The CNOOC Bid for Unocal and US National Security: Was the Political Outcry in Congress Justified?

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Abstract

The Chinese National Offshore Oil Corp (CNOOC) bid for US oil company Unocal was thwarted by a ferocity of political opposition within Congress that surprised many. It was posited that the bid was an economic strategy aimed at threatening US national security. This paper investigates whether the extent of the political outcry was rationally justified by evaluating these arguments primarily in the context of China's economic status. It finds that the arguments put forth in Congress were untenable, and national security fears were unfounded. Furthermore, this paper proposes that the implications of the political reaction are harmful to American interests.

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Introduction:

In April 2005, Chevron made an offer for Unocal at about $61 a share. China National Offshore Oil Corp (CNOOC), a semi-state owned Chinese firm, entered the race in June when it issued an $18.5 billion cash bid (at about $67 a share) for Unocal, a Californian oil company, and the 9th largest one in America. Congress feared that CNOOC's takeover bid for Unocal was part of a co-coordinated Chinese strategy aimed at eroding American energy resources and compromising its national security. China-bashing from the *Congressional Rcord* and testimony relating to this issue clearly displayed their fears. Congress pressed for the invocation of the Exon-Florio provision of the Defense Production Act, calling for an immediate review of the bid by the Committee on Foreign Investments in the United States (CFIUS).

The political opposition can be said to be the decisive factor leading to the eventual failure of CNOOC's bid. Despite Chevron's lower offer of US$17.4 billion, 77.2% of holders of its outstanding stock (210.26 million shares) voted to approve the merger with Chevron over CNOOC primarily because the latter would have brought with it much regulatory risk. CNOOC ultimately withdrew its bid in the face of the violent political opposition. Indeed, a banker on the CNOOC team said that "it was that political opposition which tipped the balance, even more than the economics of the deal".[2]

[2] Bill Powell,, Eric Roston, Adam Smith, "Sunset For a Deal: Swamped by opposition among US politicians, CNOOC finally drops its bid for Unocal—and may be better for it., Time International (Europe Edition), Aug 15, 2005, v166i7, p24

What makes this case unique is the extent and violence of the political reaction against the bid. Unocal is not a national treasure—its total oil production constitutes less than 1% of domestic oil consumption while 70% of Unocal's assets (in terms of turnover) are actually gas reserves in Asia, making it a reasonable target for China. Furthermore, CNOOC had been willing to make many compromises, including a willingness to divest itself of assets that the CFIUS review might decide as having national security implications. Why, then did this commercial bid invite such political outcry? Was such a reaction justified? These questions provided the backdrop against which this project was embarked upon in an endeavor to construct an intelligible account of the CNOOC saga. This paper will examine Congress's expressed grounds for opposition to the deal, assay the validity of these arguments, and finally evaluate the implications of the political outcry.

The Political Reaction

<u>The Rhetoric</u>:

House of Representatives Democratic Leader Nancy Pelosi said in a speech on the House Floor that should the deal go through, China will gain access to "cavitation technology"—the process where oil is drilled for in deep water—that will enable the Chinese "to do nuclear tests underground and to mask them so we would not ever be able to detect them." [3] Richard D'Amato, chairman of the US-china Economic and Security Review Commission, an influential Congress-appointed commission that reports directly

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[3] June 30, 2005, Pelosi Statement on Amendment to Block Chinese Bid to Acquire Unocal,, http://www.house.gov/pelosi/press/releases/June05/unocal.html

to Congress and recommends legislative and administrative actions with regards to China and security said that the CNOOC bid for Unocal as "not a business transaction at all…the Chinese government is going after these energy supplies to control them and lock them up." [4]

Some of the testimony offered simply steered clear of reasoned arguments. Instead, ideological rhetoric surfaced. Carolyn Cheeks Kipartick (Democrat, Michigan) added that "We're a democracy. We're not communists."[5] Joe Barton (Republican, Texas) added that "Red China...(is run by) contemporary communists who somehow learned to love profit but not freedom." Charles Schumer, sponsor of the now infamous Schumer-Graham which threatened to slap a 27.5% tariff on Chinese imports across the board, said "Does anybody honestly believe that the Chinese would ever let an American company take over a Chinese company?" [6]

The Congressional Record

On June 30, the House voted 398 to 15 for a non-binding resolution co-authored by Representatives Richard Pombo (Republican-California) and Duncan Hunter (Republican-California), calling for an immediate review by the interagency Committee on Foreign Investments in the United States (CFIUS) of the possible takeover.[7] The resolution states that a CNOOC takeover of Unocal "would threaten to impair the national security of the United States." The House also voted to approve a measure 333 to

[4] *The Associated Press*, June 28, 2005

Jonathan Weisman, "China's Demands Anger Congress, May Hurt Bid" *The Washington Post*, July 6, 2005; Page D01

[6] "Free-Trade Firefight", *US News & World Report*, July 18, 2005

[7] US Congress, House 2005, H.RES 344

92, cutting funds from the US Secretary of Treasury for a federal security review needed to allow the deal to proceed.

