

## **Sino-U.S. Energy Policy: Prospects for the Future**

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### **Introduction**

On August 2, 2005 CNOOC Ltd. withdrew its bid for Unocal Corporation, citing fierce political opposition in Washington that it deemed “regrettable and unjustified.” CNOOC Ltd. furthermore released a statement that its objectives had been “purely commercial” and that it had been prepared to address “any legitimate concerns U.S. officials may have had regarding our acquisition” (Barboza 2005, 1). As will be stated in my analysis, this is highly unfortunate considering Unocal Corp.’s unimportance for U.S. energy assets, the need for economic cooperation between these two countries, and our economic/trade codependence. It is likely that Sino-U.S. relations will suffer even more from this decision after a year of heated trade and currency disputes, as well as a defensive reaction by Chinese officials after the U.S.’s Pentagon Report claimed that China’s military had been gearing up for a military showdown over Taiwan. According to Han Xiaoping, the chief information officer at Falcon Power Limited - an energy consulting firm based in Beijing - “The way the U.S. government has treated CNOOC and politicized the deal will largely frustrate Chinese companies. The companies not only in oil but in all other industries will no longer want to play by the U.S. rules” (Barboza 2005, 1). Thwarting China and demonizing the Chinese will not benefit America – it will instead increase Chinese investment in hostile countries such as Iran, and repressive regimes such as Sudan and Myanmar. This is a particularly sensitive issue considering Israel’s withdrawal from the West Bank that is scheduled to begin August 15, 2005 may result in an onslaught of terrorist attacks in Israel from groups such as Hamas that are funded by the Iranian government. America is heavily invested in the Gaza withdrawal. Furthermore, analysts expect narrowly-orchestrated Chinese market retaliation. For example, an airplane order might be directed to Airbus, a European Consortium, as opposed to Boeing. I hope my analysis will prove that such actions by the U.S. Congress to thwart single mergers are ultimately self-destructive and irrational, setting a bad precedent for future Sino-U.S. relations.

On June 22, 2005 China National Offshore Oil Corporation (CNOOC) Ltd. made an \$18.5 billion offer to purchase Unocal Corp., the 14<sup>th</sup> largest U.S. oil company in terms of production. The proposed merger sparked pandemonium in the U.S. Congress and an equally dismal reaction among the American populace. A *Wall Street Journal*/NBC News poll released on July 13, 2005 found that 73% of Americans dislike the idea of the merger (Geman 2005, 3). The prospect of China as a growing import-based oil competitor seems daunting in the contemporary America of skyrocketing oil prices, yet these issues and the precarious Sino-American energy relationship are far more complex than they appear at face value.

The recapitulation of legislative actions to date regarding this issue is certainly impressive. On June 30, 2005 – eight days after CNOOC Ltd. made its offer to Unocal - the House passed H.Res. 344 (Pombo) by a vote of 398 to 15 expressing the sense of the House of Representatives that a CNOOC takeover of Unocal would threaten or impair U.S. national security and urged a thorough review by the Administration if the merger takes place. On the same day, the House passed an amendment, H.Amdt. 431 (Kilpatrick), by a vote of 333 to 92 to an appropriations bill (H.R. 3058) that would prohibit the use of funds by the Treasury Department to recommend approval of the sale of Unocal to CNOOC Ltd. The Senate also remained active; Sen. Byron Dorgan (D-ND) introduced an amendment (S. 1412) to an appropriations bill that would prohibit a CNOOC Ltd.-Unocal merger. This amendment is unlikely to pass as it is not germane, and a similar amendment drafted by Rep. Edward Markey (D-MA) to be added to the energy bill H.R. 6 was also defeated. I will refer more to amendments to H.R. 6 later in this analysis.

