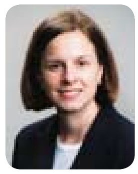
China's NOCs: lessons learned from adventures abroad

In a bid to secure much-need energy resources, China's NOCs have moved in to international mergers and acquisitions. Despite some initial disappointments they are developing a spread of global assets. Erica Downs, China energy fellow, Brookings Institution, reviews some of the lessons they have learned from their experiences


Erica Downs

THE 15 years that China's national oil companies (NOCs) have been active overseas have provided them with an education in the conduct of international mergers and acquisitions (M&A). They have arguably learned more from their failures than from their successes, and probably learned the most from their biggest setback, China National Offshore Oil Corporation's (CNOOC) failed bid for Unocal in 2005.

Beggars can be choosers

China's NOCs are learning to be more selective in their overseas acquisitions of exploration and production (E&P) assets. During their early ventures, they had little choice but to take what they could get. New to the international oil market and eager to acquire equity stakes, they largely confined themselves to pursuing projects passed over by the international oil companies (IOCs), and, especially China National Petroleum Corporation (CNPC), accumulated a rather unwieldy collection of small assets – including frontier acreage and enhanced oil-recovery projects – that spanned the globe (see Table 1).

Most of these projects have done little to bolster the companies' reserves and profits – the exceptions being holdings in Kazakhstan and Sudan, which together account for about two-thirds of their foreign oil production (see Figure 1) – but they have given them a taste for international M&A. China's NOCs used their initial ventures abroad to develop a more discriminating palate.

CNPC, in particular, no longer appears content to feed on the scraps left behind by the IOCs. According to one Beijing-based industry analyst, the company – which has upstream assets in 27 countries – is finding it difficult to manage its sprawling portfolio and would prefer to concentrate on a smaller number of larger projects. The company demonstrated its new-found appetite for multi-billion dollar projects in 2005 with its acquisition of PetroKazakhstan. CNOOC and Sinopec have also discovered that bigger is better, as indicated by CNOOC's bid for Unocal and its subsequent acquisition of a 45% stake in Nigeria's Akpo field, and Sinopec's investment in Iran's Yadavaran oilfield.

If you can't beat 'em, join 'em

The Unocal bid taught China's NOCs that CNOOC's strategy of using its internationally listed subsidiary, CNOOC Ltd, to invest overseas was not as successful a way to grow reserves as the strategy employed by CNPC and Sinopec of having the parent companies make high-risk acquisitions themselves for future injection into their internationally listed subsidiaries. CNPC's purchase of PetroKazakhstan in September 2005, the largest foreign investment made by a Chinese oil company, came just two months after CNOOC Ltd retracted its $18.5bn bid for Unocal. This hardened perceptions about the superiority of having the parent companies buy E&P assets abroad.

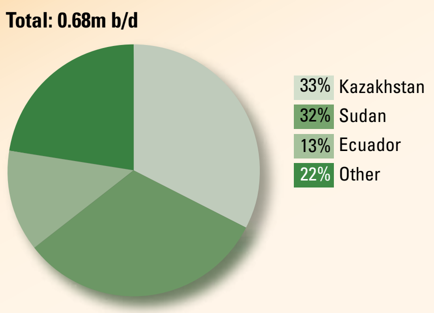
An important distinction exists in how China's three main NOCs invest overseas. In the cases of CNPC and Sinopec, both the unlisted parent and the internationally listed subsidiary can engage in E&P. By con-

Table 1: Selected countries where China's NOCs have signed contracts for equity participation*

Algeria	Gabon	Nigeria-São Tomé JDZ
Angola	Indonesia	Oman
Azerbaijan	Iran	Peru
Cambodia	Iraq †	Russia
Canada	Kazakhstan	Sudan
Chad	Kenya	Syria
Colombia	Libya	Thailand
Ivory coast	Mauritania	Tunisia
Cuba	Myanmar	United Arab Emirates
Ecuador	Niger	Venezuela
Equatorial Guinea	Nigeria	Yemen

* Includes buy-back and extended service contracts. † Signed during rule of Saddam Hussein

Figure 1: Foreign equity-oil production, 2006



Source: Wood Mackenzie; CNOOC Ltd; Sinochem; Reuters; International Petroleum Economics trast, only CNOOC's internationally listed subsidiary, can undertake upstream projects – CNOOC Ltd deliberately secured this concession from its parent ahead of its international listing in 2001 as a way to increase its attractiveness to foreign investors by burnishing its corporate-governance credentials.

