

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is centered in the narrow neck of the hourglass. The entire graphic is set against a white background.

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China and the CNOOC Bid for Unocal: Issues for Congress

Dick K. Nanto, James K. Jackson, and Wayne M. Morrison, Foreign Affairs, Defense, and Trade Division; and Lawrence Kumins, Resources, Science, and Industry Division

February 27, 2006

Abstract. The report provides an overview and analysis of the CNOOC bid, U.S. interests, implications for U.S. energy security, U.S. investment in the PRC's (People's Republic of China's) oil industry, the process for reviewing the security and other implications of foreign investment in the United States, Congressional activity, and a listing of unresolved issues.

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Summary

The bid by the China National Offshore Oil Corporation (CNOOC) to acquire the U.S. energy company Unocal for \$18.5 billion raised many issues with U.S. policymakers. Even though CNOOC ultimately withdrew its bid in the face of considerable opposition from some Members of Congress and other commentators, many economic, financial, and security issues are still to be resolved.

The CNOOC bid came at a time when China had become the second largest consumer of petroleum in the world and, rather than being a net oil supplier to the world, had become heavily dependent on imports. This new strategic challenge for Beijing had apparently caused it to pursue a more secure energy supply. The CNOOC bid also coincided with a period of high oil prices caused partly by China's increasing demand, growing uneasiness in the United States over the rise of China and the security and economic challenge it was presenting, the large bilateral trade deficit with China, and concerns about whether Beijing was playing by international trade rules — particularly giving insufficient protection to intellectual property rights and systematically holding down the value of its currency.

CNOOC Ltd is a majority-owned subsidiary of CNOOC — one of three large state-owned Chinese petroleum companies. Unocal is a relatively small U.S. petroleum company (gross revenues of \$8.2 billion in 2004) with assets primarily in the Gulf of Mexico and Southeast Asia. The combined CNOOC and Unocal oil production in 2004 amounted to 0.3% of domestic U.S. petroleum consumption. CNOOC would have followed BP (British owned), Shell (Dutch owned), and Venezuela's state oil company in investing in U.S. petroleum assets.

The question of whether the proposed acquisition would have posed a security threat to the United States ultimately would have been decided by the President after a review by the Committee on Foreign Investment in the United States (CFIUS). The policy debate centered on whether a company that is majority owned by China — a country some view as a potential military threat — should be allowed to acquire American assets that include vital energy supplies, dual use technology, or access to sensitive geographical locations. Would CFIUS give sufficient consideration to U.S. economic security? Should CFIUS be strengthened? Out of 1,500 transactions notified to CFIUS since 1988, it blocked only one. Other questions touched on whether blocking the bid would push the Chinese quest for secure oil supplies farther into countries such as Iran or the Sudan? Also, would blocking the bid affect Beijing's approval for U.S. investments in China? Are American companies seeking to invest in China given equivalent opportunities in that market?

The withdrawal of the bid by CNOOC stopped formal action against the proposed acquisition, but it left unanswered most of the questions raised by the bid. It is likely, moreover, that similar cases will arise in the future, such as the deal to allow the takeover of operations of certain U.S. ports by a United Arab Emirates company in 2006. China and other nations have large holdings of foreign exchange reserves and growing needs to recycle dollars back into the U.S. economy. This report will not be updated.

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China and the CNOOC Bid for Unocal

On June 23, 2005, the China National Offshore Oil Corporation (CNOOC) — through its Hong Kong subsidiary (CNOOC Ltd.) — announced an unsolicited bid to acquire the U.S. energy company Unocal for \$18.5 billion in cash. This attempted acquisition raised several questions among U.S. policymakers. Even though CNOOC ultimately withdrew its bid in the face of considerable opposition from some Members of Congress and others, this episode raised certain economic, financial, and security issues that are yet to be resolved. (On August 10, 2005, Unocal stockholders voted to merge with and become a subsidiary of Chevron Corporation.)

The report provides an overview and analysis of the CNOOC bid, U.S. interests, implications for U.S. energy security, U.S. investment in the PRC's (People's Republic of China's) oil industry, the process for reviewing the security and other implications of foreign investment in the United States, Congressional activity, and a listing of unresolved issues.

For many in Congress, the proposed acquisition raised a number of questions regarding three vital U.S. national interests. These are security (protection of life and property), prosperity (protection of economic well being and commerce), and value preservation (protection and projection of core values of democracy, freedom, human rights, etc.).

With respect to the first vital interest of national security, the questions raised by the CNOOC bid were several. Should a company that is majority owned by a foreign government (directly or indirectly) be allowed to acquire American assets that could include vital energy supplies, dual use technology, or access to sensitive geographical locations?¹ This was particularly cogent in the case of CNOOC, since China is

Time Line of The CNOOC Bid

April 4, 2005 Chevron announces agreement to acquire Unocal for about \$16.5 billion

June 10 U.S. Federal Trade Commission gives Chevron acquisition antitrust approval

June 23 CNOOC announces \$18.5 billion bid for Unocal

June 30 House passes H.Res. 344 (Pombo) calling for a thorough CFIUS review

June 30 House passes H.Amdt. 431 (Kilpatrick) to appropriations bill (H.R. 3058) prohibiting use of Treasury funds to approve sale of Unocal to CNOOC

July 2 CNOOC files CFIUS notice

July 20 Chevron raises its offer to about \$17 billion with 40% cash

August 2 CNOOC withdraws bid

August 8. H.R. 6/P.L. 109-58 signed into law requiring a study of PRC energy needs and delaying CFIUS consideration of CNOOC bid

August 10 Unocal votes to accept Chevron offer

¹ An example of this concern was expressed by Rep. Joe Barton, the Chair of the House Energy and Commerce Committee, who said that it is not in our "strategic interests to let a (continued...)