Congressional fears for national security about the proposed merger are not completely unwarranted; China has a 70.6% stake in CNOOC Ltd. via its government-controlled parent company, CNOOC. These fears were echoed in a House Armed Services Committee hearing on the matter held on July 13, 2005, when Committee Chairman Duncan Hunter (R-CA) repeated the prevalent axiom that the transaction would be a “strategic acquisition by the Chinese government” rather than a routine commercial transaction. Three of the witnesses – former CIA director R. James Woolsey, chairman of the U.S.-China Economic and Security Review Commission C. Richard D’Amato, and Frank Gaffney Jr., president and CEO of the Center for Security Policy – all shared this apprehensive outlook on the proposed merger. Gaffney even went so far as to claim that “[the U.S.] could suffer catastrophic damage” from an “electromagnetic pulse attack from China,” a claim that was not only far-fetched but had little to do with CNOOC Ltd. Only one witness did not share this portentous outlook: Jerry Taylor, director of natural resources for the Cato Institute. Taylor pointed out that America’s physical dependence on Unocal is inconsequential; Unocal provides 0.23% of global oil and gas production, accounting for less than 1% of U.S. consumption. Thus Unocal is “a marginal supplier” in comparison with the Organization of the Petroleum Exporting Countries (OPEC), whose oil embargo on the U.S. in the early 1970s caused chaotic domestic oil shortages. The People’s Republic of China (PRC) hoarding Unocal’s oil reserves would have negligible impact on U.S. gas prices. Taylor also recalled that China and the U.S. have the same interests in global energy because both are import-based oil economies. Oil is a highly fungible commodity; it is freely traded on the international market with numerous buyers and sellers. Owning oil pipelines is not necessarily a protection of a nation’s susceptibility to energy price changes in the global market. Thus, according to Taylor, China has

“every incentive” to reduce global oil prices. These facts and statistics led me to wonder: why has this proposed merger sparked such a controversy if the U.S. oil interest in Unocal is so insignificant?

In truth, the proposed CNOOC Ltd.-Unocal merger touches on more sensitive issues than a simplistic energy security debate. For one, there is the prospect of China’s substantial economic growth rate - averaging 9.5% in 2004 – that leads many economists to speculate that if China sustains this growth, she could potentially replace the U.S. as the world’s largest economy, as measured in purchasing power parity. China also surpassed Japan in 2003 to become the world’s second largest petroleum consumer behind the U.S.; in 2004, Chinese demand grew 15% to 6.37 million barrels of oil equivalent per day (Boe/d), which is still about one-third the level in the U.S. (Logan 2). Thus there exists national security apprehension in Congress concerning an economically and militarily strong China, coupled with concern for the growing global demand for oil, and whether energy will be a future source of conflict between America and China.

Particularly salient is the tension between integrating China globally and the current U.S. trade deficit with China that rose to \$162 billion in 2004, which is now larger than that of any other U.S. trading partner, potentially giving China significant influence over the U.S. economy (Morrison 2005, 2). Several Members of Congress fault this rising trade deficit to China’s unfair trade practices, including currency “manipulation.” For the past decade China has had her currency – the yuan or renminbi – pegged to the U.S. dollar (at roughly 8.31 yuan per U.S. dollar) as opposed to letting her currency float freely in global markets, as most developed countries do. Under a floating currency system, the relative demand for a country’s goods and assets would determine its exchange rate relative to that of another country. However, to maintain the dollar peg the Chinese bank buys or sells dollar-denominated assets in exchange for newly printed yuan to curb excess demand or supply for yuan (Labonte 2005, 1). As a result of this peg, the exchange rate between the two countries has stayed the same despite market fluctuations that would have caused the yuan to appreciate relative to the U.S. dollar. Thus the yuan is considerably undervalued - most economists estimate between 15-30%. Analysts attribute this change to China’s surging foreign exchange reserve, which grew from \$403 billion at the end of 2003 to \$711 billion at the end of June 2005. The currency peg has the overall effect of making Chinese exports – particularly goods such as textiles, toys, apparel, and furniture – much cheaper compared to U.S. exports, increasing the trade deficit. Critics further contend that China’s currency policy hurts domestic employment and production in U.S. manufacturing sectors, forcing them to compete domestically and internationally with China’s “artificially” cheap goods. Such beliefs initiated American pressure against China. In turn, Chinese officials argued that their currency policy is not designed to favor exports over imports but rather to provide for economic stability, claiming that a floating

currency could trigger an economic crisis in China. Finally responding to mounting international pressure, China took the unprecedented step of reforming her currency policy on July 21, 2005. Chinese officials announced that the yuan's exchange rate will become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket" (Labonte 2005, 2). This "basket" of unspecified currencies presumably includes the U.S. dollar, the yen, the euro, and others. China further adjusted the yuan's exchange rate against the U.S. dollar to 8.11 yuan per dollar, a modest appreciation of roughly 2.1%. Still, this currency policy is different from a true floating currency; the yuan will be allowed to fluctuate by 0.3% on a daily basis against the currency basket. It remains unclear whether China will allow these daily changes to cumulate, or will force her currency to remain relatively fixed. China hinted at further reforms, but ruled out immediate currency reevaluations. U.S. policymakers hailed these reforms as good first steps yet indicated that they expect further reforms.

