Policy Brief #154
The Brookings Institution May 2006

Untangling China's Quest for Oil through State-backed Financial Deals

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EXECUTIVE SUMMARY

The efforts of China's national oil companies to secure upstream oil assets abroad have attracted attention from U.S. officials and policymakers. Congress has taken notice, as indicated by the request of the Chairman of the U.S. House of Representatives Resources Committee Richard W. Pombo—triggered by the bid made by China National Offshore Oil Corporation Ltd. for Unocal in 2005—for a study by the Department of Energy of the economic and national security implications of China's energy demand. The report, released in February 2006, concludes that the foreign investments of China's national oil companies do not pose an economic challenge to the U.S. However, one issue the report mentions only in passing that merits further attention is how the Chinese government's financial support for some of these investments can undermine an open and competitive world oil market.

The U.S. should work with other G8 countries to address counterproductive state involvement in international oil and gas markets. The G8 summit in Moscow in July 2006, with its focus on energy security, provides a venue to do so. The strategy of the U.S. and other like-minded countries should reflect two goals: preventing China from using predatory finance by convincing Beijing that it is counterproductive; and encouraging China to provide foreign assistance on terms and conditions that fill critical gaps in the provision of public goods.

Introduction

The worldwide quest for oil resources by and investment practices of China's NOCs have triggered concerns about China's impact on international oil supplies and prices. China became a net oil importer in 1993 and has emerged as the world's second largest consumer of and third largest importer of oil. In 2005, China consumed 6.6 million barrels per day (b/d), less than one-third of the 20.8 million b/d used by the U.S. and 8% of global consumption. However, China's oil requirements are expected to increase rapidly, reaching 9 to13 million b/d in 2020.

China's growing oil demand need not lead to conflict with the rest of the world's energy needs. China's participation in the upstream oil market, in fact, can help increase supplies and lower prices, benefiting all consumers.

But China's purchase of upstream assets poses other challenges to the international community. These include the impact of China's acquisitions on the ways in which oil companies compete—especially in developing countries—through use of export credits, investment credits, and tied aid.

China's foreign assistance, which is often associated with energy investments, can benefit developing countries by rejuvenating declining aid flows. But this practice of tying aid to energy investments also raises troubling possibilities. Beijing's financial backing may distort market-based competition by subsidizing its NOCs. Similarly, China's foreign aid may be driven more by its energy requirements than by the social and economic development needs of recipient countries.

Since China's international involvement in oil and finance will increase, Washington needs to develop a more comprehensive approach that considers the role state financing plays in China's NOCs' overseas investments. Energy security concerns generate incentives for oil-consuming states to become anxious and seek to "grab" oil assets, including through state-to-state deals. However, an upstream oil market characterized by heavy government financial interventions and the use of foreign aid as a side payment to secure deals is short-sighted and threatens to undermine not only global energy security but also efforts to improve development assistance.

The United States should develop a strategy for addressing the financial element of state-to-state energy deals. The challenge is that China currently stands outside key international arrangements that monitor and regulate official finance, such as export credits, tied aid, government guarantees, and other publicly supported financial instruments in third markets. The U.S. needs to work with other major investing countries to encourage full Chinese participation in existing arrangements and to strengthen these arrangements that incompletely cover energy deals. Failure to draw China into such arrangements risks a slide into state-backed financial deals that distort energy markets and threaten the integrity of foreign aid.

Chinese State Finance

The Chinese government financially supports the foreign investments of China's NOCs for several reasons. First, Chinese officials maintain China's NOCs are at a disadvantage in the competition for global oil reserves because of their relatively late arrival to the international oil business. Second, they regard state finance as a tool commonly employed by other governments to benefit their oil companies.

Beijing, in addition to providing China's NOCs with cheap capital, aids the oil companies through the China Development Bank and the China Export Import Bank, two of the policy banks created in 1994 to manage state-directed lending. China Eximbank is the world's third largest export credit agency. Its principal mandate is to "implement state policies in industry, foreign trade and economy, finance and foreign affairs." Resource-rich countries in Africa have been a primary beneficiary. There is evidence that the banks' support favors the NOCs in ways that are beyond market terms.

