propel their political careers", said a Chinese maritime policy analyst.²³

CNOOC, China's largest offshore oil and gas producer, was created in 1982 with exclusive rights to offshore exploration, development, production and sales.²⁴ Due to technical constraints and political considerations, its operations in the South China Sea were until recently confined to shallow, undisputed waters. It lost its offshore monopoly in 2004, when CNPC obtained government permission to explore and develop eighteen South China Sea blocks, some in the disputed waters around the Spratlys. Sinopec was reported to have also submitted applications for offshore permits, including in the South China Sea, and a competition among the three NOCs began there.²⁵ Executives lobbied the government for permission and support, often in the name of asserting Chinese sovereignty.

In 2008, CNOOC announced it would invest about \$32 billion over ten to twenty years in developing the South China Sea, which CEO Fu Yucheng declared a "priority". During the National People's Congress the following March, delegate and CNOOC executive Song Enlai urged the government to boost policy and finan-

²¹ Kjeld Erik Brødsgaard, "Politics and Business Group Formation in China: The Party in Control?", *China Quarterly*, September 2012, pp. 633-634. Wang Yupu (王玉普), who was appointed chairman of Sinopec in May 2015, retained his ministerial-level ranking from his previous position as deputy secretary of the party leadership group and vice president of the Chinese Academy of Engineering. "‘三桶油’同日宣布换帅 中石化送走改革派迎来技术派", 《新京报》 ["Three buckets of oil' announce changes to commanders same day, Sinopec sent off reformist and welcomes technocrat", *The Beijing News*], 5 May 2015.

²² Zhou Yongkang, CNPC general manager 1996 to 1998, for example, joined the leadership top rank by becoming a member of the CCP Politburo Standing Committee in 2007 and China's domestic security czar. In retirement, he fell to corruption charges in 2015. "周永康简历", 人民网 ["Resume of Zhou Yongkang", *People's Daily* (online)], 29 July 2014. "Profile: China's fallen security chief Zhou Yongkang", BBC, 11 June 2015.

²³ Crisis Group interview, Beijing, October 2014.

²⁴ Lianyong Feng, Yan Hu, Charles A.S. Hall and Jianliang Wang, *The Chinese Oil Industry: History and Future*, (New York, Heidelberg, Dordrecht and London, 2013), pp. 36-37.

²⁵ "中石油'出海'悄然获批 三大巨头展开海上角逐", 《北京晨报》 ["CNPC quietly obtains permit to 'put out to sea', three giants begin maritime competition", *Beijing Morning Post*], 7 July 2004.

cial support for deep-water exploration there, an urgent task, he said, because claimant countries were engaged in “predatory exploitation” in Chinese waters.²⁶ During the People’s Political Consultative Conference, held at the same time, delegate and former CNPC Vice President Jia Chengzao said, “China already has the technical capability for large-scale oil and gas exploitation in the South China Sea. It is necessary for the state to treat it as a priority and provide policy support”.²⁷

Imports exceeded 50 per cent in China’s oil consumption in 2009, prompting the National Development and Reform Commission to convene experts to evaluate hydrocarbon exploitation in the South China Sea in early 2010. Soon after, Sinopec allotted about \$28.3 million for a survey vessel to enhance its maritime exploratory capability, and the competition between the three NOCs intensified.²⁸

Drilling in the disputed waters is politically sensitive, technically challenging and financially risky, since deposits are unproven. A Chinese energy analyst said in 2011 that “China would rather go to Africa”, as the South China Sea was “too troublesome”.²⁹ At the time, the NOCs also lacked in-house capability to drill deeper than 300 metres.

Beijing once seemed to prioritise good relations with neighbours, quietly calling off controversial projects. After Vietnam protested in 1994, CNOOC abandoned a joint exploration project with the U.S. firm Crestone Energy near the Spratlys.³⁰ In 2009, Sinopec backed away from drilling in a disputed area when Hanoi protested after company sources leaked the plan to the press.³¹

Exploration in the South China Sea cannot be done without the state providing policy support and underwriting the risk. Such sponsorship materialised as China grew richer, more powerful, hungrier for energy and bolder in its quest for resources in the South China Sea. In hindsight, 2012 was a turning point. “The Twelfth Five-Year Plan for the Development of National Strategic Emerging Industries”, issued by the State Council that year, included the goal of obtaining indigenous capability for the design and manufacture of deep-water resource exploitation equipment by 2015.³² The eighteenth party congress in November, when the CCP also completed its once-in-a-decade leadership transition, set a goal of building China into “a maritime power”.³³ In June 2012, responding to a Vietnamese law with new navigation regulations covering the disputed Paracel and Spratly Islands, CNOOC offered oil exploration leases for bid in nine blocks within the disputed areas.³⁴

²⁶ “宋恩来代表：建议加大南海油气资源开发力度” [“Rep. Song Enlai: Suggest Strengthening Oil and Gas exploration in the South China Sea”], China.com, 10 March 2009.

²⁷ “中石油前副总：中国已具备大规模开发南海油气田能力” [“Former CNPC VP: China has capability for large-scale oil and gas exploitation in South China Sea”], chinanews.com, 9 March 2009.

²⁸ “中石化挺进深海，10.6 亿新购海洋物探船”，《21 世纪经济报道》 [“Sinopec marches toward deep-water, spends 1-billion on maritime surveillance vessel”, 21st Century Business Herald], 6 August 2010.

²⁹ Crisis Group interview, Hainan, November 2011.

³⁰ Ibid.

³¹ “中石化计划明年在南海钻探第一口深水油气井”，《东方早报》 [“Sinopec plans to drill the first deep-water oil and gas well in the South China Sea”, *Dongfang Daily*], 17 June 2009. Crisis Group interview, Chinese maritime strategy analyst, Beijing, October 2014.

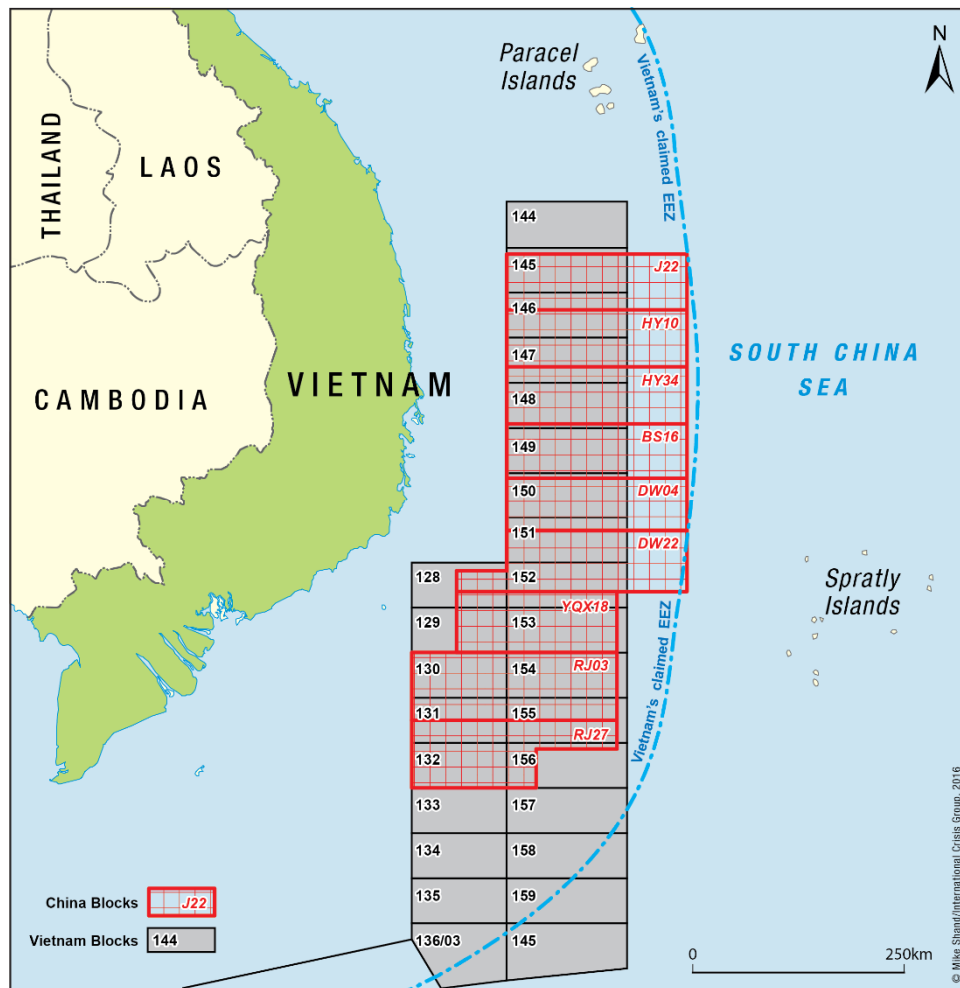
³² “The 12th 5-Year Plan for the Development of National Strategic Emerging Industries”, Article 4, State Council, 9 July 2012.