considered by many to be a possible future adversary and is building military capability to counter potential third-party intervention — including that from the United States — in a crisis between the PRC and Taiwan.² Should a Chinese company be allowed to acquire deep-water drilling equipment, technology (similar to that used in underground nuclear tests), underwater mapping capability, and platforms that could be used to observe underwater activities in the Gulf of Mexico or in assisting the Chinese navy? Should a Chinese company be allowed to gain control over a rare U.S. natural resource? (Unocal also owned a mine for a rare earth mineral. CNOOC indicated it would sell this operation.) A related question revolved around the larger Chinese quest for sources of petroleum and whether denying a Chinese company ownership of U.S. oil wells would induce them to seek supply in countries either under U.S. and other country sanctions or where the oil revenues are likely to support corrupt governments or terrorist activities. Another question dealt with the U.S. Committee for Foreign Investment in the United States (CFIUS). Is that committee sufficiently staffed to do a thorough review of such proposed mergers? Should it be strengthened? Are U.S. government review procedures adequate to deal with the complexities of the CNOOC bid as they apply to U.S. national security? Would CFIUS adequately consider economic security?

With respect to the second national interest of U.S. prosperity, the questions revolved around the operation of the free market system, the role of central governments in providing finance for market transactions, issues of fairness and reciprocity, and the balancing of stockholder and company management interests with national interests. A key question was whether a Chinese company backed by government-owned banks should be allowed to outbid a private, American company that has no direct governmental support? Much of the financing for the CNOOC acquisition would have come from Chinese state-owned or state-directed banks. Another question centered on reciprocal access. Are American companies seeking to invest in China given equivalent opportunities in that market? Are Americans able to buy into Chinese petroleum or other companies? Should this be a factor in deciding whether to allow foreigners to invest in the United States? A further question dealt with fairness in the operation of a free market. Should the U.S. government intervene to stop company stockholders and managers from receiving a higher offer for their assets because of political or security concerns? A related question touched on efficiency. Would government intervention into the marketplace create inefficiencies, or would U.S. intervention merely offset intervention by the Chinese government?

With respect to the third national interest of value preservation, the questions related to the CNOOC bid were less specific. They extended to broader issues of whether allowing CNOOC to purchase Unocal would further U.S. goals of democracy and human rights. How would the takeover of Unocal by a Chinese

¹ (...continued)

front company for the communist Chinese purchase a strategic asset, which in this case would be oil reserves and pipelines in the United States.” CNN: Lou Dobbs Tonight Barton Discusses Chinese Bid for Unocal, July 1, 2005.

² See, for example: U.S. Department of Defense. *The Military Power of the People’s Republic of China, 2005*. Annual Report to Congress.

company affect human rights, labor conditions, and democracy in other countries — particularly in Burma and Cambodia where Unocal has investments? Would blocking the acquisition cause China to negotiate more deals for oil supply with nations with which the United States had major foreign policy concerns?

The CNOOC bid also coincided with other concerns being expressed about China. There was growing uneasiness over the rise of China and the competitive challenge it was presenting to a number of U.S. industries — not only makers of labor intensive products but high-technology firms as well. Just a few months earlier, some Members of Congress had expressed concern over the acquisition of IBM's personal computer business by the Chinese company Lenovo.³ There were related concerns that China was creating national champion companies — many of them state-owned and subsidized — and that the country was not abiding by the commitments it made as a condition for accession to the World Trade Organization. This also was a period of rising prices for petroleum, copper, steel, and other commodities in short supply partly because of rising demand from China. China had become the world's second largest consumer of oil.

The withdrawal of the bid by CNOOC stopped formal action against the proposed acquisition, but it left unanswered most of the questions raised by the bid. It is likely, moreover, that similar cases will arise in the future given China's large holdings of foreign exchange reserves (more than \$800 billion), growing needs for industrial resources, and a willingness by Beijing to back its major industrial corporations. A case with similar overtones has arisen in 2006 with the deal to allow the takeover of operations of certain U.S. ports by a United Arab Emirates company.⁴

China's Energy Security and Oil Industry

According to the U.S. Department of Energy, China's oil consumption surpassed Japan's in 2003, when it reached 5.6 million barrels per day (mbd). This ranked China as the world's second largest oil consumer, after the United States. Current consumption is estimated at 7.2 mbd and is projected to rise to 12.89 mbd by 2025. At that time, imports are estimated to be 9.4 mbd, and China's call on the world's crude supply will rival that of the United States.⁵

China is a relative newcomer to the world oil market, and it does not have well established historic supply links. China's arrival as the second largest consumer of oil coincides with a tight global supply-demand situation. This unprecedented dependence on imports of petroleum has added a new strategic imperative to Beijing's security planning. It has led Chinese companies into ventures aimed at

³ Lemon, Sumner. Concerns Mount Over Lenovo's IBM Deal. *PC World*, January 27, 2005. Internet edition at [<http://www.pcworld.com/news/article/0,aid,119476,00.asp>].

⁴ Sanger, David E. and Sheryl Gay Stolberg. Dubai Deal Will Undergo Deeper Inquiry Into Security. *New York Times*, February 27, 2006. pg. A.15.

⁵ U.S. Department of Energy. Energy Information Administration. *China, Country Analysis Brief* — July 2005.

establishing supply arrangements with countries having the potential to develop new oil reserves. It has concluded deals, or is attempting to do so, in a number of countries, including Iran, Venezuela, Nigeria, San Tome, Angola, and Sudan.

In order to assure its energy future, China also needs access resources — including important technologies, such as deep water drilling and human skills in project management. Unocal, therefore, could have been seen by CNOOC as offering a number of attributes, beyond its existing production, in lining up a future supply of oil. Unocal management skill in dealing with multinational projects, its deep water drilling knowhow, the ability to operate complex pipeline systems, as well as its access in Pacific Rim producing countries close to China all would become assets whose value extends beyond Unocal as it is presently structured.