One type of support is the extension of credit lines to China's NOCs that are not necessarily tied to specific acquisitions. For example, China Eximbank has provided lines of credit of up to $1.2 billion (all currencies in U.S. dollars) to both China National Petroleum Corporation (CNPC) and PetroChina, intended, in part, for overseas exploration and development.

A second type is financing for specific investments. The most controversial case was the ill-fated attempt of China National Offshore Oil Corporation Ltd (CNOOC) to purchase Unocal in 2005. The financing CNOOC arranged for its $18.5 billion bid included a $4.5 billion subordinated loan at the below-market interest rate of 3.5% and a $2.5 billion subordinated two-year bridge loan at zero interest, both from its wholly state-owned parent company. The generous terms of these loans were unavailable to Chevron, CNOOC's rival for Unocal.

A third type is investment in infrastructure. The most prominent example is the $2 billion soft loan agreement China Eximbank signed with Angola in 2004 to finance infrastructure projects presented by Chinese companies. The terms of this line of credit were extraordinarily generous—1.5% interest over 17 years. Chinese and international observers agree that this offer persuaded Luanda to reject Royal Dutch/Shell's plan to sell its stake in Block 18 to the Indian firm ONGC Videsh and award it to the Chinese firm Sinopec. China Eximbank's largesse probably also contributed to Luanda's decision to award Block 3/80 to Sinopec.

A recent example of this type of deal occurred during Hu Jintao's visit to Nigeria in April 2006. Hu signed a memorandum of understanding for billions of dollars of investment in infrastructure. The MOU included an arrangement for CNPC to take a stake in the Kaduna refinery in return for the right of first refusal on 4 oil blocks. CNPC won the blocks in May with a commitment to invest $2 billion in the refinery.

The construction of power plants, dams, and government buildings by Chinese companies in Africa is not undertaken for the exclusive purpose of access to oil. However, some Chinese analysts have acknowledged that such investments can further this goal. Not only do these projects generate goodwill with the host country, but also some of the infrastructure financed by China Eximbank in Africa—such as the dam at Imboulou in Congo (Brazzaville) and projects in Sudan—are being repaid in oil.

It is difficult to determine the extent to which Beijing is subsidizing the acquisition of oil because publicly available data are limited. Anecdotal information indicates that some investments have been subsidized and that this practice continues. Chinese banks provided subsidized loans for CNPC's acquisition of Block 6 in Sudan and CNOOC's bid for Unocal. According to a China Eximbank official, the interest rate on funds provided through 2000 to enterprises investing abroad was 2 percentage points below that offered by commercial banks. In 2004, the National Development and Reform Commission and China Eximbank announced that the bank will provide credit on preferential terms to Chinese companies for "state-encouraged key overseas investment projects," including natural resource development. It is not uncommon in former socialist and transition economies for governments to pressure banks into extending loans that may not be profitable. Lax financial discipline—otherwise known as the "soft budget constraint"—is well documented in China's domestic economy and banking system. These financial practices may be migrating into the international arena. Internationalization of the soft budget constraint may give China's NOCs advantages in competition in global energy markets.

Tensions over Predatory Finance

China's use of public funds to secure oil assets has generated friction not only with the U.S. but also with India and South Korea. Indian officials have accused China of using below-market finance to sweeten bids for upstream assets, which pressures India to up the ante. According to one official, Nigeria and Angola have indicated that preference will be given to bidders offering attractive economic packages. New Delhi appears tempted to comply with these requests; an Indian oil official recently stated that India had decided to set aside a U.S. $1 billion per year "war chest" to fund infrastructure projects in Africa as part of its quest for oil assets. South Korea has also used side deals to enhance bids, and Korea Export Import Bank intends to extend more trade finance lines to help Korean oil companies invest abroad.

In response to the growing race for energy assets, India's former minister of petroleum, Mani Shankar Aiyar, warned that it is ultimately the sellers who win: "[i]n the end, whether the winner is China or India, the buyer ends up paying more—and sometimes substantially more—than might have been the case if bidding against each other had been replaced, or at least moderated, by prior consultation." Chinese and Indian officials signed an agreement to cooperate in foreign oil investment in 2006, which Aiyar intended to end their "mindless rivalry." This objective may be difficult to realize; China may be reluctant to eradicate a practice that has brought success.

