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China Buys Canadian Energy: Lessons for the U.S.

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China National Offshore Oil Corporation (CNOOC) this week offered to buy Canada's Nexen, Inc., for $15 billion. Nexen's board is recommending the bid to shareholders. If completed, this would be the single largest acquisition that Chinese companies have made in the outward investment splurge that started in 2005. It raises a series of issues for American policymakers to consider.

The most basic point is that the two sides freely agreeing to make this deal is a good thing; it is how market economies should work. Beyond that, it underscores that the People's Republic of China (PRC) has the means to diversify its access to key resources. China cannot simply be cut off from accessing international oil or the technology associated with it. In addition, China's high valuation of Canadian energy is at odds with the recent American decision to inhibit the development of the U.S.–Canada energy relationship by stalling the Keystone XL pipeline.

Deal Fits China's Investment Pattern. The CNOOC–Nexen transaction wins attention due to its size, but its other features fit Chinese outward investment tendencies perfectly. First, it is an energy deal, and The Heritage Foundation's China Global Investment Tracker—the only fully public dataset on Chinese global investment—confirms that energy has drawn over half of Chinese investment since spending began to rebound from the financial crisis in mid-2009.[1]

Second, the deal fits geographically. The PRC has shown a clear geographic pattern in investment. Australia received the lion's share in 2006–2007, then sub-Saharan Africa grew in prominence for several years. In 2010–2011, South America lured the most Chinese investment.

After several years of intense solicitation by PRC enterprises, the attractiveness of further projects begins to decline and local opposition begins to rise. Some firms begin to look for new markets. Europe was supposed to be that new market, but to date in 2012, it turns out that it is North America. The U.S. easily led all countries in attracting Chinese investment through June 30, and now, in one swoop, Canada has jumped to the top of the pile.

Third, the state dominates Chinese outward investment. According to the Heritage tracker, state-owned enterprises account for well over 90 percent of Chinese spending by volume. When bonds are excluded, the two biggest Chinese outward investors are oil majors China National Petroleum and Sinopec. CNOOC is the third and smallest oil major, a state-owned, centrally controlled entity with monopoly rights to offshore energy development.

Fourth, the Chinese side was again happy to overpay. CNOOC's bid added a 60 percent premium to Nexen's closing price the previous day. This is not the first time China has offered so much—it is not even the first time it has done so for a Canadian energy company.[2] Whether the assets will eventually prove worth it is not the point; the offer could have been lower and Nexen's board would still accept. The PRC often bids against itself.

There is a reason for this. A fifth characteristic that this deal has in common with many others is raising hackles in the host country and even elsewhere. A prominent