On July 27th, Congress amended an energy bill (the Energy Policy Act 2005) that was passed through Congress, requiring the US Energy, Homeland Security,, and Defense Department to conduct a 120-day study on how China's growing energy needs affect the United States. The CFIUS could only start conducting a 3-month review 21 days after this study had been completed. Effectively, this meant a 141-day delay before the deal could be approved, if approved at all.

Questioning Chinese Intentionality: Eroding American National Security

The prevailing view in Congress right now is that moves like CNOOC's bid for Unocal are part of a larger coordinated effort by the country to increase its influence and others' dependency on her. Chinese companies are tools for single-minded Chinese expansionist aims. Much has been made about CNOOC close ties to the Chinese government. Indeed, there is clear evidence that CNOOC for this. CNOOC is 70% owned by the Chinese government while its parent company, China National Offshore Oil, is 100% owned by the government. However, evidence of close ties to the Chinese government is far from sufficient to prove that a hostile broader agenda exists. If there was indeed a larger Chinese agenda, there is no reason to believe that CNOOC would be the vanguard in the Chinese bid to stockpile natural resources—one would have to look at the activities of other Chinese companies to see if any trends emerge. For American politicians to be right therefore, one must first be able to establish a firm link *among* different Chinese companies, and *with* the Chinese government.

A recent case similar to that of the CNOOC bid for Unocal, is the CNPC (China National Petroleum) bid for a Canadian owned Petrokazhakstan in Kazhakstan. Stock prices soared before stabilizing last month in reaction to the bid. Although there have been murmurs of discontent among the government, the bid is likely to go through with, but not without some payments on the side. This CNPC bid for Petrokazhakstan is similar to that of CNOOC for Unocal because both target companies were mid-sized ones. Some analysts have said that this could reflect Chinese strategy to ease into the global market without setting off the alarms. That different Chinese companies are also seeking new energy sources around the world (see Implications, above) might also be testament to this broader Chinese agenda for world domination.

At the same time, it is hard to prove concretely that these Chinese companies are tools of the Chinese government in pursuit of a broader agenda and harder yet to prove that this agenda is hostile. China is a rapidly developing country that needs energy resources to fuel its economic expansion. Rather than seeking world domination of oil wellheads or increasing other nations' dependence on her, China's search for oil is most likely motivated by the reasonable desire for energy supply assurance underscored by its economic imperatives.

There have been criticisms that China wants to "control the resources at the wellhead of the source, bypassing world market mechanisms" because of its non-membership in the International Energy Agency.[8] If China is indeed seeking to control energy resources, then it would be protective of its own energy markets. This is not the case. We see for instance that China is opening up its energy market to foreigners. The

[8] Carolyn Bartholomew, US-China Economic and Security Review Commission, Dark Clouds on the Horizon: The CNOOC-Unocal Controversy and Rising US-China Frictions, Carnegie Endowment for International Peace, July 14, 2005

Hong-Kong stock exchange—the gateway into the Chinese market—is now developing Chinese energy companies as specialized investment opportunities. One such opportunity was China Shenhua Energy's $3 billion initial public offering in June. Shenhua is majority state-owned and accounted for 6.1% of China's coal output in 2003 and is China's top coal exporter. Also, British Petroleum announced 13th October that it might buy a significant stake in Sinopec, marking it "the first time a state-owned Chinese oil group will have allowed foreign influence into its boardroom." [9] Nor are Chinese energy companies unwilling to cooperate with legitimate states. CNOOC Ltd for instance, the Hong-Kong listed subsidiary of CNOOC, already has joint ventures in Australia with Shell and in Indonesia with BP. Furthermore, its shares are available to U.S. investors as ADRs.

Is China Presently Capable of Threatening American National Security through Economic Strategy?