Along with currency issues, China has been accused of other unfair trade practices by U.S. policymakers. Since China's ascension into the World Trade Organization (WTO) on November 11, 2001, China formally ratified a series of agreements that would significantly liberalize her economy and improve infrastructure regulations. Such agreements include reducing tariffs on industrial goods, limiting subsidies for agricultural production, granting full distribution rights to foreign enterprises, implementing the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement, and fully opening the banking system to foreign financial institutions. In December 2004, the U.S. Trade Representative (USTR) issued its third annual China WTO compliance report. It affirmed that, while China's efforts to implement its WTO commitments have been "impressive," they remain "far from complete and have not always been satisfactory" (Morrison 2005, 8). As summarized by Congressional Research Services:

Major areas of concern identified by the USTR's report include discriminatory import policies, burdensome regulations and restrictions on agriculture and services, industrial policies that discriminate against foreign companies, restrictions on agriculture and services, restrictions on trading rights and distribution, failure to provide transparency of trade laws and regulations, and poor IPR protection (Morrison 2005, 8).

Thus China still has a long way to go in terms of reaching her goals of significantly modernizing her economy and privatizing burdensome State-Owned Enterprises (SOEs). A particular issue of contention between China and the U.S. is China's lax protection of Intellectual Property Rights (IPRs). Although China has taken significant steps to reduce the illicit distribution of U.S.-copyrighted materials, U.S. businesses continue to complain about the illegal reproduction of software, retail

piracy, and trademark counterfeiting. According to the Intellectual Property Alliance, IPR piracy in China cost U.S. copyright firms up to \$3.5 billion in lost sales in 2004. Furthermore, the piracy rate for IPR-related products is estimated to be at least 90% (Morrison 2005, 10). On April 29, 2005, the USTR announced that it had placed China on the Special 301 “Priority Watch List” due to “serious concerns” over China’s compliance to its IPR-related WTO obligations.

Despite these economic contentions, the U.S. remains at fault for her own economic reliance on China. As Pulitzer prize-winning journalist Thomas L. Friedman wrote in a *New York Times* op-ed about the CNOOC Ltd.-Unocal bid, the two countries are “joined at the hip” (Friedman 2005, 1). This is because U.S.-China economics are completely intertwined; while China relies on the U.S. to fund her vast economic growth, the U.S. relies on China to keep her interest rates low by investing in U.S. treasury securities (which fund U.S. federal budget deficits) due to the inability of Americans to save money and our increasing trade deficit with China. Thus, “[China] holding our depreciating dollars helped you buy a house with no money down” (Friedman 2005, 1), showing that China significantly affects prices in the American real estate market. According to the U.S. Treasury Department, as of February 2005 China held \$196.5 billion in U.S. Treasury securities, making China the second largest foreign holder of such securities after Japan. While policymakers continue to denounce China’s currency policy, they often overlook that fact that China finances and subsidizes extensive U.S. debt, meaning a significant yuan reevaluation would affect the U.S. dollar’s value against other currencies and result in pressure for domestic inflation and higher interest rates. Such changes in U.S. fiscal policy could undermine our economic growth since 9/11 and cause our economy to tumble headfirst into another recession. Also, if the U.S. were to eliminate her trade deficit with China, Chinese capital would no longer flow into the U.S. and the government would then have to find other buyers of its U.S. Treasuries, increasing its interest payments.

What results is an oil deal on the surface – a CNOOC Ltd.-Unocal merger – and deep beneath, prevailing economic tension between the U.S. and China, Congressional anger over China’s unfair trade practices and frustration with the Administration’s lack of economic retaliation (WTO sanctions against China, for example)<sup>1</sup>, and constituent pressure due to rising petroleum prices. Only then does one begin to understand what a complex issue this proposed merger is. As a result, while Unocal Corporation only has a marginal impact on U.S. energy reserves, how

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<sup>1</sup> The Bush Administration’s lack of confrontation towards China’s unfair trade practices and relative silence concerning the CNOOC offer for Unocal may be the result of appeasing China so as not to dissuade her influence over North Korea and the 6-party talks for nuclear disarmament that occurred in July 2005. The Administration has, however, tightened imports of Chinese textiles.

we handle this potential merger sets the stage for future Sino-U.S. energy transactions. It is clear that a coherent U.S. policy towards China must be developed to prepare for energy shortages, future economic transactions, and global tips in the relative balance-of-power between these two market giants.