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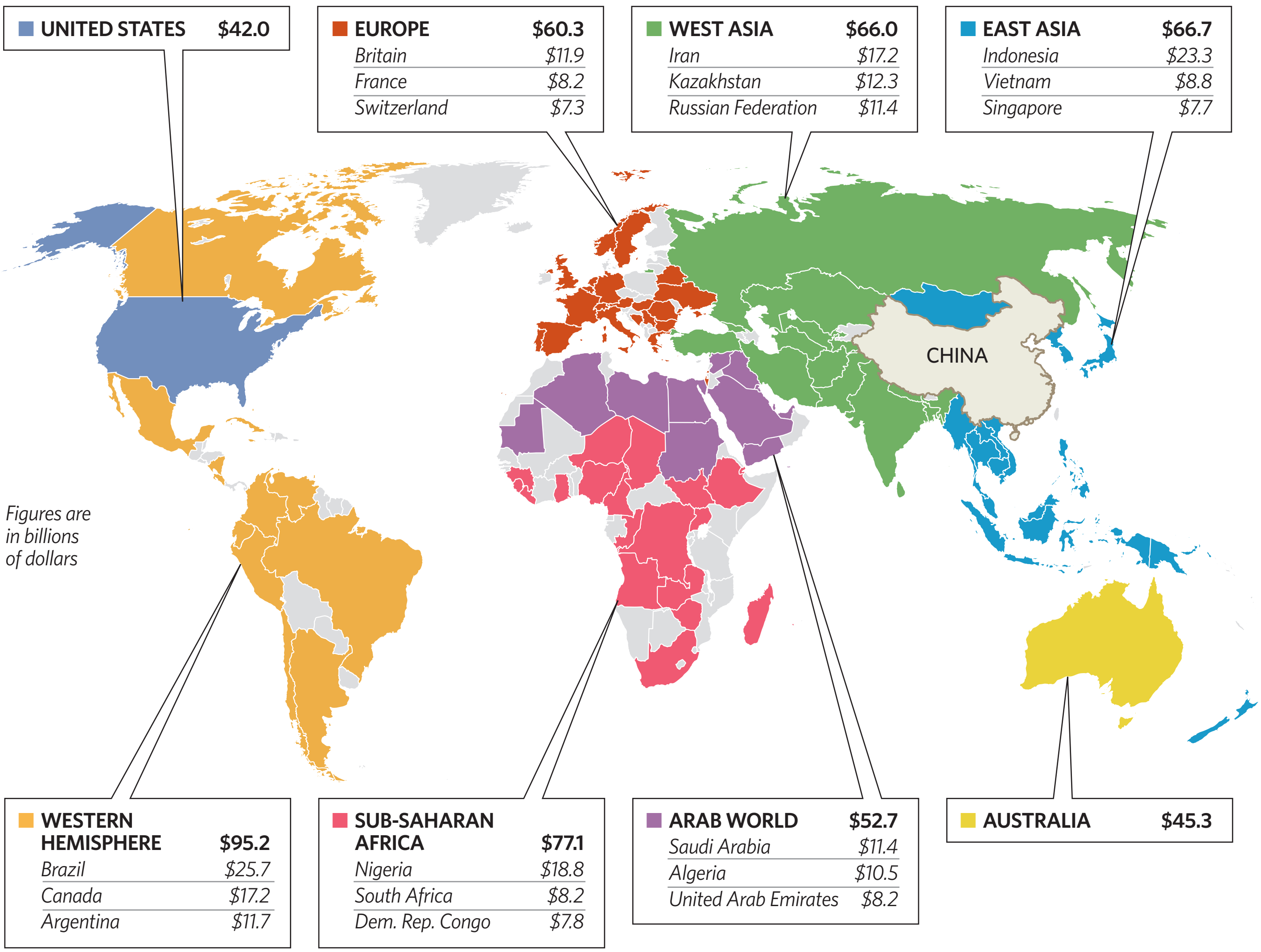
MAP 1

China's Worldwide Reach

The Western Hemisphere continues to draw the most attention from Chinese companies, but growth is occurring more rapidly in the U.S. for investments and the Arab world for engineering contracts.



Source: The Heritage Foundation, China Global Investment Tracker dataset, updated July 2012, https://thf_media.s3.amazonaws.com/2012/xls/China-Global-Investment-Tracker2012.xls.

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feature of Chinese investment is how many times the deals fail. The value of investments that faced serious difficulties since 2005 is over $150 billion.[3] CNOOC is the poster child, with its $18 billion 2005 bid for Unocal barred by the U.S. and a $16 billion proposed deal with Iran never bearing fruit. The Nexen purchase can almost be seen as the same pile of money CNOOC has been looking to spend for seven years.

1. See Derek Scissors, "Chinese Outward Investment: Acceleration Features the U.S.," Heritage Foundation *Issue Brief* No. 3656, July 9, 2012, http://www.heritage.org/research/reports/2012/07/chinese-foreign-investment-outward-investment-acceleration-features-the-us.
2. Andrew Willis, "Sinopec Pays a Hefty Sum for Syncrude," *The Globe and Mail,* April 13, 2012, http://www.theglobeandmail.com/globe-investor/investment-ideas/streetwise/sinopec-pays-a-hefty-sum-for-syncrude/article4314688/ (accessed July 25, 2012).
3. The full dataset can be downloaded at the interactive graphic here: http://www.heritage.org/research/projects/china-global-investment-tracker-interactive-map.

