

RESEARCH NOTE

# The Roots of Chinese Oil Investment Abroad

*Trevor Houser*



**TREVOR HOUSER** is a visiting fellow at the Peterson Institute for International Economics and Director of China Strategic Advisory's Energy Practice. Mr. Houser is also a visiting fellow and Adjunct Professor at the Colin Powell Center for Policy Studies at the City College of New York. He can be reached at <[tghouser@chinaadvise.com](mailto:tghouser@chinaadvise.com)>.

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## EXECUTIVE SUMMARY

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This article examines the confluence of domestic factors, both economic and political, that shape the behavior of Chinese oil companies abroad and the implications for energy security in China and the rest of the world.

### MAIN ARGUMENT

- Enterprise reform, price liberalization, and the introduction of management incentives and competition have greatly fostered the modernization and marketization of China's petroleum industry. These factors have also blurred the relationship between the oil companies and the government that owns and regulates them.
- Though Beijing actively encouraged overseas investment in the past, the companies are taking the lead today, shaping policy to suit economic interests.
- The international competitiveness of Chinese firms stems less from overt government support than from a higher risk threshold and a willingness to accept lower returns on investment.
- Because little of the oil Chinese companies produce abroad comes home and human and political costs of supporting the firms' activities overseas are growing, leaders in Beijing are actively debating the merits of China's "going out" strategy.

### POLICY IMPLICATIONS

- The U.S. would benefit more by focusing on the incentives facing individual firms than by focusing on policy pronouncements from Beijing.
- "Equity agreements" signed by Chinese oil companies look largely the same as those signed by international oil companies. These agreements, however, do not impact U.S. energy security regardless of whether the oil is shipped to China or sold on the open market.
- Rather than seeking to prevent Chinese firms from competing in the international oil market, the U.S. may find it more beneficial to encourage the companies' continued reform so that they more closely resemble the international oil majors.
- The U.S. will find some policymakers in China interested in seeing such reform take place. Yet for China to comfortably depend on the open market, the U.S. will have to demonstrate that it is a reliable partner in ensuring the security of the market for all participants.

On March 18, 2007, at a demonstration in New York City, protestors chanted “no blood for oil,” a common refrain since the beginning of the U.S. invasion of Iraq. Yet on this particular day the activists gathered near the United Nations Secretariat were not protesting the U.S. war in the Middle East but the activities of Chinese oil companies in Sudan and the reluctance of the Chinese government to endorse sending a UN peacekeeping force to Darfur. The following week actress and UN Goodwill Ambassador Mia Farrow, in a *Wall Street Journal* op-ed, took aim at the “one thing that China may hold more dear than their unfettered access to Sudanese oil” by calling on sponsors of the 2008 Olympics to pressure Beijing to change course.<sup>1</sup>

Criticism of Chinese involvement in Sudan’s oil sector adds to mounting anxiety over the implications of investment by Chinese oil companies abroad. From the aborted bid by the China National Offshore Oil Company (CNOOC) to acquire California-based Unocal in 2005 to the work of China National Petroleum Corporation (CNPC) in Venezuela, the international endeavors of China’s national oil companies (NOC) are making headlines, sparking congressional hearings, and changing the competitive landscape of the oil and gas industry. Policymakers in the United States and elsewhere are voicing concerns that Chinese NOC investments impinge on the energy security of other countries; international oil companies (IOC) are questioning the terms on which those investments are financed; and development agencies are fretting over the impact of the money on the political health of the recipient countries.

Yet while a great deal of attention has been focused on the behavior of Chinese oil companies overseas, less is known about the structure and evolution of the oil and gas industry within China, the incentives and constraints facing NOC management, and the relationship between the companies, the government, and the policymaking process. Awareness of the domestic market and policy context in which China’s NOCs operate is essential for understanding what drives these companies to invest overseas, the targets of such investments, and how the investments are carried out. This article makes four main points. First, enterprise reform, price liberalization, and the introduction of management incentives and competition have greatly encouraged the modernization and marketization of China’s petroleum industry; yet at the same time these factors have also blurred the relationship between the oil companies and the government that owns and regulates them. Second, though Beijing actively encouraged overseas investment in

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<sup>1</sup> Ronan Farrow and Mia Farrow, “The Genocide Olympics,” *Wall Street Journal*, March 28, 2007.

the past, the companies are taking the lead today and are shaping policy to suit economic interests. Third, Chinese firms' competitiveness overseas stems less from overt government support than from a higher risk threshold and willingness to accept lower returns on investment. Fourth, given that little of the oil Chinese NOCs produce abroad comes home, and that the cost of supporting the firms' activities overseas in terms of human lives and political influence is growing, leaders in Beijing have begun actively debating the merits of a "going out" strategy.