To fully grasp this potential merger (and all of the issues therein), one must understand CNOOC Ltd. and the complex characteristics that typify Chinese state-owned/private companies. Notice I did not distinguish whether CNOOC Ltd. fit directly into either of these respective categories; most policymakers would beg to differ. However, it is important to comprehend that even fully state-owned Chinese companies, such as CNOOC Ltd.'s parent company CNOOC, operate with a certain amount of corporate interest that doesn't always align with the PRC's interests. CNOOC Ltd. is a very special case; this company was incorporated under Hong Kong law, a U.K.-based legal system that is markedly different from the PRC legal system. The PRC also took the initiative to privatize and monopolize its energy companies in the early 1980s. The goal of this reform was to relieve the government of financially burdensome state-owned oil companies and thus cultivate firms that could compete with foreign oil companies to provide energy resources in China and abroad (Chang 2001, 225). The process could be achieved by freeing energy companies of the complexities and stagnation of government meddling and bureaucracy, which inevitably increases the cost of oil development. Reforms manifested by merging smaller oil and petrochemical companies to create a few large integrated private energy companies (Chang 2001, 226). China now has three main oil and gas companies that are vertically integrated. Of these three - China National Petroleum Corporation (CNPC), China National Petrochemical Corporation (Sinopec) and CNOOC - CNOOC Ltd., CNOOC's subsidiary, is the dominant offshore petroleum company. This means that CNOOC Ltd. has exclusive rights for the exploitation of China's offshore oil and natural gas resources in cooperation with foreign partners, as mandated by CNOOC. It is the third largest petroleum company and the second-largest natural gas company in China, which will play a large role in China's future as the PRC weans off of fossil fuels and other pollutants in the next 25 years. An eight-member board that acts by majority vote manages the company. Four of its directors are with CNOOC and/or its parent (and therefore have PRC ties), and there are four independent directors, which is one more than required by the Hong Kong Listing Rules. Under Hong Kong law, the board of directors has a fiduciary duty to act in the welfare of the company and its shareholders. In addition to this, the Hong Kong exchange and market regulators emphasize their dependence from all PRC governmental and regulatory authorities. They stress board autonomy with a strict "comply or explain" reporting system to ensure corporate accountability to shareholders. Moreover, CNOOC Ltd. has pledged to continue Unocal's practice of selling and marketing most of the oil and gas produced from Unocal's U.S.

properties in U.S. markets. CNOOC Ltd. also seeks to retain most of Unocal's employees, including its U.S.-based employees.

Regardless, there is no question as to whether the PRC wants a stake in Unocal. CNOOC Ltd.'s offer is being partially financed by heavily subsidized loans from government-owned companies; a total of \$16 billion in loans will be secured from Chinese and foreign financial institutions. The Industrial and Commercial Bank of China and its parent company, China Offshore Oil Group, will provide some \$13 billion in loans with an additional \$3 billion in international commercial loans. In fact, because CNOOC is borrowing such huge amounts of U.S. dollars from China's official foreign exchange reserves (up to \$13 billion) to finance this deal, if the merger goes through it will result in reduction of these funds, alleviating the current upward pressure on the yuan. China's soaring foreign exchange reserve – expected to reach \$1 trillion by late 2006 if current trends continue – has been attributed to increasing surpluses in trade and capital flow. Of course, \$13 billion is an insignificant amount when compared to the reported \$711 billion already in China's foreign exchange reserves, meaning yuan alleviation would only occur for about a month. Yet the extent to which the PRC is financing this deal merits evaluation.

All of the murky financial details of this proposed merger only cause more questions to arise. For instance: is CNOOC Ltd. being strung along by the PRC into this deal, and if so, to what degree? On July 20, 2005 I attended a panel discussion at The Center for American Progress entitled "China and the Geopolitics of Energy: Unocal and Beyond." One of the speakers in this discussion, Dr. Minxin Pei, gave the best answer to this question in my opinion. Dr. Pei is the Senior Associate and Director of the China Program at the Carnegie Endowment for International Peace in Washington, D.C. He is a small, unassuming man who speaks with a slight Mandarin accent. He is not intimidating, but I found myself shaking when I asked him questions after the discussion. I believe this can be attributed to his very smart, simple understanding of this proposed merger, raising the obligatory "why didn't I think of that?" question. When asked just how much influence the PRC had over CNOOC Ltd., Dr. Pei responded that the merger was about "both oil and something else." He added that there is a tendency to lump CNOOC and the PRC together by Congress and U.S. analysts, but Chinese companies act with a certain degree of freedom. Looking at Unocal Corp. and the facts of the situation can prove this.

