Chinese National Companies' Overseas Investment: Myth and Reality

By Xin Ma*

Chinese National Oil Companies (NOCs) have in the last few years captured the world's attention by their rapid business expansion around the world. It is claimed that their overseas activities are strongly supported by their government for the purpose of enhancing security of oil supply. It is commonly argued that their current behaviour is not sustainable because of the tendency to overbid for assets and because they are increasingly exposing themselves to reputational and political risks that they are not equipped to handle. Many have predicted that once the security of supply panic is replaced by rational thinking, China will follow the example of its neighbour, Japan, and start to rely more on market mechanisms rather than on direct administrative means to secure its oil supply.

However, it is becoming increasingly clear that China's NOCs are driven as much or more by their own ambitions than by government policy. It is a mix of commercial and broader economic concerns in addition to the security of oil supply considerations which motivate their overseas investments and explain the strong support from the government.

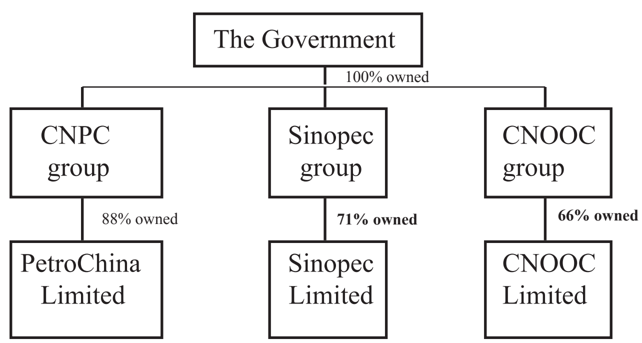
The Three National Oil Companies (NOCs)

There are three main wholly state-owned, integrated national oil companies in China: Chinese National Petroleum Corporation (CNPC), China Petrochemical Corporation (Sinopec) and China National Offshore Oil Corporation (CNOOC). CNPC and Sinopec are both integrated petroleum companies which jointly dominate the onshore upstream exploration and production inside China. CNOOC is a much smaller NOC, but it has a better corporate structure, higher standards of corporate governance, and a more commercial corporate culture than the other two. It dominates offshore exploration and production inside China. All three NOCs are holding companies of respective subordinate limited companies which hold the core businesses and productive assets, and which were partially privatised through overseas Initial Public Offerings (IPOs). See Figure 1 for the ownership structure of the three NOCs.

The Overseas Investments of the NOCs

Overseas investment by the Chinese NOCs only started in 1993. By the end of 2005, their operations had been expanded to around 35 countries through bidding, farm-ins and corporate acquisitions. Their overseas equity production has increased from zero to about 0.5 million barrels per day, equal to the whole of Argentina's oil consumption.

Figure 1



Their overseas investment caught the attention of the world not only by its speed and massive scale but also on account of the distinct business practices of the NOCs and the consequent controversy aroused surrounding certain high profile bids. In 2005 CNOOC lost to Chevron Texaco in its bid for Unocal despite a US$18.5bn offer, as a result of strong political opposition from U.S. lawmakers. In the same year CNPC secured its purchase of PetroKazakhstan, the largest overseas takeover transaction of a Chinese company. A year later, CNOOC successfully acquired a 45% stake in an offshore oil block at a cost of US $ 2.27 billion in Nigeria.

China's NOCs have displayed more willingness than their western counterparts to do business in countries with special concerns, such as Sudan, Iran and Myanmar. CNPC's investment in Sudan includes not only upstream oil and gas operation and production, but also refineries and pipelines. Oil from Sudan makes up one-tenth of China's imported oil and these investments are worth more than three billion U.S. dollars. A few years after signing an MOU, Sinopec's efforts in Iran are expected to bear fruit with a contract to develop the huge Yadavaran oil field.

The companies enjoy strong government support, especially in Africa. China's involvement in Africa often takes the form of a package of deals comprising privileged government loans, infrastructure contracts and oil supply. For example, one of Sinopec's oil exploration deals in Angola is coupled with $2 billion in aid from a Chinese policy bank.