Even if a wary Congress was correct in its suspicions, and the Chinese are indeed *intending* to erode American national security through economic strategy, it is especially pertinent to ascertain whether the Chinese are currently *in a position* to *effectively* do so. Contrary to the ostensible flood of statistics heralding China's dramatic economic growth, the country is as yet unable to pull any economic clout vis-à-vis America that would seriously threaten the latter's national security. A careful examination of China's current economic status will show that the arguments posited in Congress supporting the view that China is eroding American national security through economic strategy are exaggerated. Moreover, an examination of the existing mechanisms for the protection of

[9] *The Financial Times*, October 13, 2005

American national security against hostile foreign economic strategies will show that America has little to worry.

Comparing Present China to Japan Inc. of the 1980s

Those within Congress suspicious of China "assert that the Chinese state is a single—and single-minded—entity with a master plan to reclaim China's rightful place at the center of the world."[10] There were similar fears about Japan in the past. The period of the late 1980s and early 1990's now known as "Japan Inc." was one in which phenomenal Japanese economic growth and her acquisitions of many American companies led to widespread fears about Japan's intentions. Since the CNOOC issue and the overall China-bashing (especially in Congress) have been a very recent phenomenon, very few academic pieces have been able to sufficiently analyze these issues. The experience of Japan Inc. provides a helpful foil against which one can identify, organize and asses the validity of the current concerns about China.

This Japan Inc period was one when, according to opinion polls, a majority of Americans felt that Japanese economic competition presented a greater threat to American security than Soviet military power while many "well-informed" people felt that Japan was a "systematically predatory actor" on the international economic scene, "an authoritarian state under the irresponsible and corrupt rule", and that a policy must be devised to "contain" a rouge Japan. It was also "whispered among those whose

[10] "The myth of China Inc, The scare stories—and the chaotic reality", *The Economist*, 9/3/2005, Vol 376, Issue 8442, p53

profession is to reflect on the contingencies of the future" that it was time for the Pentagon to "draw up plans for an eventual war with Japan". [11]

At that time, there was also relatively virulent Japan-bashing within Congress, paralleling the current China-bashing. The economic concerns then with Japan Inc. are also relatively similar to the concerns over China. By comparing China now with Japan then, one will be able to conclude (leaving actual Chinese intentions temporarily aside) whether China is in a suitable economic position to threaten America's national security.

Trade Imbalance and Foreign Direct Investment

The trade imbalance with Japan was also a worry in the 1980s/1990s. 36 % of the total global trade deficit which peaked in 1986 at $159.5 billion was represented by Japan. In 1989, the trade deficit represented by Japan was estimated to be 50%. A trade deficit meant that America had to borrow to cover the deficit, borrowing most of what it needed from Japan. Other foreign capital invested in Treasury securities, bonds, and stocks, meant that American debt was a hugely pertinent issue.

However, the deficit was "intended by nobody and caused by everybody".[12] The overall external deficit soared after the 1981 tax cuts and unexpected federal budget deficits. America's low savings rates—among the lowest in the industrial world—and the growing demand for investment, pushed up real interest rates and attracted foreign savings (of which Japan had plenty) to the US. The subsequent rise in the value of the dollar strengthened imports and weakened exports. The inflow of capital from Japan and elsewhere supported, indeed, made possible, the levels of American of investment.

[11] Philip H. Trezise, "Japan, the Enemy?", *The Brookings Review*, Winter 1989/1990, p3
[12] Ibid

The trade deficit with China is one of the main concerns presently. China's country-to-country surplus with America is substantial—it stood at $162 billion in 2004, comprising approximately 24% of total US trade deficit.[13] This has led to cries from Congress accusing the artificially low Chinese yen of subsidizing exports and contributing to the trade deficit, resulting in responses like the proposed Schumer-Graham bill, calling for an across the board tariff 27.5% on all Chinese goods. This is reminiscent of the Congressional reaction to Japan Inc. In 1988, Representative R.A. Gephardt "almost succeeded in writing into law a provision penalizing nations with excessive trade surpluses, to wit, Japan".[14] To the extent that this logic was not extended to reward countries with a deficit vis-à-vis the US, measures like these were obviously protectionist.