China has been a net oil importer since 1993, and its petroleum industry is focused on meeting domestic demand. Nearly 90% of Chinese oil production capacity is located onshore with nearly a third (about 1.0 million out of a total of 3.4 million barrels per day) coming from the Daqing field in northeast China (5 billion tons of proven reserves). Given the geophysical limits on increasing domestic production, China has recently been exploring for oil offshore and acquiring interests in exploration and production abroad.

China's petroleum industry is dominated by four large corporations whose shares are owned mostly by the state. In 1998, the Chinese government reorganized most domestic state-owned oil and gas assets into two vertically integrated firms: the China National Petroleum Corporation (CNPC with its subsidiary PetroChina) operating primarily in the north and west of China and the China Petroleum & Chemical Corporation (Sinopec) operating mainly in the south. The China National Offshore Oil Corporation (CNOOC) handles offshore exploration and production while a new company, China National Star Petroleum, was created in 1997 and in 2000 merged with Sinopec.

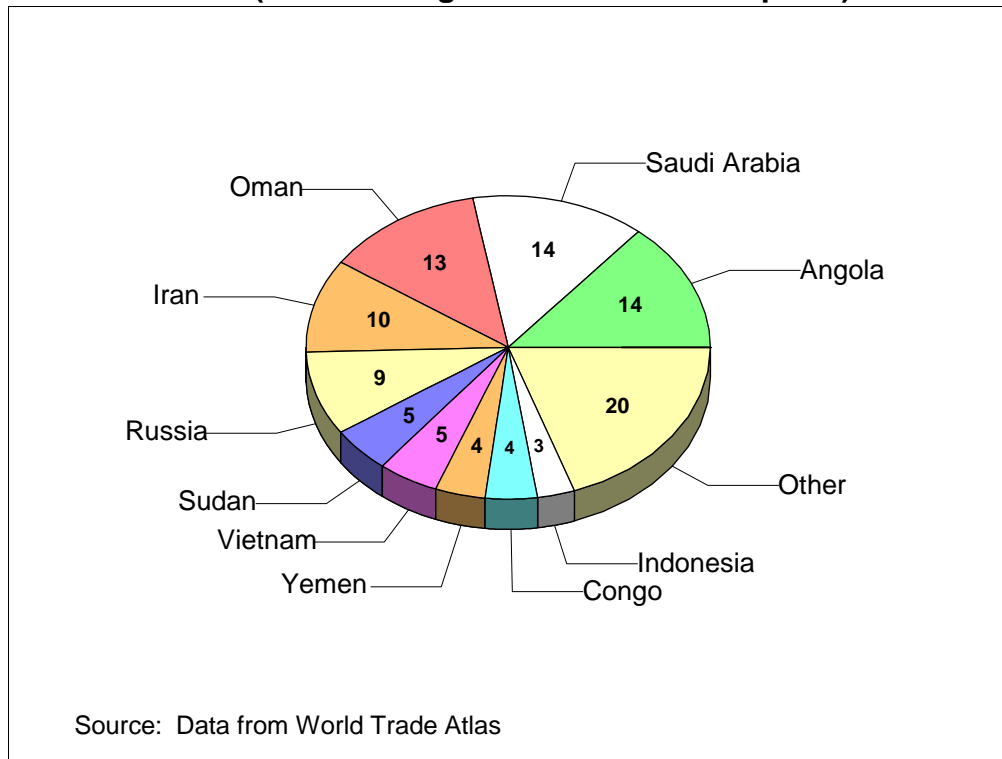
CNPC has acquired oil concessions in Kazakhstan, Venezuela, Sudan, Iraq, Iran, Peru, and Azerbaijan. Sinopec owns a stake in Sudan, while CNOOC has purchased an equity stake in an oilfield in Indonesia. Still roughly half of China's oil imports comes from the Middle East and North Africa. In 2004, 14% of China's crude oil imports (\$4.7 billion) came from Angola, 14% from Saudi Arabia (\$4.6 billion), 13% from Oman (\$4.3 billion), and 10.4% from Iran (\$3.5 billion). Crude oil imports from the United States accounted for 0.08% (\$27 million).⁶

China also is eyeing Russia as a source of additional crude oil and electricity imports. The two governments have been holding regular discussions on pipelines to carry Russian crude oil to China. One pipeline is to run from eastern Siberia to the oil-rich Daqing area (where China has an existing pipeline). A competing proposal backed by Japan would run from Russian Taishet to the Pacific seaport of Nakhodka.

⁶ World Trade Atlas (using Chinese data).

This may initially end at Skovorodino where the oil could be shipped by rail to China.⁷

Figure 1. China's Imports of Crude Petroleum by Major Suppliers, 2004 (In Percentage Shares of Total Imports)



A related factor in the Chinese attempt to establish secure sources of supply could be the threat of economic sanctions should it attempt to force unification with Taiwan or for other reasons. It is clear that a major disruption in the Middle East or a blockade of China's ports would pose a severe threat to China's economy and the operation of its military. This arguably underlies some of China's quest for secure supply sources. However, even if CNOOC Ltd. were to have acquired Unocal, the U.S. operation still would be required to abide by U.S. law — including regulations on economic sanctions — although CNOOC might have been aided by ownership of Unocal's assets in Asia.