International Arrangements Regulating State-Backed Finance

Three institutions have the potential to play a role in regulating state-to-state financial deals for oil: the International Energy Agency (IEA), the World Trade Organization (WTO) and the Arrangement on Guidelines for Officially Supported Export Credit (Arrangement). The mandates, membership, legal underpinnings, and enforcement provisions among these regimes vary. Two of the three do not include China. These factors complicate efforts to define the “rules of the game” let alone bring China into compliance.

International Energy Agency

The weakest disciplines are found in the IEA, which was formed in 1974 to promote cooperation among major oil consuming countries after the first oil crisis. Initially, participants focused on establishing emergency oil sharing arrangements and prohibiting discrimination against energy resource development within their respective territories. Later efforts focused on setting guidelines for competition over access to energy in third countries. The idea that efficient energy markets enhance energy security gained ground. The importance of free trade was incorporated in a policy statement, the “Shared Goals,” adopted by all IEA ministers in 1993: “Free and open trade and a secure framework for investment contribute to efficient energy markets and energy security. Distortions to energy trade and investment should be avoided,” they stated.

However, the IEA has never been as strong as its architects hoped. The Shared Goals have remained largely just that, shared goals. The IEA possesses no sanctioning mechanism to enforce them and no monitoring system to detect and punish cheaters. Additionally, China—like India—is not a member. These factors have undermined the IEA’s ability to regulate state-to-state oil deals.

World Trade Organization

A stronger vehicle for regulating international subsidies could be the WTO. Its Agreement on Subsidies and Countervailing Measures (ASC) defines a subsidy as a financial contribution from a government that confers a material benefit on the borrower. It holds that export credit guarantees and insurance programs provided by governments should not be at premium rates inadequate to cover long-term operating costs and losses. This has been interpreted to mean that government-backed export financing programs must at least break even. The rules also prohibit governments from offering export credits at rates below their cost of funds in ways that achieves a “material advantage” in export credit terms.

Since WTO rules deal with granting subsidies related to trade in goods, their application to investment incentives is less clear. A challenge must pass certain tests to succeed. State-to-state deals could be challenged if subsidies are found to “cover operating losses sustained by an industry.” In this case, a successful complaint by rival bidders would have to establish that, in practice, the provision of equity at below market rates amounts to assistance by Beijing to cover "operating losses" by China's NOCs.

But proof of a subsidy is not enough. A successful complaint must also show that a subsidy to cover operating losses by an industry inflicted "serious prejudice." Serious prejudice exists when a subsidy towards a particular product is sufficient to adversely affect the market share of like products of another member. This narrow definition does not seem to cover indirect sweeteners designed to make the investment packages of Chinese NOCs more attractive to recipient countries than those of rival bidders.

A successful challenge under the WTO is further complicated by the involvement of the country where the Chinese NOCs are operating. For example, if Beijing provides subsidies to Chinese NOCs in Nigeria, then it is Nigeria's market share of oil—not China's—that would increase because of the subsidies. A dispute brought against Chinese measures under this provision could be a fool's errand because a strict interpretation of the "serious prejudice" clause would focus on Nigeria, making it a poor instrument for attacking the heart of the problem. In short, there are limits to the use of the WTO to constrain government-backed financial interventions in upstream oil markets, especially if subsidized equity plays in third countries are involved.

OECD Export Credit Arrangement

A third venue that seeks to control government-backed financial intervention is the Organization for Economic Co-operation and Development Export Credit Arrangement, a special purpose regime with two basic objectives: to control the predatory use of export finance to shift rents from one supplier state to another; and to control the unintentional transfers of wealth from supplier to buyer states. This regime emerged from the failure of the General Agreement on Tariffs and Trade to effectively constrain export credit competition between Europe, Japan, and the U.S. in the 1960s and 1970s. Consequently, the WTO delegates significant authority to the Arrangement to establish rules for official export credits, despite the Arrangement's much more exclusive membership.

