

China's Foreign Energy Asset Acquisitions: From Shopping Spree to Fire Sale?

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China's determination to acquire energy assets around the world has given rise to the assumption that its appetite for such resources may be limitless. The country's oil demand has been forecast by the Paris-based International Energy Agency (IEA) to rise from 6.5 million barrels per day (mb/d) to over 14 mb/d by 2025. It has been said that China's acquisition of energy assets in Central Asia and the growing influence of the Shanghai Cooperation Organization (SCO) is set to increase China's influence in the region. While most commentators have focused on how such a development is likely to be a source of growing tension between China and the United States, the hitherto ignored factor is whether these acquisitions are profitable and sustainable in the long term.

The worldwide shopping spree by Chinese state-owned or state-controlled companies for assets, ranging from auto manufacturers to oil fields has provided the media, think tanks, policymakers and politicians much to talk about. China's demand for energy and basic commodities has been interpreted in these circles as the dominant factor in maintaining both high world oil prices and for reviving the economic fortunes of commodity exporting countries such as Argentina. China's export-oriented growth is also said to have played a significant and positive role in supplying the world with cheap consumer goods and contributed to keeping inflation low.

This state of affairs drummed along at a steady pace until June 2005 when the Hong Kong-based and state-controlled China National Offshore Oil Corporation (CNOOC) launched a \$18.5 billion cash bid for U.S.-based Unocal Corporation. This bid exceeded a rival bid from U.S. bidder ChevronTexaco by over \$1 billion and drove U.S. legislators, though significantly not the U.S. business community, into a fit of apoplexy. The U.S. House of Representatives voted by 398 to 15 against the proposed deal, calling it a risk to national security. In August, CNOOC decided to drop its bid and Unocal was taken over by ChevronTexaco.

However this move by the U.S. legislators has not bypassed criticism. James Dorn, from the CATO Institute, observes that "Politicians on

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both sides of the aisle in Congress see China as a major threat to U.S. jobs and view trade as a form of economic warfare rather than a mutually beneficial arrangement that increases the wealth of nations.”¹ He believes that such a view is wrong. Instead, the United States can do more to spread the ethos of liberty by setting high standards at home. U.S. energy security, he concludes, as well as China’s, will depend on sound free-market policies, not on destructive protectionism.

Worries in Kazakhstan

That may not be the way some opinion formers in Kazakhstan see matters. Just as the Unocal melodrama was beginning to settle down, The China National Petroleum Corporation (CNPC), the 70 percent owner and parent company of CNOOC, set its sights on Petrokazakhstan, a Canadian owned oil and gas producer formerly known as Hurricane Hydrocarbons. Petrokazakhstan produces about 12 percent of Kazakhstan’s total 1.8 mb/d oil output. The Chinese offer was the culmination of a \$9 billion agreement several years ago between the Chinese and Kazakh governments that also involved the construction, now underway, of an oil pipeline from east Kazakhstan to China.

But no sooner had CNPC’s offer become public when the Kazakh parliament passed a law tightening the regulations on such deals. The new legislation grants the Kazakh parliament the final say on the full or partial transfer of oil and gas assets. According to Ermukhamet K. Ertysbayev, advisor to Kazakh president Nursultan Nazarbayev, Petrokazakhstan wanted to sell its energy assets in the country without informing the government and this is not acceptable as Kazakhstan’s strategic interests are at stake. While Ertysbayev claimed that this would not affect the interests of foreign investors, it is clear that such new regulations has made foreign oil and gas investments in Kazakhstan a more complicated matter, not least on the issue of pre-emptive rights of foreign consortium or joint venture partners.

CNPC’s bid of \$4.18 billion to acquire Petrokazakhstan, warded off another competing bid by India’s ONGC-Mittal Corporation and also a yet to be resolved challenge by Russia’s Lukoil. The Russian company had requested a court in the Canadian province of Alberta to block CNPC’s takeover of Petrokazakhstan by claiming that it had pre-emptive rights to buy Petrokazakhstan out of its 50 percent stake in a joint venture called Turgai Petroleum that holds nearly 29 percent of Petrokazakhstan’s oil production. However, both the Canadian authorities and the Kazakh

¹ James A. Dorn, *US-China Relations in the Wake of CNOOC* (Cato Institute: Washington D.C. Policy Paper 553, November 2005).

government approved the deal in late October.² Following such setback, Lukoil has taken the case against CNPC to a court of arbitration in Stockholm. Meanwhile, CNPC launched its own counter-attack against Lukoil by claiming its own pre-emptive rights to 50 percent of the Buzachi oil field. This field is a joint venture between CNPC and Bermuda-based Nelson Resources, a company currently the object of a takeover bid by Lukoil.

China and Russia in Central Asia

Despite the dispute between the companies over the oil fields, Sino-Russo relations within Central Asia are actually improving, underlined by the ever-increasing profile of the SCO. Founded in 2001 and comprising China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan, the SCO started life aimed at halting the spread of Islamist and separatist movements in the Central Asian region. It has also been developing other areas of cooperation especially in the field of trade and development. While the SCO is meant to keep other powers, namely, the United States out of Central Asia, the extent of Russia and China's respective level of influence in Central Asia is also worth noting.

Russia's weaknesses in Central Asia and the Caspian region are apparent. It is set to lose influence in the energy markets as the Baku-Tbilisi-Ceyhan oil pipeline comes on stream, depriving Russian oil export pipelines of both revenue and market leverage. On the security front, it is bogged down by problems with militants in Chechnya and increasingly, in the North Caucasus.

However, whether China would be able to capitalize on Russian weaknesses and expand its influence in the region by buying up ever more assets in Central Asia is also open to question. CNOOC's bid for Unocal involved the provision of a soft loan from the Chinese government to the company. This is not like a commercial loan. The Chinese government protects its state companies at home and supports them financially overseas. But these companies are essentially expected to be an arm of national foreign policy in their foreign investment, rather than to create value. In common with many other state oil companies, China's two major refiners and distributors, PetroChina and Sinopec, are compelled at home to retail refined products at between 30 percent and 40 percent below cost in order to protect the domestic economy. Such a drain on companies' balance sheet should limit their capital investment capabilities anywhere and sets into motion a loss-making vicious circle.

² Under the new Kazakh law, CNPC was obliged to transfer one third of its new acquisition to the Kazakh government.

Chinese state companies' foreign investment has benefited from access to the country's \$700 million in foreign currency reserves, but this does not mask the fact that oil investments are not really so spectacular. CNPC's upstream foreign investments compare with those of a private sector company but no more. Chinese state companies face the same difficulties with contractual insecurity in Latin America, Africa and most recently Central Asia, as do private sector companies. And while foreign investment by the Chinese state companies may be a good way to develop the country's foreign policy, such investment decisions are made by bureaucrats and are political, rather than aimed at providing an adequate return.

Conclusion

Ultimately, concern in Kazakhstan about Chinese energy asset acquisitions, just like the concern of U.S. legislators after CNOOC's takeover bid for Unocal, may be misplaced. Without institutional reform and privatization, China's bureaucratically restrained, state-owned oil companies may find it difficult, maybe impossible, to develop their new acquisitions in a way where growth would be sustainable in the long term. China's shopping spree could just as easily turn into a fire sale.