Economic planners in Beijing also are likely being pulled in two directions: first by a communist tendency toward central control and second by the centripetal forces of market globalization. In global oil markets, it matters little who owns the wells. Once the crude oil has been pumped, it can be sold almost anywhere. Still, Beijing has a long legacy of central planning and the political benefits that accrue from

⁷ Goncharov, Sergey N. East Asia Energy Partners — China and Russia Reach New Agreements To Boost Collaboration in Energy Projects, *Beijing Review* (Internet version in English). August 5, 2005. Mortished, Carl. Oil Pipeline Route Keeps Asia Guessing, *The Times* (London), July 23, 2005. P. 65.

possession and control. It may, therefore, be putting excessive emphasis on ownership, and it may be uncomfortable leaving a vital energy supply to market forces.

During the congressional debates over the CNOOC bid, some Members pointed out that blocking the CNOOC deal would merely push China into making acquisitions or supply arrangements elsewhere in the world — possibly with countries such as Iran that are not in accord with U.S. interests.⁸ A week after the CNOOC deal fell through, the China National Petroleum Company announced that it would acquire PetroKazakhstan for \$4.18 billion (PetroKazakhstan produces about 150,000 barrels of oil per day). Citigroup agreed to provide CNPC with a letter of credit for the entire value of the deal, so the state-owned Chinese oil company would not have to borrow money from other Chinese government agencies (as CNOOC would have done in the Unocal deal).⁹

On January 9, 2006, CNOOC announced a \$2.27 billion deal to buy a 45% stake in a substantial offshore oil field in Nigeria, its first major purchase since its failed attempt to purchase Unocal.¹⁰ On February 17, 2006, CNOOC announced that its subsidiary CNOOC Africa had signed a five-year production sharing contract with the National Oil Company of Equatorial Guinea to explore an offshore area of about 2,287 square kilometers.¹¹

Some Members also pointed out that at the time China held more than \$600 billion (\$818 billion in December 2006) in dollar denominated foreign exchange reserves and \$256.7 billion in U.S. Treasury securities. It is not surprising that China should try to diversify its dollar-denominated investments. They also argued that U.S. borrowing from China may give Beijing some leverage and weaken the U.S. ability to influence Beijing on human rights, proliferation, and other issues. The need, they said, is for the United States to put its fiscal house in order and reduce its budget and trade deficits.¹²

Some who argued against attempts to block the CNOOC bid pointed out that the U.S. economy has benefitted greatly from being open to foreign investment and having a liberal foreign investment policy. They feared that blocking takeover bids primarily because of political factors could hurt the U.S. investment climate.

⁸ Statement by Rep. Nancy Pelosi, *Congressional Record*, June 30, 2005. P. H5515.

⁹ Guerrera, Francesco, Khozem Merchant, Bernard Simon, and Enid Tsui. Chinese Energy Group Wins Petrokaz in Dollars 4.18bn Deal. *Financial Times*, August 23, 2005. p. 17. Bradsher, Keith and Christopher Pala. Chinese Beat India for Kazakh Oil Fields But Shadow Emerges over \$4.2 Billion Deal. *International Herald Tribune*, August 23, 2005. p. 1.

¹⁰ Goodman, Peter. Cnooc Buys Oil Interest in Nigeria; Overseas Deal First Since Unocal Bid. *The Washington Post*, January 10, 2006.

¹¹ CNOOC Limited. A New PSC Signed by CNOOC Limited for Block S in Equatorial Guinea. Press Release. February 17, 2006.

¹² Statement by James P. Moran, *Congressional Record*, June 30, 2005. P. H5515-H5516.

Foreign Holdings in Chinese Energy Companies

Even though the big three Chinese oil companies are majority-owned by the Chinese government, considerable foreign investment has gone into the energy sector in China. PetroChina, Ltd., Sinopec, Ltd., and CNOOC, Ltd. all successfully carried out initial public offerings of stock between 2000 and 2002. Large blocks of shares were bought by BP, ExxonMobil, and Shell even though these minority stakes have not provided outsiders a major voice in corporate governance (e.g. no seats on boards of directors). The Chinese government retained majority positions in all three largest petroleum companies.¹³

- As part of the reorganization of the government-owned China National Petroleum Corporation in 1999, CNPC injected into PetroChina Company, Ltd. most of its assets related to exploration and production of petroleum and natural gas. CNPC owns about 90% of the shares of PetroChina. Other shareholders include Brandes Investment Partners, BP Investments China, Ltd., and Berkshire Hathaway, Inc. When CNPC carried out its initial public offering (IPO) of PetroChina in early 2000, it raised over \$3 billion with BP purchasing 20% of the shares that were offered.
- The government-owned China Petroleum & Chemical Corporation retains ownership of about 55% of the shares of Sinopec, Ltd. Other shareholders include ExxonMobil (with 19%),¹⁴ China Development Bank, China Xinda Asset Management Corporation, BP, Shell, and the general public.
- The government-owned CNOOC retains ownership of about 70% of the shares of CNOOC, Ltd. CNOOC, Ltd. carried out its initial public offering (incorporated in Hong Kong) in February 2001 of 27.5% of its shares at which time Shell bought a large block valued at around \$200 million.¹⁵

Other than the shares bought at the time of the initial public offerings of China's three largest oil companies, most foreign investments in China's oil and gas sector have not been to purchase shares of existing companies but to establish cooperative joint ventures in exploration, production, and distribution. Beijing has encouraged this activity in order to meet the country's growing energy needs. For example, in offshore oil exploration, recent interest in China has centered on the Bohai Sea area east of Tianjin (believed to hold more than 1.5 billion barrels in reserves) and the Pearl River Mouth area.

¹³ U.S. Department of Energy. *EIA Country Analysis Brief: China*. July 2004.

¹⁴ Mergent Online. Industry Report — Oil and Gas, January 2005. P. 18. [<http://webreports.mergent.com>].

¹⁵ U.S. Department of Energy. *EIA Country Analysis Brief: China*. July 2004. P. 3.