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Government Concerns About Security of Supply

This scramble for overseas oil is commonly attributed to a push by China's government to enhance security of oil supply. The logic behind this appears to be straightforward.

The country's oil consumption has more than doubled in the past decade from 3.7 million barrels per day in 1995 to 6.9 million barrels per day in 2005. Although China has a long history of basing its petroleum policy on self-sufficiency, the country became a net importer of oil in 1993 and is now the second largest oil importer after the U.S. More than 40% of its current oil consumption is met by imports and this trend of rising imports is set to continue. Additionally, 47% of China's oil imports are from the Middle East and 30% from Africa. More than four-fifth of these imports have to be transported through the high-risk passage through the Malacca Straits. In this context China has every reason to feel vulnerable in terms of security of supply: increasing import dependency; high international prices; instability in the Middle East; threats from piracy, and, given the lack of a strong Navy to counter the U.S., the remote possibility *in extremis* of a U.S. blockade. With its history of central planning, the government lacks the experience to regulate and mitigate risks related to the international oil market.

For these reasons, the NOCs are seen as the agent of the Chinese government to go overseas, secure equity oil, promote long-term relationships with oil producing countries, and invest and lobby for the building of transportation routes which favour China, all in order to enhance the security of oil supply.

However, as has been claimed by many experts and even by the governments of oil consuming countries such as France and Japan, the market is a better and more efficient means to secure oil supply. Even in China this is becoming increasingly understood. It has been claimed that control of equity oil could increase the bargaining power of the Chinese government in an international political crisis and push physical oil eastwards rather than westwards. But the control of equity oil far from its shores does not significantly increase the security of supply for the country. Indeed, a large part of Chinese NOCs' overseas investments are through PSA contracts and under many of these contracts the Chinese NOCs receive a share of revenue instead of physical oil. Even they do receive physical oil, the quality may not be suitable for Chinese refineries and the transportation cost to China may also be too high to ensure commercial viability.

Even if the quality of equity oil is suitable for the Chinese refineries and the transportation cost is commercially acceptable, the price of the oil is normally pegged to international oil prices of crude oil with similar quality. Therefore, Chinese refineries could simply import from the international oil market at a lower overall cost and risk. Also, if the blockade of transportation routes at a time of war is what the Chinese government fears, the supply of much of China's overseas equity oil will also be interrupted by such a blockade.

Government Desire to Mitigate the Risk of Price Fluctuation

If security of supply is not the main driver behind Chinese NOCs overseas investment, what is the real rationale? Is the government seeking to mitigate the risks caused by the fluctuation of international oil price?

It has been argued that direct investment overseas could mitigate the impact of oil price fluctuations on the economy of a country. This is especially important because international oil prices have become increasingly volatile in the past few years. As a net importer, China pays more to import a certain amount of oil when the oil prices increase. However, high international oil prices will tend to push up the income of the NOCs operating internationally and, therefore, any dividends and taxes received by the government from these NOCs should also rise. However, according to the current regulations, state owned enterprises do not pay dividends to the Chinese government. Therefore, the profitability of the NOCs may not have a lot to do with the revenue income of the government, let alone the small share of overseas equity oil as a percentage of total imported oil. Additionally, most of the NOCs' overseas investments are still in the stage of exploration and development, far from providing a return. Therefore, the tax benefit to the Chinese government is negligible, not to mention the impact of overbidding and the lower rate of return on these investments.

NOCs' Own Ambition?

Contrary to widespread perception, the main drivers behind the Chinese NOCs overseas investment may be their own commercial ambitions. First, all the three NOCs have been floated overseas. As publicly-listed companies they are required by their shareholders, at least by their overseas shareholders, to maximise shareholder value by increasing their return on capital employed and booking reserves. These NOCs have each stated ambitious aims themselves, to grow into international oil companies like BP and Shell. However, all three are currently based mainly inside China, with domestic production and revenue accounting for more than 90% of their total production and revenue. The reserve potential inside China is very limited and most of the main oil provinces have peaked and are depleting.