³³ “十八大在京开幕 胡锦涛作报告”，财新网 [“Eighteenth part congress opens in Beijing, Hu Jintao delivers report”, Caixin (online)], 8 November 2012.

³⁴ “中海油公布南海招标区块”，中新社 [“CNOOC announced SCS blocks open for bids”, China

It may not be a total coincidence that Haiyangshiyou (HYSY) 981, China's first indigenously-designed and manufactured ultradeep-water semi-submersible drilling platform, began operations in May 2012, drilling its first well in the Liwan gas field, 198 nautical miles from Hong Kong. Ten years and roughly \$1 billion in the making, it is owned by CNOOC, operated by its subsidiary, China Oilfield Services, and reportedly increases China's deep-water drilling capability from 300 to 3,000 metres.³⁵ However, it spent part of 2013 in repairs.³⁶

Map 1: Overlapping CNOOC and PetroVietnam blocks



News Service], 27 June 2012.

³⁵ “我国首座深水钻井平台‘海洋石油 981’首钻成功”，新华社 [“China’s first deep-water drilling platform ‘HYSY 981’ successfully conducts first drill”, Xinhua News], 9 May 2012; “‘海洋石油 981’建造记：为南海而生”，《瞭望东方周刊》 [“The building of ‘Haiyangshiyou 981’: Born for the South China Sea”, Oriental Outlook], 21 July 2014.

³⁶ James Manicom, “The Energy Context behind China’s Drilling Rig in the South China Sea”, *China Brief*, vol. 14, issue 11, 4 June 2014.

Map 2: Deployment of HYSY 981



Said to be “born for the South China Sea”, HYSY 981’s mission has always been more than commercial. Then CNOOC Chairman Wang Yilin called it on commissioning “mobile national territory” that would help “ensure our country’s energy security, advance maritime-power strategy and safeguard our nation’s maritime sovereignty”.³⁷ In May 2014, China deployed it seventeen nautical miles from the south-western-most island in the Paracels, whose sovereignty Vietnam also claims. The ferocity of Hanoi’s pushback and a chorus of regional criticism prompted Beijing to quietly adjust tactics. HYSY 981 was sent to the Bay of Bengal from February to April 2015.³⁸ In June, it was again deployed to an area where Chinese and Vietnamese claims overlap, but on the Chinese side of the median line between the two coasts. Hanoi largely remained mute.³⁹

³⁷ “中国骄傲：记‘海洋石油 981’深水半潜式钻井平台”，《经济日报》[“China’s pride: The story of ‘Haiyangshiyou 981’ deep-water semi-submersible drilling platform”, *Economic Daily*], 8 August 2012; “China’s first deep-water drilling platform”, op. cit.

³⁸ Crisis Group Report, *Stirring up the South China Sea (III)*, op.cit., p. 4. “海洋石油 981’孟加拉湾完成海外首秀”，《人民日报》[“HYSY 981’ completes its first overseas drilling in the Bay of Bengal”, *People’s Daily*], 13 April 2015.

³⁹ “中国再次在南海部署‘海洋石油 981’钻井平台”，财新网 [“China redeploys ‘HYSY 981’ in South China Sea”, *Caixin* (online)], 27 June 2015. “China’s HD-981 Oil Rig Returns, Near Disputed South China Sea Waters”, *The Diplomat*, 27 June 2015. Crisis Group interview, Vietnamese analyst, Hanoi, August 2015.

China, however, has not given up its ambition to develop the South China Sea. Construction of HYSY 982 began in July 2015. Expected to be delivered in the second half of 2016, it is said to be a sixth-generation deep-water, semi-submersible drilling rig specifically designed for “hazardous weathers in the South China Sea”.⁴⁰

B. Hainan Province

The NOCs have not been the only ardent supporters of and participants in South China Sea ventures. China’s island province Hainan has claimed to govern all South China Sea islands and their surrounding waters since 1988.⁴¹ Its officials often have a maritime background. Current governor Liu Cigui served as director of the State Oceanic Administration and political commissar of the coast guard.⁴² A booming resort island, Hainan relies on natural gas for power generation and transportation. It is highly dependent on CNOOC production from the South China Sea and faces a growing supply deficit. In 2011, offshore fields supplied 97 per cent of its natural gas.⁴³ In 2014, CNOOC estimated Hainan’s annual natural gas consumption had grown to 5.6 billion cubic metres (bcm), while supply remained at 4.4 bcm, leaving a deficit of 1.2 bcm to be filled by imported LNG.⁴⁴

Unsurprisingly, Hainan has long pushed for more aggressive development of the ocean. In January 2006, then Governor Wei Liucheng, formerly CEO of CNOOC, prioritised tourism, deep-sea fishing and energy exploration in the South China Sea in the province’s next five-year development plan.⁴⁵ In March 2006, during the fourth session of the Tenth National Political Consultative Conference, Hainan delegates proposed a bill that described expanding exploration further out into the South China Sea as vital to the defence of China’s maritime rights and interests.⁴⁶ In 2014, Hainan’s Political Consultative Standing Committee proposed to “push the central government to partially decentralise the rights of energy development in the South China Sea; support Hainan’s participation in the development of South China Sea ... actively support CNPC, CNOOC and Sinopec’s energy surveillance and development in the South China Sea ... and encourage large-scale offshore oil field service companies to set up offices in Hainan”.⁴⁷ It has been unsuccessful, but not for want of trying.

⁴⁰ “大船集团‘海洋石油 982’钻井平台开工” [“DSIC began construction of ‘HYSY981’”], chinaship.cn, 27 July 2015.

⁴¹ “Overview of Hainan”, provincial government website, http://en.hainan.gov.cn/englishgov/AboutHaiNan/200909/t20090910_7125.html.

⁴² “Resume of Liu Cigui”, Archive of Chinese leaders and officials, <http://cpc.people.com.cn/gbzl/html/121000987.html>.

⁴³ “海南迎天然气消费时代，”气荒”问题将解决”，《中国日报》[“Hainan welcomes the era of natural gas, ‘gas famine’ will be solved”, *China Daily*], 1 August 2011.

⁴⁴ “海南液化天然气项目完成，八月底向全岛供气”，《海南日报》[“Hainan completes LNG project, supply starts island-wide late August”, *Hainan Daily*], 7 August 2014.

⁴⁵ 卫留成，”关于海南省国民经济和社会发展第一个五年规划纲要的报告” [Wei Liucheng, “Report on the 11th Five-Year Plan for Hainan’s socioeconomic development”], 16 January 2006.

⁴⁶ “海南全国政协委员联名提议：加大南海资源开发”，新华社 [“NPCC delegates from Hainan propose to step up development of South China Sea resources”, *Xinhua News*], 5 March 2006.

⁴⁷ “省政协：海南打造 21 世纪海上丝绸之路南海基”，人民网 [“Provincial Consultative Standing Committee: Hainan to become South China Sea base for 21st Century Maritime Silk Road”, *People’s Daily* (online)], 21 January 2015.