- ConocoPhillips announced in March 2000 that it had completed its appraisal drilling of the Peng Lai find in the Bohai Sea and began production in 2002.
- Canadian independent Husky Oil signed a production sharing contract in July 2001 with CNOOC.
- A consortium including ChevronTexaco and CNOOC has developed a major offshore oilfield in the Pearl River Mouth area.
- ChevronTexaco concluded an agreement with CNOOC in October 2002 for the development of the Bozhong field in the Bohai Sea.
- ExxonMobil is helping Sinopec establish more than 500 gas stations across China and is building at least two refineries in southern China.¹⁶

Over the past two decades, China's economy has been relatively open to many types of foreign investment, and it continues to improve its investment climate under the commitments it made in its accession agreement for joining the World Trade Organization. However, many sectors, especially those dominated by state-owned companies, are still closed or restricted to foreign direct investment. (Many nations block foreign investments in sectors such as broadcasting, telecommunications, nuclear power generation, or military equipment.)

In non-petroleum sectors of the Chinese economy, major recent foreign acquisitions include HSBC with a 20% stake in the Bank of Communications; Newbridge Capital Group with its 18% share of the Shenzhen Development Bank; Anheuser-Busch Co. with a controlling share (more than 50%) of Harbin Brewery Group, Ltd. as well as a 9.9% share of Tsingtao Brewery Co. Ltd.; and the purchase by Kodak of 20% of the shares of Lucky Film, the first acquisition of a non-tradable State-owned company by a foreign investor.¹⁷ Goldman Sachs and Allianz of Germany are in talks to acquire a \$1 billion stake in China's largest state-owned bank, the Industrial and Commercial Bank of China.¹⁸ In June 2005, China Construction Bank sold a 9% stake to Bank of America for \$3 billion. In August, the Bank of China announced it was selling 10% of its shares for \$3.1 billion to a group of investors headed by the Royal Bank of Scotland, Merrill Lynch, and the Li Ka-shing Foundation (Hong Kong).¹⁹

¹⁶ Mergent Online. Industry Report — Oil and Gas, January 2005. p. 18. [<http://webreports.mergent.com>].

¹⁷ The U.S.-China Business Council, Foreign Investment in China, First Half 2004. Eastman Kodak, Lucky Form Partnership. *China Daily*, October 30, 2003.

¹⁸ Barboza, David and Keith Bradsher. Another China Bank is Courted by the West. *The New York Times*, July 11, 2005. Online version.

¹⁹ The Economist Intelligence Unit Newswire, *China industry: Banking on China*, Country Briefing, August 24, 2005. See [<http://www.viewswire.com/index.asp?layout=>

During the CNOOC bid for Unocal, a question relating to reciprocity and fairness in U.S.-China relations arose: can a U.S. company acquire a Chinese oil company? An example of this concern was a study released by Senator Charles Schumer detailing various barriers to foreign investment and business in China.²⁰ Under PRC regulations, foreign investors may acquire PRC companies — in any permitted industry — either by equity or asset acquisitions. Where the target Chinese company is one in which the PRC has a state-owned equity interest, the acquisition must be approved by both a board meeting of the target and a shareholder's meeting. Since the Chinese government is the largest shareholder in CNOOC, CNPC, and Sinopec, it could control the outcome of any board or shareholder meetings of these companies. If a company agrees to a foreign acquisition, the transaction must be approved by the State-owned Assets Supervisory & Administrative Commission (SASAC). This commission oversees the operation of all state-owned assets in China. In essence, any takeover of a major Chinese oil company would require approval by Beijing.

Further approvals are required by the Ministry of Commerce (for compliance with the Foreign Investment Industrial Guidance Catalogue and for review of the establishment of a foreign-invested enterprise as a result of an acquisition). The foreign firm must also file an antitrust report with the Ministry and a report to the China Securities Regulatory Commission.²¹

Unocal As a Strategic Asset

Unocal (formerly the Union Oil Company of California) is a familiar name in the United States, although the company today has streamlined itself and downsized by shedding refining and other assets as well as gasoline stations. Its gross revenues were \$8.2 billion in 2004. When it was placed on the market in 2005, most observers no longer categorized it as a major oil company. For example, well known integrated major ConocoPhillips' gross revenues totaled \$135.4 billion in 2004; much less well known independent producer Anadarko Petroleum grossed \$6.1 billion last year. Viewed in this context, Unocal is more like a large independent producer than the major multinational oil company it once was.

During 2004, Unocal produced a total of 159,000 barrels per day of petroleum and 1.5 billion cubic feet per day of natural gas from domestic and foreign locations, including Canada, where it has significant oil and gas production. North American production accounted for 38% of Unocal's natural gas production and 44% of its

¹⁹ (...continued)

display_print&doc_id=629363848]

²⁰ Schumer, Charles E. *China's One-way Street on Foreign Direct Investment and Market Access*, August 18, 2005, 15 p. Available at [http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2005/08.18.05%20China%20Report.pdf]

²¹ Liu, David and Roger Yao. Procedures for Acquisition of State-owned Equity by Foreign Investors. *China Law & Practice*, June 2004. P. 1-2.

petroleum output. It also operates a domestic and Canadian pipeline system, with storage and marketing capabilities for natural gas and petroleum liquids,²² the firm's Midstream & Trade division.

On July 11, 2005, Unocal announced the sale of its Canadian oil and natural gas subsidiary, Northrock Resources Ltd., to U.S. independent Pogo Producing Company for \$1.8 billion. Northrock operates nearly all of Unocal's oil and gas assets in Canada.²³

Unocal's North American Oil and Natural Gas Operations

Unocal produced 577 million cubic feet of natural gas and 69,700 barrels per day of petroleum in 2004. This is the equivalent of about 1% of U.S. natural gas consumption. Similarly, the company's liquid petroleum production amounts to about 1% of U.S. liquid hydrocarbon production, but only 0.3% of petroleum products consumed. The United States produces about 7.6 mbd of crude oil and NGLs.