Unocal is primarily engaged in the exploration and production of crude oil and natural gas, as well as project development in the U.S. and various other countries – particularly those located in Southeast Asia. Unocal produces geothermal energy that supplies steam to power plants for electricity generation and owns a mine with the capacity to produce some non-energy minerals, including rare

earths.<sup>2</sup> In 2004, Unocal produced 155 million Boe and reported natural gas and crude oil reserves of 1.754 billion Boe. Unocal's global production totaled in 169,000 barrels of petroleum liquids<sup>3</sup> and 1.56 billion cubic feet of dry natural gas per day in the first quarter of 2005 (Table 1). Unocal's North American production accounts for 35% of its worldwide dry natural gas production and 43% of its worldwide liquids production. Of these reserves, 43% of its liquids reserves and 36% of its natural gas reserves are located in North America. On the contrary, 68% of Unocal's oil and gas reserves are located in Asia. Unocal's U.S. production of 58,000 b/d represents 0.8% of U.S. production of petroleum liquids and 0.3% of U.S. consumption of petroleum. Essentially, what all of these figures prove is that Unocal Corp. is, in the words of Thomas L. Friedman, a "second-tier energy company" (Friedman 2005, 1) that is hardly worth \$18.5 billion, let alone \$16.8 billion. The latter price is what Chevron Corp., the U.S.'s third largest oil producer, originally offered to merger with Unocal. Incidentally, Chevron Corp. is also interested in acquiring Unocal, and made its \$16.8 billion cash-and-stock offer for the El Segundo based oil company on April 4, 2005 – nearly three months before CNOOC Ltd. entered the equation with controversial chutzpah. Taking on CNOOC Ltd.'s challenge, Chevron Corp. later raised its offer to \$17.3 billion, or \$63.67 per share<sup>4</sup> in a familiar cutthroat takeover dance that so often characterizes competition over oil company mergers. CNOOC Ltd.'s all-cash offer currently stands at \$67 per share. Unocal's stock has gone up 60% since CNOOC Ltd. entered the mix to \$64.11 per share thanks to heightened public and investor attention. On July 20, 2005 Unocal's board voted to accept Chevron's offer in the face of heated Congressional opposition. CNOOC Ltd. is expected to raise its bid before Unocal's shareholders vote on which offer they prefer on August 10, 2005.

Returning to Dr. Pei, I recall his words that Unocal is a "bad deal" for CNOOC Ltd.'s shareholders. CNOOC Ltd. is essentially willing to pay billions of U.S. dollars over market price for company that is barely worth \$15 billion, which can be proved by a cursory look at Unocal's assets, as achieved in my analysis above. Yet there is a legitimate interest in Unocal, mostly concerning the location of its reserves; on a combined basis, 85% of CNOOC/Unocal reserves will be located in Asia and the Caspian regions. Unocal is also attractive to CNOOC Ltd.

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<sup>2</sup> Although President of the Center for Security Policy Frank Gaffney Jr. called attention to the national security importance of Unocal's Molycorp mine in Mountain Pass, Calif. in a hearing before the House Armed Service Committee on 7/13/05, rare earths are largely used in automotive pollution-control catalysts, permanent magnets, and rechargeable batteries as opposed to weapons manufacture. Incidentally, the U.S. imports most of her rare earths from China.

<sup>3</sup> Crude oil, condensate, and natural gas liquids.

<sup>4</sup> As of July 19, 2005.

in that it can increase its current production from 383 million Boe/d to 795 million Boe/d and increase reserves from 2.2 billion Boe to 4.0 billion Boe based on 2004 figures. While these numbers seem significant, in the world of oil trade the merger would not be especially impressive. According to Congressional Research Services, whether or not CNOOC Ltd. acquires Unocal, it can “much more easily, and at basically the same price, obtain oil to meet China’s domestic needs from a geographically closer supplier” (Gelb 2005, 2). Because CNOOC Ltd. is willing to make a rather poor business decision proves that it is not entirely controlled by the PRC, according to Dr. Pei. In fact, one member of CNOOC Ltd.’s board resigned after the company made its offer for Unocal. While this may seem to be a protest against the PRC to Western eyes (the member was one of those representing the private sector), Dr. Pei claimed that the member was angry because CNOOC Ltd.’s offering price for Unocal was too high. This member later rejoined the board after further negotiations, quieting his temporary dissent.

Perhaps the most ironic aspect of this potential merger is the fact that the ultimate beneficiaries of a CNOOC Ltd.-Unocal merger would be Unocal’s shareholders – or Americans - who would be overpaid the worth of their stock. Dr. Pei attributed CNOOC Ltd.’s unusual eagerness to overpay for Unocal to the company’s CEO Fu Chengyu, whom he believes is suffering from “imperial CEO syndrome,” or the need to garner international attention by making liberal, drastic overseas offers. Dr. Pei claimed that Chairman Fu picked up this character trait by paying “one too many visits to the United States,” acquiring a taste for risky business maneuvers by CEOs. This makes enough sense; if CNOOC succeeds to merger with Unocal it will be the largest overseas merger transaction of a Chinese enterprise in history, in monetary terms. There is certainly no lack of ambition on Chairman Fu’s part. Also, before CNOOC Ltd. made its offer, Fu Chengyu was a virtual unknown – now he is a household name in the business world.