C. *The Ship Builder*

China Shipbuilding Industry Corporation (CSIC), the country's largest and also state-owned, built HYSY 981, which on delivery was hailed as a major boost to a shipbuilding industry that, facing overcapacity, had hung its hopes for revival on "a rapid expansion of the offshore equipment market".⁴⁸ CSIC has been a strong advocate for hydrocarbon exploration in the South China Sea. During the March 2014 National People's Congress, Chief Engineer Yan Kai, representing Jiangsu province, said the lack of ocean infrastructure had handicapped economic development, including "oil and gas exploitation in central and southern South China Sea". He proposed China "urgently" build multiple sea bases to give "comprehensive support" for development of the South China Sea and defence of sovereignty.⁴⁹ Around that time, China began the large-scale construction of artificial islands in the Spratlys that it said would serve both civilian and defence purposes.⁵⁰

⁴⁸ "深水钻井平台运行平稳 造船业角逐海工装备市场", 新华社 ["Deep-water drilling platform operates smoothly, shipbuilding industry competes in offshore equipment market", Xinhua News], 24 August 2012.

⁴⁹ "全国人大代表呼吁提高南海基础设施水平 建议建设南海辐射基地", 中国日报网 ["NPC delegate calls for enhancement of South China Sea infrastructure, proposes construction of South China Sea radius bases", China Daily (online)], 9 March 2014.

⁵⁰ Crisis Group Report, *Stirring up the South China Sea (III)*, op. cit., pp. 7-8.

III. Vietnam's Reliance on Oil

Vietnam is fourth in South East Asia for oil and gas production, after Indonesia, Malaysia and Brunei. The bulk of its reserves are in the South China Sea and Gulf of Thailand. A net exporter of crude oil but a net importer of oil products, with domestic consumption increasing in line with robust growth that surged by more than 70 per cent between 2004 and 2013, it has been self-sufficient in natural gas. However, demand is projected to surpass supply eventually, particularly in the south. The 2011 Gas Master Plan includes initiatives to promote natural gas in the primary energy mix, gas production and consumption targets and detailed infrastructure plans for gas gathering systems, pipelines and processing facilities.⁵¹

Vietnam gives high priority to developing South China Sea economic resources. Policy directives by the Vietnamese Communist Party's (VCP) top echelon since the early 1990s have specified that "becoming a strong marine economy" is the "strategic goal". Official documents set guidelines for development of sea-related industries, especially hydrocarbons and fisheries. The most important is the "Vietnam Maritime Strategy Toward the Year 2020", adopted by the Central Committee in 2007, which set the target that sea-related economic activities should be 53-55 per cent of GDP and 55-60 per cent of exports by 2020.⁵²

Oil and gas extraction has been a large feature of its marine economy. In August 1975, a few months after toppling the South Vietnamese government, the triumphant VCP issued a resolution outlining guidelines for oil and gas exploration throughout the country. It identified the continental shelf off the southern coast and the Tonkin Gulf in the South China Sea as priority exploration areas, but it was not until 1986 that Vietnam, with help from the Soviet Union, produced its first barrels of oil from the Bach Ho (White Tiger) field in the South China Sea.⁵³ Since then, a series of party resolutions and nation strategic plans have promoted development of the oil and gas industry.⁵⁴

A. *PetroVietnam*

The national priority accorded to the oil and gas industry gave rise to the Vietnam Oil and Gas Group (PetroVietnam). Wholly owned by the central government, it is responsible for all oil and gas exploration and production, as well as storage, processing and distribution, on its own or through joint ventures.⁵⁵ By early this decade, it had become Vietnam's largest corporation, accounting for about 20 per cent of GDP and generating 25 to 30 per cent of annual government revenue.⁵⁶ Its chairman, appointed by the prime minister, also serves as party secretary and a mem-

⁵¹ "Vietnam country analysis", USEIA, updated November 2014. "Oil and gas law in Vietnam: An overview", Norton Rose Fulbright, July 2013.

⁵² Le Hong Hiep, "Vietnam's South China Sea Disputes with China: The Economic Determinants", *The Korean Journal of Defense Analysis*, vol. 2, no. 2, June 2014, p. 178.

⁵³ "History of PetroVietnam", company website, updated 5 May 2010, http://english.pvn.vn/?portal=news&page=detail&category_id=7&id=1057.

⁵⁴ Le Hong Hiep, *op. cit.*, p. 179.

⁵⁵ "South China Sea", USEIA, updated 7 February 2013. "Vietnam country analysis", *op. cit.*

⁵⁶ Le Hong Hiep, *op. cit.*, p. 179.

ber of the VCP Central Executive Committee.⁵⁷ The company's general director (equivalent to CEO) is appointed by the PetroVietnam Members' Council with the prime minister's approval.⁵⁸ PetroVietnam thus has a major role in making laws, regulations and policy concerning the oil and gas industry.⁵⁹

Given the outsized share of oil – crude petroleum was the third largest category in 2013 – in overall exports, GDP and government revenue, the recent decline in prices has meant pressure to increase production. PetroVietnam has in recent years intensified deep-water exploration and exploitation activities with the hope of bringing new fields into production.⁶⁰ It also has at times been on the front line of disputes with China. In 2012, after CNOOC opened bidding on blocks within Vietnam's claimed EEZ, PetroVietnam called the Chinese action illegal and urged foreign firms to stay away.⁶¹

B. *Foreign Partners*

With claims significantly overlapping, Vietnam's endeavours in the South China Sea have frequently resulted in friction with China. Partly to insulate itself from pressure, PetroVietnam actively courts foreign partners and had signed about 100 exploration and production contracts by 2013.⁶² Leaked U.S. State Department cables revealed Chinese campaigns since 2006 to persuade companies such as BP, Chevron, ConocoPhillips and ExxonMobil to cancel oil exploration deals. BP and Chevron, both with significant investment in China, cancelled operations after Beijing warnings, though BP insisted its decision was purely "commercial". ConocoPhillips divested its interest in South China Sea blocks. ExxonMobil, which has limited stakes in China, continued exploration with PetroVietnam.⁶³

In 2006, ONGC Videsh, an Indian state-owned oil exploration corporation, obtained permission from Vietnam to explore several blocks (including 127 and 128) in the South China Sea in waters also claimed by China. In 2011, Beijing warned ONGC that its activities were illegal and violated China's sovereignty, but the pressure seemed to have backfired.

After relinquishing its lease on Block 127 where it found no oil or gas, ONGC in June 2012 also sought to abandon Block 128 as not commercially viable. However, it later extended that lease three times, reportedly at insistence of the Indian foreign ministry, which was said to want to maintain the country's strategic presence in the South China Sea via its NOC. The current lease expires in June 2016. ONGC and PetroVietnam further agreed to expand cooperation on exploration and production in September 2014. According to Vietnamese analysts, "Chinese pressure has made India dig in and become more determined to work with Petro

⁵⁷ "Task handover by PetroVietnam Chairman of Board of Directors and the Party Secretary", TMC News, 9 June 2014.

⁵⁸ "Oil and gas law in Vietnam", *op. cit.*

⁵⁹ "Vietnam country analysis", *op. cit.*

⁶⁰ "Vietnam may raise crude oil output in pursuit of economic growth", *Thanh Nien News*, 30 June 2015. "Vietnam Sees Oil Output in 340,000 Barrel Range for 'Few Years'", Bloomberg, 1 December 2013. Le Hong Hiep, *op. cit.*, p. 180.

⁶¹ "Vietnam Spars With China Over Oil Plans", *Wall Street Journal*, 27 June 2012.

⁶² "Oil and gas law in Vietnam", *op. cit.*

⁶³ "2008 Recap of the Sino-Vietnam South China Sea Territorial Dispute", U.S. embassy Hanoi cable, 20 January 2009, as made public by Wikileaks. "China Flexes Might With Energy Giants", *Wall Street Journal*, 16 July 2014. Bill Hayton, *The South China Sea*, *op. cit.*, pp. 121-150.