The article is organized as follows:

- ≈ pp. 144–51 overview the evolution of China's oil sector and examine the current relationship between the NOCs and the government
- ≈ pp. 151–61 address Chinese oil firms' motives and strategies and examine the companies' execution of overseas investment
- ≈ pp. 161–66 respond to four prevalent concerns regarding China's NOCs and assess the implications for China and the United States

#### FROM MINISTERS TO MANAGERS: THE EVOLUTION OF CHINA'S NOCS

Unlike its neighbors in East Asia, China has had a robust domestic oil and gas industry for several decades. An oil boom in the late 1960s and early 1970s turned China into the world's fourth largest producer outside the Middle East—a title that the country still holds today.<sup>2</sup> With a decade of 20% annual output growth and oil prices at all-time highs, in the late 1970s Beijing harbored ambitions of becoming the "Saudi Arabia of the East" and planned to finance China's modernization with a bounty of oil riches.<sup>3</sup>

In 1978–79 prospectors drilled over fifteen million meters of new wells in an attempt to increase oil production from two to five million barrels per day (mbd) but found only one new field. As a result, oil output nationwide expanded at a rate of less than 3% per year over the next decade. Not only were plans to build the country's future on the back of oil completely abandoned, but production struggled to keep up with domestic demand. Beijing began to restructure the petroleum industry in an attempt to improve productivity. Until that time oil and gas production, processing, and distribution were controlled

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<sup>2</sup> "Statistical Review of World Energy 2006," BP p.l.c., 2006 ≈ <http://www.bp.com/>.

<sup>3</sup> See Barry Naughton, *Growing out of the Plan: Chinese Economic Reform, 1978–1993* (New York: Cambridge University Press, 1995); and Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: MIT Press, 2007).

by two government agencies—the Ministry of Petroleum Industry and the Ministry of Chemical Industry—which allocated resources in quantities and at prices specified by input-output tables in the State Planning Commission’s economic blueprints.

In the early 1980s Beijing began to convert these ministries into the state-owned enterprises (SOE) that dominate the country’s oil sector today.<sup>4</sup> CNOOC was created from the offshore assets of the Ministry of Petroleum Industry in 1982. Because the Chinese oil industry was relatively novice in this area of exploration and production, CNOOC was given the mandate to invite and cooperate with the IOCs in developing new oil and gas resources off China’s coast. The China Petrochemical Corporation (Sinopec Group) was created the following year from the downstream assets of the Ministry of Petroleum Industry and the Ministry of Chemical Industry. Sinopec was made responsible for all oil refining, marketing, and petrochemical manufacturing. The remaining onshore upstream oil and gas production activities were folded into the newly formed China National Oil and Natural Gas Corporation, which became the China National Petroleum Corporation (CNPC) in 1988.<sup>5</sup>

Although all three of these SOEs remained under the control of the State Council (by way of the State Planning Commission), changes to their incentive and cost structures introduced by the central government as part of broader economic reforms in the 1980s and 1990s affected the firms’ behavior as corporate entities in important ways. First, a twin pricing system permitted the companies to sell at market prices any crude oil and natural gas produced in excess of the quota set by the State Planning Commission. Second, each company’s management was assigned responsibility for the firm’s balance sheet and given the ability to use performance metrics in determining employee compensation. Third, with new freedom to cut costs and boost profits, the three NOCs were expected to finance their own investments, either through retained earnings or bank loans. Government allocations were gradually cut off.

The introduction of limited competition and investor oversight—where previously there had been none—heightened the impact of these reforms on the performance of the country’s oil sector. In 1998 Beijing attempted to create world-scale vertically integrated oil and gas companies by forcing CNPC and

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<sup>4</sup> Fuqiang Yang et al., “A Review of China’s Energy Policy,” Lawrence Berkeley National Laboratory, 1995 ~ [http://china.lbl.gov/publications/china\\_e\\_policy.pdf](http://china.lbl.gov/publications/china_e_policy.pdf).

<sup>5</sup> Ibid. For an excellent discussion of institutional change in the energy sector, see Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures, and Processes* (Princeton: Princeton University Press, 1988); and Philip Andrews-Speed, *Energy Policy and Regulation in the People’s Republic of China* (The Hague: Kluwer Law International, 2004).