Operations at Sudan's Heglig field. CNPC holds a 40% stake in GNPOC, the operating company

But CNOOC Ltd's rebuff in the US gave it a greater appreciation for CNPC and Sinopec's practice of having the parent company take the lead in international M&A. Soon after CNOOC Ltd withdrew its bid for Unocal, it sought to amend the non-compete agreement to allow only its parent company to engage in upstream activities. CNOOC Ltd executives argued that such an arrangement would benefit their company by allowing it to take advantage of the following benefits parent companies enjoy when conducting business abroad:

The parent companies can close deals faster because they do not have boards of directors to which they must justify investments. CNOOC Ltd says the main reason it was unsuccessful in its bid for Unocal was because the time it spent garnering the support of its sceptical outside directors gave Chevron an opening;

The parent companies have more investment opportunities than their internationally listed subsidiaries because they are not constrained by shareholders from undertaking high-risk projects. Both CNPC and Sinopec have made substantial investments in countries where their internationally listed subsidiaries dare not tread. The most prominent example is Sudan, where CNPC has amassed assets valued at $7bn – if the assets were held by PetroChina CNPC's listed subsidiary, many investors would be uncomfortable because of political or human-rights concerns. Once Sudan is no longer an international pariah, it is likely CNPC will sell its Sudanese holdings to PetroChina.

After CNOOC Ltd's failed bid for Unocal, it began to pursue investment opportunities in countries where the higher level of political risk make having its parent company involved increasingly attractive – before Unocal, Africa and the Middle East were off-limits because of the high-levels of political risk. CNOOC Ltd's first post-Unocal deal was the $2.7bn acquisition of a 45% stake in Nigeria's Akpo field. More recently, CNOOC has negotiated a $16bn LNG investment in Iran; and

The parent companies are better able to use their ties to Beijing because, unlike their internationally listed subsidiaries, they are viewed by host countries as representatives of the Chinese government. This theory is suspect as it was the perception that CNOOC Ltd was an arm of state policy that fuelled US opposition to its bid for Unocal. Moreover, most countries are unlikely to make much of a distinction between CNOOC Ltd and CNOOC because CNOOC owns 70% of CNOOC Ltd, and the general manager of CNOOC is chief executive of CNOOC Ltd.

Unsuccessful bids by CNPC for Russia's Slavneft in 2002 and by CNOOC Ltd for Unocal in 2005 taught China's NOCs that deep pockets did not guarantee success

Unfortunately for CNOOC Ltd, its minority shareholders voted down the amendment to the non-compete agreement in December 2005, partly because of concerns that CNOOC and CNOOC Ltd might engage in transactions that benefited CNOOC at their expense. CNOOC Ltd pledged to respect the decision of its shareholders. However, the fact that its parent is negotiating in Iran suggests that the company is still trying to emulate the overseas acquisition strategy of its domestic rivals.

Money can't buy you love

Perceiving themselves to be handicapped in the global competition for E&P assets by their late arrival to the international scene and confronting a dwindling supply of opportunities as a result of rising resource nationalism, China's NOCs have sought to increase their attractiveness as suitors by paying handsomely for assets. While their deep pockets have won them some smaller assets (such blocks won by CNPC during Venezuela's marginal fields auction in 1997 and the gas-exploration blocks acquired by Sinopec in Saudi Arabia in 2004), the unsuccessful bids by CNPC for Russia's Slavneft in 2002 and by CNOOC Ltd for Unocal in 2005 taught China's NOCs that deep pockets did not guarantee success.

CNPC's willingness to pay $3bn failed to entice the Russian government to sell it a 75% stake in Slavneft. The firm, never intended to fall into foreign hands, was bought by Russian companies for the much lower price of $1.85bn. Similarly, CNOOC Ltd's bid of $18.5bn for Unocal, although $0.7bn higher than the price paid by Chevron, was not enough to woo Unocal.

One of the most important lessons CNOOC Ltd learned from its Unocal bid is the importance of managing international public opinion. During CNOOC Ltd's courtship of Unocal, it allowed US public perceptions of its intentions to be defined by policymakers and pundits opposed to the take over of a US oil company by a Chinese firm. Opponents sought to derail the bid by capitalising on US anxieties about the rise of China and the increase in world oil prices through warnings that the company would undermine US energy security by spiriting Unocal's production to China and harm the US economy by replacing Unocal's US employees with Chinese ones.