As aforementioned, China's global trade surplus comprised a mere 8% of the total US deficit in 2004.[15] Furthermore, in comparison to China's trade surplus, surpluses from Japan, the Euro currency area and other oil exporting countries account for more than 60% of the US trade deficit. However, even if one chooses to focus on China's country-to-country surplus with America, the question is whether the Chinese should be blamed for this. A trade imbalance was not forced onto America by a coercive China. The trade imbalance, like that between Japan and America in the 1980s, arose naturally from US trade in response to market forces driven by prices. Since the US trade deficit by definition must equal US consumption minus US output, given these levels, the aggregate US deficit is independent of China's actions. America's capital stock is also ultimately

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[13] Albert Kiedal, "China's Currency: Not the Problem" , Carnegie Endowment for International Peace Policy Brief, June 2005, p5
[14] Tresize, "Japan, the Enemy?",the *Brookings Review*, Winter 1989/1990. p4
[15] Kiedal, p3

bigger because of this inflow of capital. The key point is that these movements were wholly voluntary responses to economic incentives. China should not be blamed.

A second concern regarded Japan's foreign direct investment—capital used to acquire control of an American firm or to invest in an already foreign-owned firm. These concerns were unfounded. Despite the high visibility of Japan's purchases, Japan's FDI then comprised just slightly more than 3/100000 of America's national wealth during that period. Furthermore, foreign firms establishing themselves in America *become* American firms, and are liable to for laws and regulations that local firms are subject to. [16]

Likewise, Chinese FDI in America means that these firms will be subject to the same laws and regulations as American ones, and pay the same taxes. Also, given the vast amount of money that flows into China from its exports to America , it is natural for China to invest in higher yielding investments than Treasury bonds, of which it already has plenty. In addition, contrary to American fears that China is on a foreign buying spree, China has actually experienced a string of failures in acquiring foreign companies. Although China's Lenovo Group succeeded in purchasing IBM's personal computer unit for $1.75 billion, China Mobile's bid for Pakistan telecom was overtaken by a competitor from the United Arab Emirates in July 2005, China Minmetals' $7 billion bid for Canada's Noranda failed, and China's Haier Co. withdrew its $1.13 billion bid for Maytag. Furthermore, to put things in perspective, American firms have 120 times as much invested in China than vice versa: Chinese FDI in America is about $2 billion while American FDI in China (including Hong Kong) is about $60 billion.[17] We also know now from the benefit of hindsight that even if a country's FDI in America is

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[16] Trezise, "Japan, the Enemy?"p8

[17] Lael Brainard, Michael E. O'Hanlon, Brookings Institution, "A Test of American Independence", the *Financial Times*, July 26, 2005.

substantial. America might not be the party that looses--Japan Inc ended up buying American companies for more than they were worth.

Some other problems are still extremely relevant. America remains a country with one of the lowest savings rates in the developed world. Much of its investment is being supported by foreign capital. China held US$243 billion worth of Treasury bonds at the end of June (a large jump from US$165 billion last year) as the second largest holder of Treasuries. The largest holder of treasury bills is still Japan with US$680 billion. Treasury holdings by Asia alone are about US$1.2 trillion. Members of Congress worry that this gives the Chinese considerable economic and political leverage. This puts America in a quandary. If America is indeed uncomfortable being so dependent on foreign countries, then she should find a means to decrease this dependence by increasing her national savings' rate

At the same time, Japan Inc. is not perfectly analogous with the current Chinese situation. Japan at that time posed more of a potential threat than China now does. Japan Inc, via foreign direct investment, had bought real estate in New York and LA and textile mills in the Carolinas; and built auto plants in Ohio, Tennessee, Illinois, and Michigan, It also bought such American icons as the Rockefeller Center and Columbia studios and Pebble Beach golf course, sparking fears that Japan may be colonizing the United States. In contrast, the CNOOC bid for Unocal represented the biggest ever Chinese bid for an American company.

Furthermore, China is not in nearly the same economic position as Japan was then. China's huge population and land size means that most of the country –about 60% —is still rural and lacking the necessary higher-level skills to compete in high-end manufacturing sectors. One of the key engines of Japanese growth was its high-tech capabilities. It established dominant market share in the US through three major products: video cassette recorders, fax machines, and memory chips. In contrast, China's key export products now are those in lower-end manufacturing like textiles. It will take a while before China will be able to catch up with the industrialized world, and longer still to buy these high-tech firms en masse and keep them running profitably. It is true that the figures now show China most likely surpassing Japan by 2020. However, apparent trends could go awry. In the '80s for example, Japan's rate of increase of GDP and exports to the U.S. indicated they could possibly overtake America by 2020. That did not happen. We also saw that Japan's 10-11 percent annual growth in the 1960s fell to an average of 4-4.5 percent in the1980's, in part because such phenomenal growth cannot be sustained in the long run, especially as a country industrializes. There are signs indicating that China's growth is already slowing.