Aside from the Canadian assets scheduled to be sold, Unocal has a number of other U.S. operations, including:

- Gulf of Mexico exploration and development, which includes both deep water drilling (water depths of 1,000 to 10,000 feet) and deep well drilling operations (to sub-surface depths of up to 35,000 feet). The company commercializes proven reserves and also drills "wildcat" or exploratory wells.
- Unocal operates 10 platforms in Alaska's Cook Inlet. Additionally, the company holds interests in two North Slope fields, Endicott (10%) and Kuparak (4.95%). Unocal's share of the production of these two fields is about 20,000 barrels per day.
- Pure Resources is a wholly owned subsidiary firm, producing natural gas in the U.S. mid-Continent (Permian and San Juan Basins) area.

Unocal's International Operations

Unocal produces and/or explores for oil and gas in eight countries outside North America. These are Thailand, Indonesia, Bangladesh, Myanmar, the Netherlands, Azerbaijan, Congo, and Brazil. The company operates 100 platforms in the Gulf of Thailand, where it has had operations since 1981. Production is mostly natural gas, but includes 16,000 barrels per day of crude oil. It also operates fields in the region

²² Petroleum liquids, or Natural Gas Liquids (NGL) include propane, butane, and similar fuels.

²³ AP, Unocal Sells Unit to Pogo for \$1.8 billion. July 11, 2005; 8:25 am.

for other firms and has access to unexplored offshore tracts which are seen as having hydrocarbon potential.

The company has also been active in the Congo. In 1984, it acquired a 17.72% working interest in exploration and development rights to the whole offshore. Chevron (with a 50% share) is currently the operator in this venture, which also includes the Teikoku Oil Company (32.18% share). This concession is currently producing 18,000 barrels per day.

Unocal also has a well established position in Indonesia, where it began operations in 1968. It has production in ten offshore areas; it is operator of seven. Of perhaps greater importance are a number of exploration concessions, which offer both crude and natural gas potential.

Unocal activity in Azerbaijan began in 1991 as one of ten partners in the Azerbaijan International Operating Company (AIOC). Production from fields operated by this consortium is growing. Unocal is a partner in the Baku-Tbilisi-Ceyhan pipeline, which has just started operations. This pipeline transports crude from the Caspian Sea to the Mediterranean port of Ceyhan in Turkey and provides economical access to world oil markets, allowing Caspian production to grow.

Unocal owns no refineries, so it does not import crude oil into the United States (nor does it produce gasoline or other fuels). Therefore, a merger with CNOOC would not cause a direct loss of imported supply — at least in the near term. Longer term, however, both the United States and China will be competing for larger amounts of crude oil. To the extent that Unocal assets would have assisted CNOOC in forming exclusive supply arrangements for new oil production, that oil might not have been accessible to other participants in the world oil market. As part of the proposed deal, however, CNOOC stated that all U.S. production of crude oil would remain in the United States.

With regard to Unocal's existing North American production, the Canadian properties were in the process of being sold to another U.S. producer. As far as U.S. production is concerned, that production has its highest value in this country, since the shipping cost to a foreign destination, assuming transport links exist, and they may not, would reduce the effective price received by CNOOC.

If the deal had gone through, the combined CNOOC-Unocal's natural gas production would have amounted to about 1% of U.S. consumption (based on North American production in 2004), and combined oil production would have been equivalent to about 0.3% of domestic U.S. consumption.

With respect to other foreign investments in the U.S. energy supply, the United States does not ban foreign investment in U.S. hydrocarbons. There are myriad foreign holdings of U.S. properties. Among the largest is BP Plc., which owns among other producing assets, a significant stake in Alaska's North Slope production. Royal Dutch Petroleum (better known as Shell), a Dutch firm, also owns substantial U.S. production, including output from Federal lands. Both firms own a considerable refining capacity, as well as large assets in all phases of the oil and

natural gas business. Venezuela's national oil company, PDVSA, also has acquired CITGO, which owns about 7% of U.S. refining capacity.

Review by the Committee on Foreign Investment in the United States (CFIUS)

The question of whether the CNOOC acquisition would have threatened to impair U.S. national security would ultimately have been addressed by the Executive Branch through an established review process. In 1988, amid Congressional concerns over foreign acquisitions of certain types of U.S. firms, Congress approved the Exon-Florio provision of the Defense Production Act. This statute grants the President the authority to block foreign acquisitions of "persons engaged in interstate commerce in the United States" firms that threaten to impair the national security. Congress was concerned at the time that foreign takeovers of U.S. firms could not be stopped unless the President declared a national emergency or regulators invoked federal antitrust, environmental, or securities laws.

The Exon-Florio provision grants the President the authority to take what action he considers to be "appropriate" to suspend or prohibit foreign acquisitions, mergers, or takeovers of persons engaged in interstate commerce in the United States which threaten to impair the national security. In addition, Congress amended the statute in 1992 through section 837(a) of the National Defense Authorization Act for Fiscal Year 1993. Known as the "Byrd" amendment after the amendment's sponsor, the provision requires CFIUS to investigate proposed mergers, acquisitions, or takeovers in cases where (1) the acquirer is controlled by or acting on behalf of a foreign government; and (2) the acquisition results in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.²⁴ Congress directed, however, that before this authority can be invoked the President is expected to believe that other U.S. laws are inadequate or inappropriate to protect the national security and that he must have "credible evidence" that the foreign investment will impair the national security. For the purposes of this legislation, Congress purposely did not define national security, but it apparently intended to have the term interpreted broadly without limitation to a particular industry.