With more than three million staff to employ, the NOCs have to seek new business opportunities in order to survive. Overseas expansion could provide the NOCs with not only new reserves, but also work opportunities for their employees, not to mention more contracts for the large Chinese petroleum services industry covering engineering, drilling, and other oilfield services as well as manufacturing.

In order to gain opportunities as new players with not much experience in an already crowded market, China's NOCs have no choice but to start by bidding high, or go to places that are shunned by their competitors, such as Sudan or Myanmar. The extra costs and risks that have to be borne by these NOCs may be likened to an entry fee for them to have the chance to work side-by-side with international majors, get acquainted with international practice, give their senior managers international experience, and, to put it simply, to 'learn by doing'.

Government Deceived by NOCs?

If this is all for the good of the NOCs, has the government been deceived into supporting these overseas investments on the pretext of security of supply? Probably not. The Chinese government's support for its NOCs is not in nature any different from that of other governments, despite the choice of target countries. Most governments provide greater or lesser degrees of assistance to support the export of investment, goods and services. China's willingness to do business with countries that are shunned by others has its roots in its diplomatic philosophy of non-interference in other countries' internal affairs. In this, China is not alone. For example in Sudan, they are partnered with NOCs from India and Malaysia.

The support of its NOCs is actually in accordance with the economic policy objective announced by the Chinese government some years ago to establish between thirty and fifty of its best state-owned enterprises as 'national champions' with international competitiveness by 2010 in order to maintain national competitiveness in the globalised economic environment.

The government not only encourages these companies to fully employ both domestic and international resources but also to operate in both domestic and international markets. Therefore the support of the overseas activities of its flagship companies is in accordance with the economic policy of the government. In Africa for example, government support not only applies to the oil companies, but also to many engineering, manufacturing and construction companies. It is the sensitiveness of natural resources that makes these particular transactions more visible and controversial.

Will they Succeed in the Future?

Is the growth of Chinese NOCs' overseas investment likely to continue or will it falter, as in the case of the Japanese oil companies? The distinctiveness of the Chinese NOCs should help them avoid repeating the experience of Japan. However, there are a few pitfalls which, if not recognised and addressed, may yet lead to failure.

Two main factors distinguish the oil companies of China and Japan. First of all, the overseas activities of Chinese NOCs' are driven more from an economic and commercial perspective than by pure security of supply concerns. Second, , China's domestic petroleum industry is very large, employs more than three million people, has more than sixty years of experience and possesses a degree of technological competitiveness. As long as economic logic persists, the overseas activities of Chinese NOCs' are likely to continue. Also, because their investments are more commercial driven than those of their Japanese counterparts in the past, once experience and skills have been acquired and certain comparative advantage has been established, their investment behaviour is likely to be progressively rationalised.

There are a few pitfalls that both the government and the Chinese NOCs should seek to avoid and which could drastically undermine the overseas investment strategy. First of all, it is likely that tension will arise between the Chinese government and the minority shareholders due to their different perspectives. The Chinese government will continue to be reluctant to cede control over the petroleum sector which is seen as being a strategically important sector for the Chinese economy. The minority shareholders, in contrast, are likely to push for less government control over certain issues and, as a consequence, disputes between the two may arise.

Secondly, sustained overseas acquisition requires a large amount of capital commitment over several decades. The Chinese NOCs could run into financial difficulties and become insolvent if oil prices decline.

Thirdly, through these overseas investments, the Chinese NOCs and their government are exposing themselves to higher levels of geo-political and social risk that they are not very experienced in managing. One high profile failure in dealing with sensitive issues relating to the environment, social responsibility or human rights could cause irreversible damage to the reputation of Chinese NOCs and of the government, and result in a sudden decline in their overseas investment.