Although not a formal legal directive of the OECD, members of the Arrangement meet regularly in Paris under the auspices of the OECD, which is the group's secretariat. In practice the Arrangement operates like a cartel, albeit with the purpose of controlling subsidies rather than charging monopoly prices as is found with most clubs that seek to constrain competition. It sets and enforces terms and conditions on official export credits and foreign aid. Presently, floors on interest rates, maximum loan tenor, risk premium guidelines, and other conditions regulate roughly $70 billion a year of medium to long-term business supported by the participating countries. The Arrangement's proceedings are secret; information sharing is restricted to participants.

These characteristics provide the Arrangement with advantages in disciplining official trade finance. Unlike the WTO, the Arrangement has avoided mixing sellers and capital constrained buyers and formed a group with a common interest in constraining credit competition. Additionally, it has avoided the constraints associated with third party dispute resolution processes, permitting faster results. Washington views the Arrangement as a useful trade policy instrument. According to one U.S. Treasury secretary, it has “enormous—and underappreciated—success in preventing much counterproductive, expensive subsidy competition in international trade.”

But the Arrangement also has flaws. China and India are not members. Consequently, they do not share information under the Arrangement, which is necessary to monitor behavior and punish violations. The Arrangement does not cover all forms of public finance. It lacks the scope to discipline all of the financial instruments that China and India may use to secure oil assets.

Where Do We Go from Here?

China is not the only country that has government banks engaged in promoting the nation’s interest in external trade and investment. Other examples include the U.S. Export Import Bank, the Overseas Private Investment Corporation, Export Development Canada, and the Japan Bank for International Cooperation. An important difference is that these entities operate under constraints established by the OECD Export Credit Arrangement and other institutions that govern public finance.

China should be brought within the existing framework of international rules. An open world trading system demands that states be prevented from pursuing predatory trade practices and encouraged to supply public goods. Africa needs foreign assistance. China can indeed help ease the financial burden of infrastructure development in places like Angola and Nigeria. However, since state-backed financial deals can distort energy markets, rules are needed to disentangle state-backed finance for development from predatory and distorting investment.

The strategy of the U.S. and other like-minded countries should reflect two goals: prevent China from using predatory finance by convincing Beijing that it is counterproductive; and encourage China to provide foreign assistance on terms and conditions that fill critical gaps in the provision of public goods.

First, Washington and other world capitals should call on Beijing to demonstrate that is a “responsible stakeholder” in the international system by conforming to global arrangements governing state-backed finance. Deputy Secretary of State Robert Zoellick, while introducing this concept in 2005, identified energy as an arena in which China could take steps to enhance the international system. Given that Chinese officials are eager to demonstrate that China’s demand for energy—and efforts to satisfy that demand—are not threatening to other countries, a multilateral invitation to establish common rules for energy investment would pressure Chinese officials to support their words with actions.

The U.S. should work with other G8 countries to address counterproductive state involvement in international oil and gas markets. The G8 Summit in St. Petersburg in July 2006, which China is expected to attend, offers one venue to do this. With its focus on energy security, the G8 meeting provides an opportunity to announce principles that should govern government intervention in energy market competition. There is precedent for placing government finance on the agenda. Past summits have issued communiqué concerning the need to avoid counterproductive export credit competition, which provided the basis for the development of international rules. Indeed, the secretariat of the OECD Export Credit Arrangement, with the support of the U.S., has begun an "outreach program" to encourage non-members to abide by the regime's rules and procedures. However, these efforts are unlikely to succeed without a higher-level political mandate.

Second, trade and finance officials and experts from the U.S., Europe, and Japan should hold discussions with their counterparts in China who seek to reform China's foreign aid program. Multilateral dialogues on this issue should be continued. Participants should jointly develop ways to maximize the impact of their foreign assistance on poverty reduction.

History shows that regulating state-backed finance can be a protracted affair. Disputes between the U.S. and Europe over aircraft financing have continued for over two decades. Washington should not expect to bring China within the scope of international rules quickly. Still, the risk for global energy security is too high to ignore the role of state-backed finance and the ways it can be regulated internationally, so it is important to start the process now.

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