Vietnam”, despite questionable commercial prospect.⁶⁴ After Vietnam accused China of interfering with its exploration, the chief admiral of India’s navy pledged in December 2012 to protect ONGC’s interest in the South China Sea.⁶⁵

⁶⁴ “ONGC gets one-year extension to explore Vietnam block in South China Sea”, *The Economic Times*, 27 August 2015. “ONGC looks for equity partner in Vietnam project”, livemint.com, 6 April 2014. Crisis Group interviews, Hanoi, August 2015.

⁶⁵ “India’s South China Sea Gambit”, *The Diplomat*, 5 December 2012.

IV. The Philippines' Hunger for Energy

The Philippines import more than 90 per cent of their crude oil and petroleum products, as they produce only a minuscule amount domestically. In 2014, about 75 per cent of the crude oil imports originated from the Middle East, with Saudi Arabia alone supplying 57.1 per cent.⁶⁶ State-owned Philippines National Oil Company (PNOC) is the primary operator in the oil and gas industry.⁶⁷ Its chairman is appointed by the president and is simultaneously secretary of the energy department.⁶⁸

The Malampaya natural gas field – jointly operated by PNOC, Shell and Chevron – is the largest source of energy, providing 30 per cent of power needs.⁶⁹ For the last few years, it has been the primary power source for Luzon, the largest and most populous island. The gas reserve is expected to run dry, though the estimated depletion date has been extended from around 2024 to 2029 or 2030 thanks to new extraction technology.⁷⁰ Electricity demand in Luzon is projected to increase by 4.59 per cent annually in the same period.⁷¹ Without a new supply and unable to import LNG due to lack of infrastructure, the Philippines will have to rely more heavily on coal for power generation.⁷²

Developing new energy sources has proved extremely challenging, if not impossible, for the Philippines. Such projects – financially risky, capital intensive and technologically demanding – are impossible without foreign partners, as “even the biggest Philippine company doesn’t have that kind of resources or experience”.⁷³ Most blocks explored or studied for potential reserves are “marginal”, meaning small, thus unattractive to large conglomerates. The only sizable commercial-grade natural gas reserves are on the Reed Bank, which Manila claims as part of its EEZ but is within Beijing’s nine-dash line.⁷⁴

Despite five rounds of offering blocks for bidding since the early 2000s, the Philippines have failed to attract large investors. “We went around the world to attract bidding. Nobody came. Not a single bid”, said Eduardo Manalac, former energy under-secretary, recalling the disappointment after the first effort in 2003. Many foreign companies, he said, stayed away for fear the maritime boundary dis-

⁶⁶ “Oil Supply/Demand Report FY 2014”, The Philippine energy department.

⁶⁷ Created by presidential decree in 1973 following the global oil crisis, its original mission was to secure an adequate oil supply. Its charter was later amended to include oil exploration and development, and the company branched into gas and other areas as a “total energy” company. “About PNOC”, company website.

⁶⁸ Crisis Group interviews, former and current officials, Philippine energy department, Manila, June 2015. Confirmed in review of recent PNOC chairmen from PNOC website.

⁶⁹ “The Philippines Country Analysis”, USEIA, updated December 2014.

⁷⁰ “Malampaya gas to last till 2030, says study”, *The Philippine Star*, 29 September 2014.

⁷¹ “Final Report on the Data Collection Survey on Utilization of Clean Alternative Energy in the Republic of the Philippines”, Philippines energy department, March 2012.

⁷² Crisis Group interview, Jay Layug, former under-secretary, Philippine energy department, senior lawyer, Manila, June 2015.

⁷³ Crisis Group interview, Guillermo R. Balce, former under-secretary, Philippine energy department, Manila, June 2015.

⁷⁴ Crisis Group interview, Jay Layug, former under-secretary, Philippine energy department, senior lawyer, Manila, June 2015.

pute with China would jeopardise their investment. “We threw a party and nobody came”, he recalled with chagrin.⁷⁵

The companies’ concerns about Chinese interference have proven justified. Forum Energy, a UK-incorporated upstream oil and gas firm with a Philippines focus, acquired a 70 per cent interest in a service contract awarded by Manila for exploration of Block SC-72 on the Reed Bank. SC-72 is known for indications of natural gas based on previous PNOC drilling. After obtaining the requisite license and contract, Forum Energy began seismic surveys in 2011. In March that year, two Chinese law enforcement vessels used aggressive manoeuvres to force a Philippine survey ship to leave the area. Exploration has since stalled. Forum Energy confirmed in March 2015 that the energy department had ordered it to halt activities on SC-72, as the area is subject to the arbitration case that Manila initiated against Beijing. Energy department officials said the order came from the foreign ministry, which is concerned that exploration at the Reed Bank would undermine Manila’s position in The Hague arbitration.⁷⁶

Parallel to friction and confrontation, however, hydrocarbon exploration in the South China Sea is also a tale of repeated attempts at cooperation.

Map 3: SC-72



⁷⁵ Crisis Group telephone interview, June 2015.

⁷⁶ See fn. 9 above. “DOE stops oil drilling in West Phl Sea”, *The Philippine Star*, 4 March 2015. Crisis Group interviews, Manila, June 2015. SC-72 was formerly known as the Sampagua field.

V. Joint Development

“Setting aside disputes and pursuing joint development” of natural resources, including oil and gas, has been a central component of China’s maritime-dispute policy since the 1970s. Created by Deng Xiaoping, it proposes that “when conditions are not ripe to bring about a thorough solution to a territorial dispute, discussion on the issue of sovereignty may be postponed”, while “the territories under dispute may be developed in a joint way”.⁷⁷

Subsequent leaders have repeatedly promulgated “joint development” as a potentially effective approach to managing South China Sea disputes.⁷⁸ “China is very keen on joint development, even if it’s just a symbolic gesture and nothing of substance is achieved”, a Chinese analyst on Asia-Pacific security said. “It shows China’s contribution to maintaining regional peace and promoting regional cooperation”.⁷⁹ But because so many leaders have endorsed the concept, objective analysis of obstacles can be politically perilous. Instead, Chinese analysts often cursorily attribute lack of success to rival claimants’ preference for unilateral development at China’s expense and call for Beijing also to go it alone.

A. Obstacles

1. China’s precondition and Vietnam’s suspicion

Beijing’s policy has four components. The first states: “The sovereignty of the territories concerned belongs to China”.⁸⁰ “Vietnam and other countries can’t accept that”, said a Vietnamese foreign ministry official.⁸¹ A Philippine politician explained: “In principle we are open to joint development, but the dilemma is that joint development necessitates we recognise hereto unrecognised claims of China”.⁸²

The undefined nature of Chinese claims is another obstacle, especially for Vietnam, which deeply mistrusts China and 60 to 70 per cent of whose claimed EEZ is within China’s nine-dash line, which takes in most of the South China Sea’s

⁷⁷ According to China, such a policy took shape in the 1970s and 1980s when it established diplomatic relations with its South East Asian neighbours. During talks with South East Asian leaders, including two Philippine presidents, Deng affirmed China’s sovereignty over the Nansha (Spratly) Islands, but stated: “Considering the fact that China has good relations with the countries concerned, we would like to set aside this issue now and explore later a solution acceptable to both sides. We should avoid military conflict over this and should pursue an approach of joint development”. “Set aside dispute and pursue joint development”, Chinese foreign ministry.

⁷⁸ As recently as November 2014, Chinese Premier Li Keqiang promoted the concept at the East Asia summit in Naypyitaw. “李克强: ‘双轨思路’处理南海问题”, 《新京报》[“Li Keqiang: ‘Dual-track thinking’ for South China Sea issues”], *The Beijing News*, 11 November 2014.

⁷⁹ Crisis Group interview, Beijing, October 2014.