While China is still not an entirely open economy however, she is achieving such phenomenal growth in part because she has opened herself to foreign investment. China has made a genuine attempt to herald the change. For instance, regulations requiring all foreign companies investing in China to form joint ventures with Chinese companies and to give the latter a controlling share were lifted in most industries by the end of 2004. Only the automobile and financial sectors retain this ownership cap. Although there are still some protectionist measures like pressure on U.S. companies to share technological advances in order to enter the Chinese market, John Frisbie, president of the U.S.-China

Business Council, says that the FDI in the unrestricted sectors greatly overwhelm that in the restricted sectors.[18]

Ultimately China, in its present state, is not powerful enough to threaten America in the way that the Japanese could have. However, China's sheer size and its potential for growth—judging by its current economic trends—promise to make her a real force to reckon with in the near future. However, what remains necessary to give America reason to worry about is hostile *mens rea*, or intention, on China's part. That remains now an answer that only speculation can provide.

<u>Existing Mechanisms are adequate to protect US National Security</u>

There are mechanisms already in place that assesses whether foreign acquisitions are in America's economic interests, and whether they threaten American national security. Firstly, there is a framework for routine assessments of acquisitions of American companies, whether the buyers are domestic or foreign; private or state-owned. The Justice department decides if the acquisition will limit market competition. If it is so decided, then the deal will be "blocked altogether" or "its approval can be made conditional on substantial deal modification."[19]

Next, the Committee on Foreign Investments in the United States (CFIUS) comprising different agencies, is permitted to conduct an interagency review of any deal displaying "credible evidence" that it threatens US national security. (For a more detailed examination of this review below, see Implications) These existing measures would have sufficiently identified any potential threat to US national security through a

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[18] Jim McTague, DC Current, *Barron's New York* ,August 2005.

[19] All information and quotes here from, Laura D'Andrea Tyson, "What CNOOC Leaves Behind; Existing mechanisms can asses risks to US national security", *Business Week*, 08/15/2005, i3947, p 101

foreign acquisition of an American company. Extraordinary intervention in Congress is redundant. Indeed, "existing mechanisms for a rigorous analysis of a deal's competitive and national security impact should yield the answer (to whether a Chinese acquisition of any particular US company is harmful to the US). Protectionist sentiment and alarmist China-bashing will not."

Other Reactions to the CNOOC Bid

The American political reaction to the CNOOC bid cannot be seen in vacuous isolation. In order to properly assay the political reaction, it is instructive to view it in a context through comparing it with other prevailing reactions. By demonstrating the prevailing sentiment, these other reactions ranging from those of think-tanks to the Chinese government, together provide a touchstone against which the American political reaction can be more holistically viewed.

I. Think-tanks

Think-tanks have been the one conduit for academic coverage of the issue. The major think-tanks concerned with international politics and economy have generally been advocating the view that the CNOOC bid does not threaten national security. Cato, the Brookings Institution and the Carnegie Endowment for International Peace were of this opinion, to varying degrees.

Cato for instance, approached the issue by focusing on America's continued security to oil access via the market place. The think-tank expressed in a policy brief that fears that a transaction like that between CNOOC and Unocal would harm national security by making the United States more dependent on foreign oil, or that the proposed transaction threatens to provide China with an "oil weapon" are ill-founded. Cato believes that "America's vulnerability to oil supply disruptions is primarily related to how much oil we consume, not where the oil we consume happens to originate." Unocal's reserves would not have been enough to provide CNOOC with "significant market power in the global oil economy". The reasoning seems to be that as long as America maximizes its level of income and secures its position of wealth, then she will always be able to buy oil from the global marketplace.

The Brookings Institution, while acknowledging that this CNOOC bid was less than hostile, nevertheless posits that "whatever the merits of the Unocal deal, this should be a wake-up call"[20] for America to assess its dependence on China. It provides four benchmarks with which to measure when American economic dependence on China is "too much". These are related to critical technologies, computer technologies, natural resources, and "overall economic dependence"—the development of an economic relationship with China that will lead America to become a "hollow economy, living far beyond our means." Only the last benchmark should be a worry now, and should be combated by US fiscal policy and further Chinese currency revaluation.