The authority to administer the Exon-Florio provision was delegated to the Committee on Foreign Investment in the United States (CFIUS), which is housed in the Department of the Treasury. The Committee had been established under a previous Executive Order with broad responsibilities, but few powers. It was originally established with eight members, but it has expanded to twelve. The members include the Secretaries of State, Treasury, Defense, Commerce, and Homeland Security; the United States Trade representative; the Chairman of the Council of Economic Advisers; 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

²⁴ P.L. 102-484, Oct. 23, 1992.

to the President for Economic Policy. The Committee has 30 days to decide whether to investigate a case and an additional 45 days to make its recommendation. Once the recommendation is made, the President has 15 days to act.²⁵

Through the Exon-Florio provision, Congress directed that CFIUS, and therefore the President, should consider a list of factors in deciding to block a foreign acquisition, merger, or takeover. This list contains the following elements:

- domestic production needed for projected national defense requirements;
- the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services;
- the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the U.S. to meet the requirements of national security;
- the potential effects of the transactions on the sales of military goods, equipment, or technology to a country that supports terrorism or proliferates missile technology or chemical and biological weapons; and
- the potential effects of the transaction on U.S. technological leadership in areas affecting U.S. national security.

In November 1991, the Treasury Department issued final regulations, after extensive public comment, implementing the Exon-Florio provision. These regulations create an essentially voluntary system of notification by the parties to an acquisition, but they also allow for notice by agencies that are members of CFIUS. Despite the voluntary nature of the notification, firms largely do notify because the regulations stipulate that foreign acquisitions that are governed by the Exon-Florio review process that do not notify the Committee remain subject indefinitely to divestment or other appropriate actions by the President. Under most circumstances, notice of a proposed acquisition that is given to the Committee by a third party, including shareholders, is not considered by the Committee to constitute an official notification. The regulations also indicate that notifications provided to the Committee are considered to be confidential, and the information is not released by the Committee to the press or commented on publicly.

As a consequence of the confidential nature of the CFIUS review of any proposed transaction, there are few public sources of information concerning the Committee's work. For the most part, information concerning individual transactions that have been reviewed by CFIUS or any final recommendations that have been issued by CFIUS have come from announcements made by the companies

²⁵ For information on CFIUS, see U.S. Department of the Treasury's website at [<http://www.treas.gov/offices/international-affairs/exon-florio/>].

involved in a transaction and not by CFIUS. Therefore public information concerning the outcome of CFIUS's reviews are incomplete. According to one source, CFIUS has received more than 1,500 notifications, of which it conducted a full investigation of 25 cases. Of these 25 cases, 13 transactions were withdrawn upon notice that CFIUS would conduct a full review, and 12 of the remaining cases were sent to the President. Of these 12 transactions, only one was prohibited.

The transaction that was prohibited by the President involved the acquisition of Mamco Manufacturing Company by the China National Aero-Technology Import and Export Corporation (CATIC). Mamco was an aerospace parts manufacturer. CATIC, which is owned by the Government of the People's Republic of China, acted as the purchasing agent for the Chinese Ministry of Defense. President Reagan ordered CATIC to divest itself of Mamco under the authority of the Exon-Florio provision because of concerns that CATIC might gain access to technology through Mamco that it would otherwise have to obtain under an export license.

Most often, CFIUS has approved proposed transactions if the parties involved agreed to certain conditions. For instance, in 2000, the Committee allowed Nippon Telephone & Telegraph Company to acquire Verio, Inc, an internet service provider, by obtaining a strict ban on involvement by the Japanese government in the firm. Similar concerns arose with the proposed acquisition in 2003 of Global Crossing, Ltd. by Hutchinson Whampoa Ltd. of Hong Kong and Technologies Telemedia of Singapore. U.S. officials reportedly were concerned that foreign ownership of Global Crossing's fiber-optics network might make the U.S. government vulnerable to eavesdropping from overseas, and some Members of Congress were concerned about Hutchinson's ties to the Chinese military. To ease these concerns, Hutchinson offered to play a passive role in the company. Nevertheless, CFIUS decided to conduct a full 45-day review of the transaction, at which point the Chinese firm backed out of the deal. Eventually, CFIUS approved the acquisition by the Singapore firm by itself, because it offered to put Americans on the board of Global Crossing.

CNOOC took steps to pass a CFIUS review. In response to potential objections, CNOOC stated that it was fully prepared to participate in a CFIUS review of the transaction and that it had made assurances to Unocal to "address concerns relating to energy security and ownership of Unocal assets located in the United States." CNOOC said that it was prepared to sell or take other actions with respect to Unocal's minority pipeline interests and storage assets so long as such a sale did not cause substantial economic harm to Unocal. CNOOC also was open to discussing with CFIUS placing non-exploration and production assets under American management through arrangements that it claimed CFIUS had approved often in the past. CNOOC further emphasized its commitment to retain the jobs of substantially all of Unocal's employees, as opposed to Chevron's plan to lay off employees, especially in the United States.²⁶ CNOOC also stated that it was willing to continue

²⁶ CNOOC, Ltd. "Statement by Fu Chengyu, Chairman and CEO of CNOOC Limited." Beijing, June 24, 2005.

Unocal's practice of selling and marketing all or substantially all of the oil and gas produced from Unocal's U.S. properties in U.S. markets.²⁷

Congressional Activity

The Executive Branch was virtually silent on the proposed CNOOC bid. In Congress, however, the attempted acquisition generated considerable concern — both for the implications of the deal itself and because it coincided with other issues and policies related to China. Congressional activity took two tracks. The first was to generate public awareness, discussion, and analysis that would highlight the implications of the proposed deal and put pressure on CNOOC to alter or withdraw it. Through hearings, statements, and studies, the issue was raised and scrutinized by the American public. The other track was through letters to the Secretary of Treasury (as chair of CFIUS) and legislation aimed at CFIUS. These raised concerns, called for a thorough review, required a study of China's energy requirements and how that affects the United States, or, in the case of one bill, would prohibit CFIUS from approving the proposed acquisition.