⁸⁰ The four components are: 1. The sovereignty of the territories concerned belongs to China. 2. When conditions are not ripe to bring about a thorough solution to territorial dispute, discussion on the issue of sovereignty may be postponed so that the dispute is set aside. To set aside dispute does not mean giving up sovereignty. It is just to leave the dispute aside for the time being. 3. The territories under dispute may be developed in a joint way. 4. The purpose of joint development is to enhance mutual understanding through cooperation and create conditions for the eventual resolution of territorial ownership. “Set aside dispute and pursue joint development”, op. cit.

⁸¹ Crisis Group interview, Hanoi, September 2014.

⁸² Crisis Group interview, Manila, September 2014.

surface area.⁸³ Hanoi thus fears that joint development before agreeing on the disputed areas according to the UNCLOS would amount to legitimising the nine-dash line. A Vietnamese foreign ministry official commented:

Joint development is one of the practical and provisional steps toward settling disputes. But the number one thing we need to do is to verify claims. If a partner can't show me which area it claims with reasonable legal ground, we can't do joint development. We can't accept ambiguous claims without clarification. We can't just accept some dotted lines.⁸⁴

Without Beijing's clarification, Hanoi suspects that "China ... wants to develop on Vietnam's EEZ", especially the resource-rich area in the south.⁸⁵ "Vietnamese people and leaders see that as our backyard. It's what we own. Someone comes in and say we want to do joint development in your backyard. It's not acceptable".⁸⁶

2. The Philippine law

Oil and gas exploration and development involving foreign companies are governed in the Philippines by the 1987 constitution and 1972 Oil Exploration and Development Act. The former stipulates that exploration, development and utilisation of natural resources is under the control and supervision of the state, which may enter into co-production, joint venture or production-sharing agreements with private companies, but Philippine citizens, corporations or associations must own at least 60 per cent of the capital.⁸⁷ The latter requires the government to retain at least 60 per cent of net profit.⁸⁸ Collectively, these provisions are known as the 60/40 rule. The government may, however, offer investing companies financial incentives, including service fees, cost reimbursement and tax exemptions.⁸⁹ The net effect is that foreign partners may receive financially advantageous contracts, but Philippine law requires that joint development projects in disputed waters include majority Philippine ownership, a nonstarter for China, which requires equal division of ownership.⁹⁰

In late 2014, a resolution was introduced in the Congress that aims to loosen these requirements. Known as the Charter change (Cha-cha), it would add the phrase "unless provided by law" to the constitution's foreign-ownership provision, enabling Congress to begin an arduous process to modify or remove the 60/40 rule. Proponents argued that the constitutional restrictions on foreign ownership have impeded investment and thwarted economic development. Opponents charged that the resolution would lead to foreign possession of Philippine land.⁹¹

The Cha-cha resolution became fodder for election politics when President Benigno Aquino III said on TV in August 2014 that he was open to seeking a second term through constitutional amendments, despite popular opposition to term

⁸³ See fn. 11 for estimates on how much of the South China Sea the nine-dash line includes.

⁸⁴ Crisis Group interview, Hanoi, September 2014.

⁸⁵ Crisis Group interview, Vietnamese foreign ministry official, Beijing, September 2014.

⁸⁶ Crisis Group interview, Vietnamese scholar, Hanoi, September 2014.

⁸⁷ 1987 constitution, Article XII, section 2.

⁸⁸ Presidential Decree no. 87, section 18.b, 2 October 1987.

⁸⁹ *Ibid*, sections 8, 12.

⁹⁰ Crisis Group interview, Chinese maritime scholar, Beijing, August 2014.

⁹¹ "House to fast track constitutional amendments to allow foreign ownership", *The Philippine Star*, 9 February 2015. "House fails to vote on Cha-cha resolution", *ibid*, 11 June 2015.

extension. This roused suspicion that his allies in Congress would tack changes to presidential term limits onto the process that would modify the economic clause of the constitution.⁹² Despite support among businesses, the resolution's prospects appear dim, especially with politics heating up ahead of the May 2016 election. "Waiting for it to succeed is like waiting for the sun to become the moon", said a former energy department under-secretary.⁹³

B. *Attempts at Joint Development*

Despite diplomatic, political and legal obstacles, claimants have attempted joint development, albeit with scant success.

1. The Joint Marine Seismic Undertaking

In 2003, Manila was short on options after failing to attract international investors to develop indigenous hydrocarbon resources. "At that time, the situation in the Philippines was such that we imported almost 99.9 per cent of crude oil and petroleum products, mostly for transportation. It was ... the era of \$100 per barrel of oil. We wanted indigenous oil but couldn't explore ourselves in our backyard", said Manalac, then PNOC president and CEO and energy under-secretary. During his tenure at Phillips Petroleum, Manalac worked with Chinese NOCs on joint projects. "I was close to the Chinese companies. My instinct was, why can't I ask these guys to help out with joint development? So I presented this to the [Philippine] president, and she enthusiastically approved".⁹⁴ Concerns about sovereignty and possible problems under Philippine law were suppressed but surfaced later to haunt the project.

Then President Gloria Macapagal-Arroyo was presiding over a "golden age" of Sino-Philippine relations, underwritten with generous Chinese infrastructure loans.⁹⁵ During her 2004 state visit to Beijing, PNOC and CNOOC signed the Agreement for Joint Marine Seismic Undertaking (JMSU) to collaborate on seismic surveillance. It covered an area of 142,886km². Without directly mentioning sovereignty, the agreement stated that it "shall not undermine the basic position held by the Government of each Party on the South China Sea issue".⁹⁶ According to Manalac, the parties looked for an area only the two sides claimed but "couldn't find anything that's of significant size", due to China's nine-dash line and Vietnam's also substantial claims.⁹⁷ The area covered by the bilateral agreement overlapped with Vietnam's claims, and after six months of strong objection, Hanoi reluctantly joined the deal in order to "make the best of an unsatisfactory situation".⁹⁸

⁹² "Drilon, Belmonte: Charter change to lift foreign equity limits", *Philippine Daily Inquirer*, 20 August 2014. "Allies not giving up on 2nd term", *The Philippine Star*, 4 October 2014.

⁹³ Crisis Group interview, Jay Layug, now a senior lawyer, Manila, June 2015.

⁹⁴ Crisis Group telephone interview, June 2015.

⁹⁵ Aileen S.P. Baviera, "The Influence of Domestic Politics on Philippine Foreign Policy: The case of Philippines-China Relations Since 2004", RSIS Working Paper, 5 June 2012.

⁹⁶ "An Agreement for Joint Marine Seismic Undertaking in Certain Areas in the South China Sea by and between [CNOOC] and [PNOC]", 1 September, 2004.

⁹⁷ Crisis Group telephone interview, Eduardo Manalac, former under-secretary, Philippine energy department, June 2015.

⁹⁸ Quote attributed to Rodolfo Severino, former secretary general, ASEAN. Barry Wain, "Manila's Bungle in The South China Sea", *Far Eastern Economic Review* (January/February 2008).

Under the tripartite agreement, CNOOC geological surveillance vessels collected data that was processed in Vietnam and subsequently brought to the Philippines for interpretation. All three parties were present at each step. “One of the strongest incentives of the tripartite agreement was the confidence building among the countries. We worked together to demonstrate it could be done. We succeeded at that”, said Manalac.⁹⁹

In late 2007-early 2008, when data arrived in the Philippines for interpretation, the JMSU was up for renewal and facing a public backlash. According to then Energy Under-Secretary Guillermo Balce, a Manila press conference was held to publicise the surveys. “It was then the media asked about the location of the area, and the controversy began”. Though the size of the area the JMSU covered had been made public, its location was confidential. Balce said the intent was not to deceive. “It was done among the companies. The foreign ministries advised the process. The negotiations were very technical ... I don’t think it was necessary to divulge technical details to the public. It was normal business activities”.¹⁰⁰

Press articles, especially one in the *Far Eastern Economic Review*, revealed details of the JMSU, including its location. The author said the Philippines had “made breathtaking concessions in agreeing to the area for study”, and “about one-sixth of the entire area, closest to the Philippine coastline, is outside the claims by China and Vietnam”.¹⁰¹ Manalac admitted the Philippines may have appeared to have conceded too much. “The real question, however, is what’s our national interest? If there’s no joint development, nobody will come to help us develop it. We don’t have the money to explore it ourselves. ... Who else will come if China claims it?”¹⁰²

⁹⁹ Crisis Group telephone interview, Eduardo Manalac, former under-secretary, Philippine energy department, June 2015.