Of course, the merger would not be completely uncharacteristic of Chinese energy-securing moves. Securing access to energy by ensuring that demand does not outstrip supply powers China’s emergence and economic growth, which in turn guarantees economic and social stability. Social stability provides for the Communist Party to stay in power, and that a country of 1.3 billion people continues to grow economically without erupting into social chaos. Thus energy is a top priority for the PRC because much is at stake if international oil prices rise too high, or if discontent grows over pollution and other energy-related misgivings. Although protesting and other forms of civil disobedience are illegal in China, such events of public outcry have become more commonplace in the past decade – skyrocketing to 74,000 incidents last year from about 10,000 in 1994 (French 2005, 1). For instance, on July 18, 2005 as many as 15,000 rioters stormed a chemical plant in Xingchang, China, 180 miles south of Shanghai. Their main grievances concerned environmental degradation that contaminated their water supply,

coupled with complete disregard to public uproar for medical compensation (French 2005, 1). Such events shake the foundations of the PRC, a government that relies heavily on aggressive energy self-reliance to keep its citizenry content and increase the Chinese standard of living. This energy policy was set in place throughout the 1980s, when Beijing hoped that oil and natural gas discoveries in the energy-rich Tarim Basin would adequately provide energy resources for China to sustain her rapid economic development (Chang 2001, 233). Yet obstacles inevitably arose in the Tarim Basin, especially as China's economic growth reached unprecedented levels in the mid-1990s. As Felix K. Chang - associate scholar at the Foreign Policy Research Institute – further elucidates:

By the mid-1990s, China's Ministry of Geology and Mineral Resources privately admitted that the [Tarim] basin was not going to yield enough energy resources to fuel China's economy. To meet the 1993 goal set forth by Premier Li Peng "to secure the long-term and stable supply of oil to China," Beijing would have to ensure an international energy supply that would not be vulnerable to blockade or embargo by any single country... this strategy was referred to as a "strategic oil supply security system (Chang 2005, 233).

These adamant energy realizations led to China's current policy of securing energy for herself by inviting international investment to help develop refineries and improve access to oil. China's energy policy is not completely isolationist, but foreign investment can be seen as a logical extension of China's policy of energy self-reliance (Chang 2005, 233), or a method of streamlining production with the ultimate aim of increasing China's access to energy. CNOOC Ltd.'s aggressive offer for Unocal, although probably not the best business decision, is an extension of Chinese energy policy that seeks to secure energy effectively to ensure a stable economic future for her people. Although it is not typical for China to invest heavily in American energy markets, it would make sense considering how heavily American companies such as Chevron-Texaco and Exxon-Mobil invest in China; the latter signing a \$35 billion contract with China earlier this year. Total U.S. Foreign Direct Investment (FDI) in China amounted to \$4 billion in 2004, with a cumulative figure of \$55 billion. On the contrary, Chinese FDI in the U.S. amounts to only \$500 million, proving that China is open to FDI, although she only allows foreign companies a minority stake in Chinese oil companies.

Aside from looking at the main actors of this situation – CNOOC Ltd. and Unocal – it is important to understand that an official process is already in place to review the proposed merger and see that it does not pose as a threat to national security. The obscure committee granted authority to review foreign acquisitions of U.S.-based firms - the Committee on Foreign Investment in the