The expressed opposition by certain Members of Congress to the proposed CNOOC bid for Unocal arguably played a key role in the withdrawal of CNOOC's offer on August 2, 2005. In explaining why it withdrew the bid, CNOOC stated that the company had "given active consideration to further improving the terms of its offer, and would have done so but for the political environment in the U.S." CNOOC said that the political environment made it very difficult for them to accurately assess their chance of success, creating a level of uncertainty that presented an unacceptable risk to their ability to secure this transaction. They accordingly reluctantly abandoned their offer.²⁸

The bills in the 109th Congress that directly address the CNOOC bid for Unocal are as follows.

H.Res. 344. (Pombo) Expressing the sense of the House of Representatives that a Chinese state-owned energy company exercising control of critical United States energy infrastructure and energy production capacity could take action that would threaten to impair the national security of the United States. Calls on the President to make a thorough review if the deal takes place. August 30, 2005. Passed/agreed to in House.

H.Amdt. 431. (Kilpatrick) to H.R. 3058 (P.L. 109-115, Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006). Prohibits the use of funds from being made available to recommend approval of the sale of Unocal Corporation

²⁷ CNOOC, Ltd. Transaction Information Website. At [<http://www.transactioninfo.com/cnooc/home.php>].

²⁸ CNOOC, Ltd. "CNOOC Limited to Withdraw Unocal Bid," Press Release, August 2, 2005.

to CNOOC Ltd. of China. Amendment agreed to on June 30, 2005. Struck out of final bill.

S. 1412. (Dorgan) A bill to prohibit the merger, acquisition, or takeover of Unocal Corporation by CNOOC Ltd. of China. Introduced July 15, 2005.

H.R. 6. (Barton) Energy Policy Act of 2005 (P.L. 109-58, signed into law August 8, 2005). Section 1837 requires a study by the Secretaries of Defense and Homeland Security of the growing energy requirements of the PRC and the implications of such growth on the political, strategic, economic, or national security interests of the United States. The study would include an assessment of the relationship between the Chinese government and energy-related businesses located in China and delays CFIUS from reviewing sensitive international energy mergers and making recommendations to the president.

Unresolved Issues

The failed CNOOC bid for Unocal left several potential issues still outstanding.

- To what extent does a threat to economic security constitute a threat to national security? Would foreign ownership of oil supply in the United States threaten to impair U.S. national security sufficiently to deny that ownership? This question would have to be answered on a case-by-case basis by CFIUS.
- To what extent would foreign ownership of dual use technology — such as deep water drilling — threaten to impair U.S. national security? Unocal's use of cavitation for deep water drilling apparently also is used by the Chinese military to do nuclear tests underground.²⁹ Since this is not an export of such technology, it would not fall under export controls of the U.S. Export Administration Act. Again, this would be determined by CFIUS on a case-by-case basis.
- What changes, if any, should be made to CFIUS to enable it to consider national economic security as well as traditional national

²⁹ CNOOC Bid for Unocal, if Successful, Would Face Tough Scrutiny in Washington. *International Trade Reporter*, Current Reports: Foreign Investment. July 14, 2005. Statement by Rep. Nancy Pelosi, *Congressional Record*, June 30, 2005. P. H5516.

security in its decisions?³⁰ Should the Exon-Florio provision be amended?

- To what extent should companies that rely on financing by a central government or government-owned financial institutions be allowed to outbid U.S. companies that do not benefit from such backing? There is no U.S. law or provision of the World Trade Organization that deals with such capital transactions. U.S. subsidy law is aimed at exports and not acquisitions. How can a determination be made as to whether a loan is made on a commercial, rather than a political, basis? What rate of interest constitutes a subsidy?
- Should policymakers be concerned when a Chinese state-backed company takes over a privately owned U.S. company? Should potential acquisitions by Chinese companies be treated differently because some consider China to be a potential military rival? Would BP or Shell, but not CNOOC, PetroChina, or Sinopec, be allowed to acquire a company like Unocal?
- To what extent should reciprocity enter into CFIUS reviews? If acquisitions by U.S. companies are not allowed by a country, should that country's companies be permitted to acquire American firms? What about other trade-related problems, such as enforcement of intellectual property rights or access for U.S. exports?
- To what extent should the United States intervene in Chinese acquisitions of American assets located in countries with questionable human rights and other records? If an American company has operations in Burma, for example, should human rights considerations enter into a decision to allow an acquisition of that company by a Chinese firm — considering the poor record of human rights by Beijing?
- How will the political opposition to CNOOC's bid affect U.S.-China relations? Will it lead China to restrict U.S. investment in China? Will this incident discourage Chinese investment in the United States? If China stops purchasing or sells some of its holdings of U.S. Treasury securities, what impact will that have on U.S. interest rates and the ability to finance U.S. government debt?

³⁰ A recommendation by the U.S.-China Economic and Security Review Commission in its *2004 Report to Congress* was that Congress should revise the law governing the CFIUS process to expand the definition of national security to include the potential impact on national economic security as a criterion to be reviewed, and should direct the administration to transfer chairmanship of CFIUS from the Secretary of the Treasury to the Secretary of Commerce. (P. 11)

[<http://www.house.gov/hasc/openingstatementsandpressreleases/108thcongress/04-06-16/robinsonbartholomew.pdf>]

- Should the U.S. government intervene to stop company stockholders and managers from receiving a higher offer for their assets because of political or security concerns? Would government intervention to block a private transaction create inefficiencies in the market, or would U.S. intervention merely offset a market distortion caused by intervention by the Chinese government?