¹⁰⁰ Crisis Group interview, Manila, June 2015.

¹⁰¹ Barry Wain, “Manila’s Bungle”, op. cit. Other reports described the one-sixth of the JMSU in undisputed Philippine territory as approximately 24,000 sq. miles, eg, Yvonne T. Chua and Ellen Tordesillas, “Six RP-occupied islands covered in controversial Spratlys deals”, *Vera Files*, 9 March 2008.

¹⁰² Crisis Group telephone interview, June 2015.

Map 4: Joint Marine Seismic Undertaking



Around the same time, sentiment was turning against Arroyo and Chinese investments. The president and her husband were accused of corruption in a \$329 million telecommunications deal with a Chinese company, and JMSU revelations further energised her critics.¹⁰³ Opposition lawmakers filed resolutions seeking probes into whether the administration had compromised sovereignty and sold out national territory for an \$8 billion loan package. Some urged impeachment.¹⁰⁴

Critics also challenged the JMSU's constitutionality for not abiding by the 60/40 rule.¹⁰⁵ Opposition lawmakers further argued that it should have been treated as an international agreement, not a commercial contract, and thus, under the constitution, that it required ratification by the Senate.¹⁰⁶

¹⁰³ The contract with China's ZTE Corporation to establish a national broadband network was allegedly overpriced by as much as 100 per cent in order to account for kickbacks to officials, as well as to Arroyo and her husband. Arroyo cancelled the deal in 2008. Both Arroyo and her husband denied the accusations. "Philippine officials implicated in telecom kickbacks", *The New York Times*, 18 September 2007; "The Philippines: Impeachment charge", *ibid*, 13 November 2007; and "Philippines: Former president faces new round of charges", *ibid*, 29 December 2011.

¹⁰⁴ "Lawmakers seek Senate, House probes on Spratlys deal", *Philippine Daily Inquirer*, 7 March 2008.

¹⁰⁵ Ian Storey, "Trouble and Strife in the South China Sea Part II: The Philippines and China", *China Brief* 8:9, 28 April 2008.

¹⁰⁶ "Lawmakers seek Senate, House probes on Spratlys deal", *op. cit.* "Malacanang open to probes on Spratlys deal", ABS-CBN News, 9 March 2008. According to Article VII, Section 21 of the constitution, "No treaty or international agreement shall be valid and effective unless concurred in by at least two-thirds of all the Members of the Senate".

According to Manalac, the negotiators had foreseen and sought to forestall the legal troubles with clever wording:

The title of the agreement was Joint Marine Seismic Undertaking. There's no mention of oil exploration, so we said this had nothing to do with petrol exploration. It was an undertaking. The Philippines said there could be no mention of exploration.¹⁰⁷

The agreement's careful language specified that the parties would be "engaging in a joint research of petroleum resource potential ... as a pre-exploration activity".¹⁰⁸ The Arroyo administration thus argued that JMSU data-gathering was outside the constitutional requirements for exploration and development.¹⁰⁹ Nevertheless, the Supreme Court was petitioned in May 2008 to nullify the JMSU, inter alia, for violating the 60/40 rule. China and Vietnam wanted renewal, but the Arroyo administration, besieged by legal challenges and political troubles, chose to let it expire on 1 July 2008, after reportedly keeping it on operational hold since March.¹¹⁰

Had the parties managed to push forward, said Manalac, the 60/40 rule might have proved insurmountable, as the next stage would have involved drilling. More than seven years after the JMSU expired, the challenge to its constitutionality is still pending before the Supreme Court and a threat to new joint projects.¹¹¹

2. China-Vietnam

In 2006, CNOOC and PetroVietnam agreed on joint exploration in the Tonkin Gulf, at the north-western corner of the South China Sea, framed by China's Hainan, its southern coast and Vietnam's northern coast. China had first marked its boundary in the South China Sea in 1936, with eleven dashes, two in the Tonkin Gulf. In 1953, the CCP erased the two dashes as a gesture of communist camaraderie to Vietnam. The sides agreed in 2000 on the boundary delimitation in the Gulf, and joint exploration has been ongoing there since 2007.¹¹² The sides extended the agreement in 2013 to the end of 2016 and expanded its area from 1,541km² to 4,076km², with each contributing an equal amount across the boundary line. The boundary settle-

¹⁰⁷ Crisis Group telephone interview, June 2015.

¹⁰⁸ "An Agreement for Joint Marine Seismic Undertaking", op. cit.

¹⁰⁹ "Spratlys' seismic survey is not oil exploration – DoJ chief", *Philippine Daily Inquirer*, 9 March 2008. "Joint Statement of former Energy Secretary Vince Perez and former PNOC President Eduardo V. Manalac", press release, Philippines' Presidential Communications Operations Office, 9 March 2008; and "No sell-out in Spratly deal – energy execs", *Philippine Daily Inquirer*, 8 March 2008.

¹¹⁰ "RP-China-Vietnam exploration deal on Spratlys lapses", *Philippine Daily Inquirer*, 11 July 2008; and "Malacanang open to probes on Spratlys deal", ABS-CBN News, 9 March 2008. Crisis Group telephone interview, Eduardo Manalac, June 2015.

¹¹¹ Crisis Group telephone interview, June 2015. "Colmenares prods 7-year-old petition vs joint marine seismic undertaking with China", *InterAksyon*, 16 March 2015.

¹¹² "Joining the dashes", *The Economist*, 4 October 2014. "Agreement on the Delimitation of the Territorial Seas, Exclusive Economic Zones and Continental Shelves in the Tonkin (Beibu) Gulf", 25 December 2000. An unofficial translation is in the appendix to Zou Keyuan, "The Sino-Vietnamese Agreement on Maritime Boundary Delimitation in the Gulf of Tonkin", *Ocean Development & International Law*, vol. 36, issue 1, 2005. The legislatures ratified it in 2004.

ment made cooperation uncontroversial, but despite seismic surveillance and the drilling of one well, commercial-grade deposits have not been found.¹¹³

Cooperation where the boundary is unsettled has been more challenging. In October 2011, China and Vietnam agreed to speed up delimitation outside the mouth of the Tonkin Gulf and discuss joint development there.¹¹⁴ During a Hanoi visit in October 2013, Chinese Premier Li Keqiang urged that the sides “try to make substantive progress” on jointly developing the outer mouth of the Gulf by the end of 2013 to “demonstrate to the world that China and Vietnam have the ability and wisdom to maintain peace in the South China Sea”.¹¹⁵ They did create a working group, but seven rounds of consultations have made little progress.¹¹⁶

Beijing and Hanoi disagree on the priorities. China presses for progress on joint development first; Vietnam insists on delimitation first.¹¹⁷ On delimitation, they vaguely agree to the principle of a median line between China’s Hainan Island and Vietnam, but Vietnamese sources say Hanoi insists it be drawn between the territorial sea baselines of each, while Beijing wants to draw it between the coasts, resulting in a difference of about ten to twenty nautical miles.¹¹⁸ Further, Hanoi seeks to use the political significance Beijing attaches to joint development to open negotiations on the Paracels, which both claim but China occupies, denies they are disputed and refuses to negotiate about.¹¹⁹ “The ultimate issue is the Paracel [group]. Joint development is Vietnam’s leverage, but China doesn’t want to discuss the Paracel, so it’s deadlocked”, said a former Vietnamese foreign ministry official.¹²⁰

¹¹³ “PetroVietnam and CNOOC signed the 4th Amendment to the Agreement on Joint Exploration in the Gulf of Tonkin”, press release, PetroVietnam, 21 June 2013. “Vietnam, China to Extend Oil Project”, *Wall Street Journal*, 20 June 2013.