Wide-Ranging Implications. One policy implication of CNOOC–Nexen is thus a bit stale: Blocking the Unocal deal was a mistake. As with Nexen, CNOOC's bid for Unocal was freely agreed to. Its rejection by the U.S. government merely caused CNOOC to invest elsewhere, along with its bigger sisters in oil and other Chinese firms in other sectors. American participation in Chinese investment was delayed a few years, and the PRC was encouraged to seek oil in places where the U.S. now does not want it to be, such as Iran.

Another implication follows immediately: If the U.S. wants to influence the way the Chinese participate in the global energy market, it should not object to the Nexen deal. Washington rightly wants the PRC to move away from dubious oil-producing regimes in Venezuela, Sudan, and elsewhere. Where should China go? A country that will respect international sanctions, has sound regulatory oversight, and is a close American ally is the ideal alternative.

There is also is a bit of a role reversal occurring. The PRC envies American success in diversifying its energy use away from Middle Eastern oil.[4] The acquisition of Nexen, which produces multiple kinds of fossil fuels around the world, is a step in the direction the U.S. has adroitly moved. Meanwhile, the U.S. is now derailing its own closer energy relationship with Canada by playing politics with the Keystone XL pipeline. Beijing's willingness to overpay for remote energy assets may or may not prove wise, but it stands in stark contrast to the Obama Administration's unwillingness to let America access nearby energy assets.

On the security dimension, China has again demonstrated the ability to improve its technology base through foreign acquisitions. Nexen represents its main areas of expertise as petroleum extraction from oil sands, deepwater oil drilling, and floating production, storage, and off-loading systems. Given their pressing energy needs, the PRC is naturally working in all of these areas. The acquisition of Nexen will improve CNOOC's capacity and, in the area of the oil sands, the capacity of the other two state oil majors as well.

Consequently, while there is no apparent direct security impact from this acquisition, it is likely tvo have long-term consequences for regional security far removed from Nexen's area of operations. In particular, development of South China Sea oil reserves is currently dependent upon private corporations, which have the bulk of the world's expertise on deepwater drilling.

However, once CNOOC has assimilated Nexen's deepwater drilling techniques, it will be much more capable of undertaking difficult South China Sea projects. It also has the standard advantage for Chinese state firms of not being particularly worried about financial losses from any instability in the area. Coupled with China's growing military presence in the region, this could back "comprehensive" long-term measures to more firmly assert Chinese control. This is not grounds for opposing the Nexen sale, but it is another reason to maintain or, if necessary, expand the American presence in the South China Sea to make clear to the PRC that the U.S. stands with its allies.

Recommendations:

- Neither the Administration nor Congress should publicly oppose CNOOC's acquisition of Nexen or privately pressure Canada to block the deal;
- The U.S. should monitor Chinese oil activity in the South China Sea, press for clarification of Chinese claims there, and advocate for an effective, binding code of conduct among the parties to the territorial dispute—before Chinese state-owned enterprises make a more concerted push into the area; and
- Pursuant to its authority to regulate commerce with other nations, Congress should recognize the State Department finding that Keystone XL would pose no significant environmental threat and authorize the pipeline.

Welcome Investment. America and the world benefit from commercial energy investment in free-market economies. Chinese investment in Canada is part of that and should be welcomed—even while the PRC's employment of acquired technology in sensitive areas should continue to be monitored.

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4. Yang Yanchun, "US' Diversification Strategy Influences the Oil Market," translated by Peter Nix, *Watching America,* February 28, 2012, http://watchingamerica.com/News/145848/us%E2%80%99s-diversification-strategy-influences-the-oil-market/ (accessed July 25, 2012).