United States (CFIUS) - was established in 1988 under the Exon-Florio provision as added to the Defense Production Act. The Exon-Florio provision allayed prevalent fears over foreign acquisitions of certain U.S. firms, particularly those conducted by Japanese firms. This statute grants the President the authority to block foreign acquisitions of U.S. firms that are proven with “credible evidence” to threaten or impair national security by CFIUS. The Exon-Florio provision also dictates that before authority can be invoked the President must believe other U.S. laws are inadequate protectors of national security in the given situation. For the purposes of this legislation, Congress deliberately did not define national security, intending to leave the term up to broad interpretation with no limitations to particular industries (Jackson 2005, 2). Incidentally, CFIUS – whom is delegated the authority to carry out the Exon-Florio provision – is housed in the Department of the Treasury. CFIUS is an inter-agency panel made up of twelve members including the Secretaries of State, the Treasury, Defense, Homeland Security, and Commerce; the USTR; the Chairman of the Council of Economic Advisors; the Attorney General; the Director of the Office of Management and Budget; the Director of the Office of Science and Technology Policy; the Assistant to the President for National Security Affairs; and the Assistant to the President for Economic policy. The Committee has 30 days to decide to investigate a case and an additional 45 days to make a recommendation to the President. Once this recommendation is made, the President has 15 days to act. CFIUS is certainly adequate to perform tests of threats to national security considering the composition of its panel, yet the review process remains secretive and opaque. In November 1991, the Treasury Department issued its final regulations to the Exon-Florio provision, among which was a requirement that CFIUS keep its proceedings confidential and that the information it produces must not be released to the press or commented on publicly. This lack of transparency is a concern to policymakers who oppose the CNOOC Ltd.-Unocal merger. Also of concern is CFIUS’s track record: according to *The Washington Post*, CFIUS has received more than 1,500 notifications, of which it conducted a full investigation of 25 cases. Of these 25 cases, thirteen transactions were withdrawn immediately following CFIUS’s announcement to conduct a full review; twelve of the remaining cases were sent to the President, and of these only one was prohibited<sup>5</sup> (Jackson 2005, 4). This leaves

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<sup>5</sup> The one case prohibited in 1990 involved the acquisition of Mamco Manufacturing Company – an aerospace parts manufacturer - by the China National Aero-Technology Import and Export Corporation (CATIC). CATIC is owned by the PRC and acted as the purchasing agent for the Chinese Ministry of Defense. President Reagan blocked the transaction under the Exon-Florio provision because of concerns that CATIC would gain access to technology via Mamco that it would otherwise have to obtain under an export license (Jackson 4).

a track record of 1,500:1, a prohibition rate of nearly .0007%. This poor track record allows me to understand why the U.S. policymakers reacted in such opposition to the proposed merger; there is a lack of trust for the CFIUS review process.

This lack of trust explains legislation to date that attempts to block the specific CNOOC Ltd.-Unocal merger, particularly S. 1412 as drafted by Sen. Dorgan (D-ND). However, in my opinion it is unwise to aggressively prohibit this single merger through policy on an *ad hoc* basis. Such policy sends ominous signals to potential foreign investors; namely that individual transactions can and should become political issues. The U.S. should demonstrate to domestic and foreign capital markets that it favors and seeks to foster the free flow of capital subject to well-established and defined procedures.

A policy that would do so without undermining the CFIUS review process was drafted by Rep. Richard Pombo (R-CA) and adopted into the comprehensive energy bill (H.R. 6) on July 26, 2005. This amendment requires the Administration to conduct a further study if Unocal accepts the CNOOC offer analyzing economic, national security and other aspects of the merger. In Rep. Pombo's draft, this process would take 180 days to complete and would be carried out prior to the CFIUS review, effectively killing a CNOOC Ltd.-Unocal merger. It is noteworthy that Rep. Pombo's 11th District encompasses the San Ramon headquarters of Chevron Corp., suggesting the "180 days" wording is the result of Chevron Corp.'s influence. With the help of my colleagues in the minority staff of the Senate Energy and Natural Resources Committee, I drafted a second degree amendment to the Pombo amendment for the Committee's Ranking Member, Sen. Jeff Bingaman (D-NM), to introduce in the conference on H.R. 6. This second degree amendment would limit this additional study to the same amount of time taken for the CFIUS review. The time was finally compromised to 120 days, to be conducted at the same time as the CFIUS review. This additional measure somewhat quells Congressional woes concerning transparency in the CFIUS review process.

In the future, if the CNOOC Ltd.-Unocal merger is approved by the Administration, energy reserves and national security will not be in jeopardy. Public opinion, however, will likely disapprove of the merger. Thus developing a review process for future takeovers of American companies by government-owned entities may be necessary. This could be accomplished through the reformation of CFIUS by adding energy experts on the panel and increasing transparency, or by developing an entirely new review process that could complement or coexist with CFIUS without precluding it.