¹¹⁴ “VN-China Basic Principles on Settlement of Sea Issues”, press release, U.S. embassy Hanoi, 14 October 2011.

¹¹⁵ “中越：正磋商共同开发争议海域” [“China, Vietnam are discussing jointly developing disputed sea areas”], *inewsweek.cn*, 17 October 2013.

¹¹⁶ “Vietnam, China issue joint statement”, *Vietnam Plus*, 15 October 2013; and “新时期深化中越全面战略合作的联合声明” [“Joint Statement on Deepening Comprehensive Strategic Cooperation between China and Vietnam in a New Era”] press release, Chinese foreign ministry, 15 October 2013.

¹¹⁷ Crisis Group interviews, Vietnamese officials and scholars, Chinese scholars, Beijing and Hanoi, August and September 2014, August 2015.

¹¹⁸ Crisis Group interviews, Vietnamese scholars, Hanoi, August 2015. The UNCLOS sets out rules for the delimitation of the territorial sea boundary, providing that failing agreement between opposite and adjacent states to the contrary, the boundary should be a median line, every point of which is equidistant from the nearest points on baselines. However, a departure from the median line may be justified on the grounds of historic title or other special circumstances. The convention is vague about rules to delimit the EEZ or continental shelf boundaries, reflecting disagreements among member states. It only specifies that the delimitation is to achieve an “equitable solution”. UNCLOS, *op. cit.* Article 15, 74 and 83. Robert Beckman, “China, UNCLOS and the South China Sea”, paper submitted to the Asian Society of International Law Third Biennial Conference, Beijing, 27-28 August 2011.

¹¹⁹ Crisis Group interviews, Vietnamese foreign ministry official and analysts, Hanoi, September 2014 and August 2015.

¹²⁰ Crisis Group interview, Singapore, July 2015.

3. China-Philippines

The Philippines' hunger for domestically produced energy and inability to obtain this on their own have continued to fuel their desire to cooperate with China. As put by Energy Secretary Petilla, "the alternative is not to drill, probably forever".¹²¹ In May 2012, Philex Petroleum – a private Philippine company and majority shareholder of Forum Energy – held initial talks with CNOOC, offering it an investor role in SC-72 on the Reed Bank. CNOOC reportedly responded "positively", yet ultimately declined, as participation could be interpreted as recognising Philex ownership and, by extension, Philippine sovereignty.¹²² Talks have continued on-and-off, most recently in July 2014, but without agreement.¹²³

The Aquino administration has insisted that any prospective Chinese partner for development of Reed Bank must recognise Philippine sovereignty and accept all royalties going to the Philippines.¹²⁴ Further, it has stressed that "any exploration agreement in the West Philippine Sea must be in accordance with Philippine law", ie, the 60/40 rule.¹²⁵ Partnership is thus unlikely under the Aquino administration, but the president to be elected in May could be more flexible. When asked about joint development, Jejomar Binay, vice president and presidential candidate, said, "China has all the capital and we have the property so why don't we try and develop that property as a joint venture?"¹²⁶ Another frontrunner, Senator Grace Poe, said she expected a Senate committee to "recommend new approaches to solve the conflict that may include regional cooperation, joint exploration based on parity and law and continuing dialogue".¹²⁷

A willing president could supply the political will, but joint development would still face nationalist pushback – Binay was accused of being a "Manchurian candidate" after his remark – and legal obstacles, including the 60/40 rule and the challenge to the JMSU pending before the Supreme Court.¹²⁸ Many supporters of cooperation with China are energy officials and industry executives who tend to discount the political and legal difficulties. For example, a former energy under-secretary said, "at the end of the day, it's the economics that matter. It's about whether we can find oil and gas. CNOOC only wants oil and gas out".¹²⁹

Chinese actions in recent years – seizing control of the Scarborough Shoal, blocking Philippine access to the Second Thomas Shoal, refusing to participate in

¹²¹ "Oil Companies Try to Collaborate in Spite of S. China Sea Disputes", Voice of America, 1 November 2013.

¹²² CNOOC was granted exploration rights to an overlapping area by the Chinese government. Theresa Martelino-Reyes, "Chinese firm rejects MVP offer for share in PH project in Reed Bank", ABS-CBN News, 9 March 2014.

¹²³ Iris C. Gonzales, "MVP sees start of exploration at Recto Bank", *The Philippine Star*, 28 October 2013; Iris C. Gonzales, "As territorial dispute heightens: Talks between MVP Group, China oil firm stalled", *The Philippine Star*, 4 April 2014; and Neil Jerome C. Morales, "Philex Pet, China oil firm restart talks", *The Philippine Star*, 19 July 2014.

¹²⁴ TJ Burgonio, "Aquino open to joint oil dev't of Recto Bank, but...", *Philippine Daily Inquirer*, 14 January 2013.

¹²⁵ Foreign Affairs Secretary Albert del Rosario, quoted in Tarra Quismundo, "Philippines 'cautious' on China's offer to jointly explore for oil in Spratlys area", *Philippine Daily Inquirer*, 7 January 2013.

¹²⁶ "VP Binay open to exploring for oil with China in disputed sea", GMA News, 24 April 2015.

¹²⁷ "Will the next Philippine government be nicer to China?" Bloomberg News, 27 May 2015.

¹²⁸ "Is Binay the Manchurian Candidate?" *Global Nation Inquirer*, 24 April 2015.

¹²⁹ Crisis Group interview, Manila, June 2015.

arbitration at The Hague and building large artificial islands in the Spratlys – have also made joint development less palatable to the Philippine public and politically more perilous for leaders.¹³⁰ “Joint development is China’s preferred approach, but it requires trust and confidence”, an academic noted. “... China has not done anything recently that could generate trust. In fact, China’s actions have only deepened suspicion that joint development is just another ploy”.¹³¹

¹³⁰ For analysis on China’s actions and their impact on Sino-Philippine relations, see Crisis Group Report, *Stirring up the South China Sea (III)*, op. cit., pp. 14-18.

¹³¹ Crisis Group interview, Aileen Baviera, professor of China studies, University of the Philippines, Manila, September 2014.

VI. Conclusion

Joint development as a confidence-building measure has potential but is not compatible with the current political environment. Beijing is an eager proponent for joint measures but lacks appreciation for the political, technical and legal obstacles, including other claimants' suspicion that the precondition China sets and its unwillingness to clarify its claims suggests its objective is less confidence building than obtaining resources from their EEZs.

The start of the JMSU showed that concerns can be allayed if relations are stable, flashpoints are kept under check and diplomacy is unimpeded. The demise of that project, however, was evidence that the obstacles have to be addressed. Several years of tensions have undermined political will – especially in Manila and Hanoi – to work for cooperation and fuelled the nationalism that was a major factor in derailing the JMSU. It is highly unlikely a similar endeavour would succeed in today's climate.

Bilaterally, China and the Philippines appear the best aligned for cooperative energy exploration. China considers such an endeavour would vindicate a central pillar of its South China Sea approach, prove the wisdom of generations of its leaders and showcase its constructive role in maintaining regional stability. The Philippines have compelling economic incentives that make cooperation with China appear a financially attractive option. Due to Beijing's sharp-elbowed pursuit of claims and Manila's arbitration case, however, relations are at an all-time low. In Manila, advocating cooperation with China has become riskier politically, and the 60/40 rule remains a major roadblock. Prospect for Sino-Philippine joint development, therefore, is dim at best. China and Vietnam have nominally active consultations on the somewhat less controversial measure of joint exploration outside the mouth of the Gulf of Tonkin, but scant progress has been made due in part to a mismatch in priorities.