CNOOC Ltd and its advisors failed to predict the hostility to the bid. When CNOOC Ltd did its due diligence, it focused on the executive branch of the US government, which generally believes that the US economy, including the energy sector, should remain open to foreign investment, and is eager to avoid adding energy to the growing list of issues that generate frictions in the bilateral US-China relationship. By ignoring the legislative branch, where China's rising power is a concern, CNOOC Ltd and its advisors failed to recognise how its attempt to purchase Unocal would ignite the tinderbox of anti-China sentiment that had been building on Capitol Hill.

After CNOOC Ltd withdrew its bid, the company's chief executive, Fu Chengyu, was quoted in the Wall Street Journal as saying: "We learned we need to be more prudent in terms of public relations and political lobbying when dealing with such a big deal. Now that we understand American politics better, if such thing were to happen again, perhaps the important part is not to go for the deal. Perhaps, the first things you need to go for are public relations and political lobbying. And then if those work out, you turn to talk about the deal."

Do the right thing

CNPC is learning that it can do well by doing good. The company has begun to flirt with some of the corporate social responsibility (CSR) practices of its Western peers with an eye towards burnishing its reputation, expanding operations and bolstering its bottom line. It recently published its first stand-alone CSR report in Chinese and English, detailing its efforts to do the right thing at home and abroad.

CNPC's increased focus on CSR is partly motivated by a desire to improve its international image. Primarily because of its operations in Sudan, the crown jewel of its international portfolio, CNPC has acquired a reputation for social irresponsibility. Policymakers, pundits and human-rights activists have charged CNPC with aiding and abetting the atrocities in Darfur by filling Khartoum's coffers with oil profits. These criticisms have not only blackened CNPC's name, but have also threatened to affect adversely the performance of its internationally listed subsidiary, PetroChina, by pressuring institutional investors to divest.

Perhaps even more alarming to CNPC is how it is assessed by Fortune, the business magazine whose rankings of the world's largest companies are the gold standard by which Chinese officials and executives measure the international competitiveness of Chinese firms. Fortune's rankings are especially important to CNPC, which aspires to stand alongside the IOCs on all benchmarks. In 2007, Fortune ranked CNPC 80th out of 100 firms, 23 spots below Sinopec, far behind all the Western oil firms, and ahead of only Gazprom and Mexico's Pemex, highlighting a gap between itself and the company it wishes to keep (see Table 2).

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Table 2: Rankings of oil companies in Fortune**'s most "accountable" companies, 2007**

Company	Rank (out of 100)
BP	1
Eni	3
Royal Dutch Shell	6
Chevron	9
Statoil	17
Total	18
Marathon Oil	21
Petrobras	28
ExxonMobil	48
ConocoPhillips	51
Sinopec	57
CNPC	80
Gazprom	86
Pemex	91

Source: Fortune

CNPC's efforts to do the right thing are also aimed at gaining and maintaining access to reserves abroad. Protests in Ecuador and Kazakhstan against the company's labour and environmental practices underscore the importance of winning the hearts and minds of local populations if CNPC wishes to remain a welcome guest in the communities where it operates. Meanwhile, domestic pressures reinforce the need for CNPC to improve its CSR practices.

In 2003, CNPC received strong criticism over poor safety and environmental standards in the wake of a gas-pipe explosion near the city of Chongqing that killed 243 people. In 2005, the firm was criticised again as a result of a petrochemicals plant explosion in Jilin Province that killed eight people and severely polluted the Songhua River, contaminating the water supply of millions of people in China and Russia. Moreover, as China's NOCs have seen their profits soar in recent years along with the price of oil, they have come under increasing attack at home for being a "monopolistic interest group" that prioritises profits over social welfare.

Failure breeds success

China's NOCs would undoubtedly agree with the adage that "failure breeds success." The setbacks they have suffered abroad have proven to be blessings in disguise. They have provided useful insights into the politics of cross-border M&A. These lessons have helped China's NOCs transform themselves from companies that, in the words of one Chinese oil industry analyst, were "just learning to walk" in the global oil patch into firms with a growing international footprint.