It is also important to view this potential merger geopolitically. It is significant that despite China's efforts to diversify her international oil reserves, she depends on the Middle East for about 60% of her energy imports, most notably

those of Iran, a country particularly hostile to the U.S. as well as Israel and known to support terrorist groups such as Hamas and Hizbollah. In 1997, CNPC began courting Iran's National Oil Company for a joint venture to explore for oil in offshore blocks of Iran and other countries. Eventually the China-based Dagang Oil Field Company signed contracts worth over \$12 million to drill or service over 70 oil and gas wells in offshore Iran. Additionally, Chinese oil companies were invited to bid on 43 Iranian exploration projects in August 1998 (Chang 2001, 237). In November 2004, Sinopec signed a contract with to develop Iran's Yadavaran oil field. Yadavaran may eventually produce as much as 300,000 Boe/d. Further speculation suggests that Chinese energy investment in Iran has fostered military and political ties. During the 1980s, Beijing provided Tehran with military equipment, including dual-use technology that could be used for creating nuclear, biological, and chemical weapons as well as abetting missile programs (Chang 2001, 237). However, China purportedly ceased sending Iran dual use technology in 1997 and its arms sales to the region have since dwindled. Regardless, China has continued to aid Iran in building a missile factory at Isfahan and to improve its Zelzal-3 missile program with guidance, gyroscope, and solid fuel technology (Chang 2001, 237). It has also been reported that Chinese engineers are working in Iranian missile fabrication plants. China also has oil investments in Sudan - a country denounced by the U.S. for allowing genocide in the Darfur region - and Venezuela, a country that is also hostile to the U.S.

These ominous signs - particularly oil investments in Iran that could allow for the formation of a Sino-Middle Eastern bloc - allowed me to realize the utter importance of establishing *some* energy ties with China, including a measured form of reciprocal investment. This will allow the U.S. to avoid future conflicts over oil with China and to dissuade investment in volatile countries in the Middle East and elsewhere. Both the U.S. and China have import-based energy reliance, thus have similar global interests in keeping prices low.

In terms of Sino-U.S. relations, it is important to use our economic influence over the PRC to help establish organizations to improve energy relations. For instance, although China's tensions with Japan have greatly increased in recent months, urging the formation of an Eastern Pacific energy regulatory agency similar to the IEA and involving such countries as China, Japan, Taiwan and the Korean Peninsula may help the U.S. in the long-run by encouraging China to keep oil prices low rather than hoarding supplies during market spikes in prices. Another possibility is urging China to create a central administration for energy. Since the abolition of the Ministry of Energy in 1992, China does not have a central-government entity in charge of energy policy and regulation aside from the State Energy Administration (SEA) that was created in 2003. The SEA, however, has very limited powers; its sole responsibility is to oversee domestic crude oil production. This poses as a major obstacle for a country that plans to increase her

reliance on natural gas significantly over the next 25 years. Currently, natural gas prices are inefficiently governed by a hodgepodge of local regulations (Feld 2005, 7). As China is committed to removing regulatory functions from SOEs, the establishment of her own central energy agency will provide resources to more efficiently govern such matters.

It is clear that the U.S. must take an active role in shaping future Sino-U.S. energy policy to avoid potential confrontations. As economic and trade partners, there is no excuse – whether isolationist or xenophobic – as to why we cannot work with China through reciprocal investment to prevent future global energy shortages or price spikes. The controversy over the potential CNOOC Ltd.-Unocal merger is essentially symbolic for our need to establish reliable legislation to review future foreign acquisitions of U.S.-based firms. This step will prevent Congressional opposition that allows for such mergers to become politicized, embarrassing both the U.S. and China. Deeper still are economic issues that permanently join the U.S. and China, suggesting that both countries must measurably reform to avoid tension and allow for market cooperation. China must reform to abide by her WTO obligations and increase transparency in her currency policy, and in turn the U.S. must develop domestic programs that encourage household savings and decrease the U.S. trade deficit with China. The goal is a stable Sino-U.S. relationship that will discourage investment in hostile areas in the Middle East, encourage economic growth and prosperity for both countries, and decrease the likelihood of a major future showdown – whether economic or military – over issues that can be resolved now.

**Table 1: Production of Oil and Gas by Unocal, by Country**

First Quarter of 2005<sup>6</sup>

Region or Country	Liquids <sup>7</sup> (thousand barrels per day)	Dry Natural Gas (million cubic ft. per day)
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<sup>6</sup> Source: Wright, Robert E. and Nancy A. Murachanian, *2005 Net Production Outlook*, Unocal Corporation, April 28, 2005

<http://www.unocal.com/investor/index.html>.

<sup>7</sup> See footnote 3.

North America	73	538
United States	58	455
Canada	16	83
Southeast Asia	76	1,011
Thailand	38	691
Indonesia	38	164
Myanmar	0	76
Bangladesh	1	80
Other Overseas	20	10
Azerbaijan <sup>8</sup>	14	0
Other	6	10
TOTAL	169	1,559

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<sup>8</sup> Unocal reports this as the Azerbaijan International Operating Company.

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