Joint development, therefore, is unlikely to be implemented in the near term. The first step toward establishing norms that would allow the benefits of South China Sea hydrocarbon resources to be exploited might be to address in greater detail the less controversial issue of exploration. However, understanding and highlighting the overall challenges of partnership is crucial to discredit the assertion that China needs to respond with unilateral actions to other claimants' refusal to cooperate.

Acknowledging the obstacles could change the narrative from assigning blame to seeking remedies and managing expectations. China's precondition might be countered by specifying in legal terms in the agreement that participation in joint development does not imply a sovereignty concession or prejudice future delimitation negotiations.

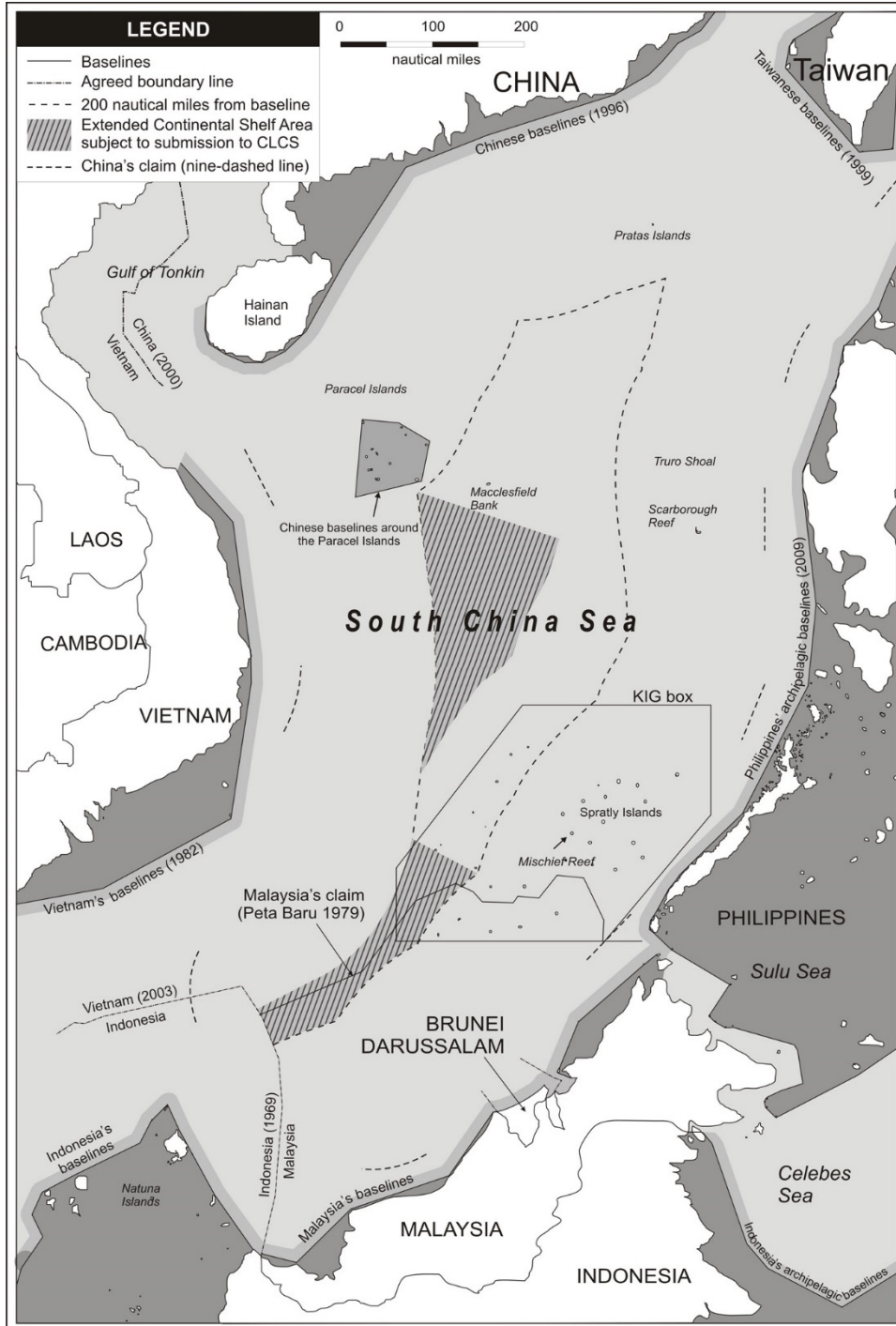
Misgivings about the nine-dash line could be mitigated if China were to move toward bringing its claims into compliance with international law, even implicitly. Beijing, though not ready to publicly clarify its claims, could allay Vietnam's suspicion by following UNCLOS principles in defining overlapping claims, which could then provide the basis for closed-door consultations to establish areas of joint exploration outside the mouth of the Gulf of Tonkin. In exchange, Vietnam might refrain from trying to open talks on the Paracels.

These enabling diplomatic and legal manoeuvres would need to be preconditioned on a favourable and stable regional environment. Preserving the long-term prospect of joint development requires all parties to manage flashpoints, refrain

from provocation and invest in diplomacy. In particular, they should refrain from unilateral exploration or development in the most contested areas, those around the Paracel and Spratly Islands. The arbitration ruling in The Hague, when it is eventually handed down, could provide legal clarity on maritime zones (though not sovereignty) that land features are entitled to. Even if it does not accept the ruling, China should use it to guide its behaviour, for example by refraining from policing areas that it cannot claim legally even if they are within the nine-dash line. A degree of confidence needs to be built first by such means before joint development itself can become a viable confidence-building measure.

Beijing/Hanoi/Manila/Brussels, 26 January 2016

Appendix A: Map of the South China Sea



Prepared by I Made Andi Arsana, Department of Geodeting Engineering, Universitas Gadjah Mada, Indonesia. Reproduced with permission.

Appendix B: Glossary of Terms

60/40 rule	The requirement under Philippine law and the constitution that Philippine entities must own at least 60 per cent of the capital for contracts involving natural resources, and the Philippine government must retain at least 60 per cent of the net profit.
CCP	Chinese Communist Party.
Cha-cha	Abbreviation for the “Charter change”, a resolution pending in the Philippine Congress aiming to loosen the 60/40 rule by amending the constitution.
CNOOC	The state-owned China National Offshore Oil Corporation.
CNPC	The state-owned China National Petroleum Corporation.
CSIC	The state-owned China Shipbuilding Industry Corporation.
EEZ	Exclusive economic zone, as set out in the UN Convention on the Law of the Sea.
GDP	Gross domestic product.
HYSY	Haiyangshiyou, meaning “ocean oil”, the name given to a series of deep-water semi-submersible oil platforms commissioned by CNOOC.
JMSU	The Joint Marine Seismic Undertaking between China, the Philippines and Vietnam to survey for hydrocarbon deposits in some disputed areas between 2004 and 2008.
LNG	Liquefied natural gas.
NOC	National oil companies.
ONGC	The state-owned Indian Oil and Natural Gas Corporation.
PetroVietnam	The state-owned Vietnam Oil and Gas Group.
PNOC	The state-owned Philippines National Oil Company.
Sinopec	The state-owned China Petroleum & Chemical Corporation.
UNCLOS	United Nations Convention on the Law of the Sea.
VCP	Vietnamese Communist Party.

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Crisis Group's approach is grounded in field research. Teams of political analysts are located within or close by countries at risk of outbreak, escalation or recurrence of violent conflict. Based on information and assessments from the field, it produces analytical reports containing practical recommendations targeted at key international decision-takers. Crisis Group also publishes *CrisisWatch*, a twelve-page monthly bulletin, providing a succinct regular update on the state of play in all the most significant situations of conflict or potential conflict around the world.

Crisis Group's reports and briefing papers are distributed widely by email and made available simultaneously on the website, www.crisisgroup.org. Crisis Group works closely with governments and those who influence them, including the media, to highlight its crisis analyses and to generate support for its policy prescriptions.

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