The most detailed coverage was provided by the Carnegie Endowment for International Peace. The primary figure analyzing the case is its senior associate Albert Kiedal. Kiedal argues that in exploring whether the Chinese are threatening American

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[20] Lael Brainard, Michael E. O'Hanlon, "A Test of American Independence" *Financial Times*, July 26, 2005

national security with the CNOOC attempt for Unocal, one needs to look at "actual (military, security, and national security) contingencies". Furthermore, one should emphasize the role of price. By intervening in the CNOOC bid, America is "eshew(ing) market forces and a global system based on price."[21]

There were some think-tanks however, which were more suspicious of China's motives and more pessimistic about the possibility of clashes between the two titans in the future. "The Bush administration's attitude toward China at the moment is to look for ways to work with it, but I don't know how sustainable this policy is going to be," said Gal Luft, executive director of the Washington-based Institute for the Analysis of Global Security, a conservative think tank. "At the end of the day, you've got two very large consumers competing over the same sandbox. Sooner or later the Chinese are going to run out of places they can look for oil."[22]

II.The Media

The CNOOC issue and subsequent ferocity of the political opposition was regularly covered in the press in newspapers and periodicals from The Financial Times and the Washington Post, to Business Week and Barron's. The controversy has even been covered in Turkish and Indian news. [23] Most media publications have cautioned against America's overreaction. For example, articles included "Mishandling the China Challenge" in *Newsweek* (8/15/2005), "Sunset for a Deal: Swamped by opposition among US politicians, CNOOC finally drops its bid for Unocal—and may be better for it." in

[21] Albert Kiedal, transcript from Dark Clouds on the Horizon: the CNOOC-Unocal controversy and rising US-China frictions, July 14, 2005.
[22]Mark Magnier, "China Stakes Claim for Global Oil Access", the *Los Angeles Times*, 7/7/2005
[23] For example, the *Turkish Daily News* had an article "CNOOC wages public relations, lobbying battle for Unocal" on June 29th, 2005

Time International (Europe Edition) (8/15/2005), and "Foiled Bid Stirs Worry for US Oil" in the New York Times. (08/11/2005).

The *Economist* magazine has been especially vocal about the issue. The publication posits that "In Washington, the bid was…portrayed as a state-funded grab for strategic American assets" (*9*/3/2005"the Myth of China Inc"), and that CNOOC "became a lightning rod for all the issues that now enrage American politicians about China". (8/6/2005 "Giving China a Bloody Nose") It went on to say, "The most worrying aspect of the CNOOC episode…is what it says about America. The anti-China hysteria in Washington, DC, the cowardly silence of the pro-China business lobby, and the blatant disregard for fair play and open markets is deeply disturbing."

III. Other Industry Players and Energy Experts

Most major oil companies had been supportive of the CNOOC bid, if not cautionary about America's political opposition to the deal. *Time Magazine* reported that "Most energy experts believe that the risks either didn't exist, or could have been easily dealt with. The magazine quoted oil consultant Philip Verleger as saying that "There are no security issues—none". "The bottom line is, the U.S. will have to make room for China," said Youssef M. Ibrahim, an oil analyst with Strategic Energy Investment Group of Dubai, United Arab Emirates. "If it doesn't make room for China, China will take the room." Even other American companies have expressed reservation about Washington's intervention in what is seen as a free-market transaction. The *New York Times* reported that Lee R. Raymond, chief executive of Exxon Mobil, said that it would be a "big mistake" for Congress to interfere with the bid because it the interference may well "backfire on American companies seeking to do business abroad."

Mr. Mosbacher, chairman of the Mosbacher Energy Company who served as secretary of commerce from 1989-1992 wrote an article warning about sending protectionist signals to the rest of the world. Mr. Moscbacher said, in the article that " we must be extremely careful not to send a signal limiting foreign investment, in general, and Chinese investment, in particular. We are a free-trade nation which overall has worked very well for us. Free trade must be a two-way street."[24]

IV.Chinese Government Reaction

To gain an insight into the motivations of the Chinese government, it is instructive to see how it was involved in the issue. One way to do this is to examine its reaction as the deal progressed. The initial reaction of Chinese politicians to Congress's opposition to the CNOOC-Unocal deal was defiant. In response to the resolution passed by the House of Representatives opposing the CNOOC bid on the grounds of national security, the Foreign Ministry issued a clear statement: "We demand that the U.S. Congress correct its mistaken ways of politicizing economic and trade issues." It went further to say that "CNOOC's bid to take over the U.S. Unocal company is a normal commercial activity between enterprises and should not fall victim to political interference. The development of economic and trade cooperation between China and the United States conforms to the interests of both sides."[25]

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[24] Robert A. Mosbacher, "Trade is a Two Way Street", *the Wall Street Journal,* Jul 19, 2005

[25] Peter S. Goodman , "China Tells Congress To Back Off Businesses, Tensions Heightened by Bid to Purchase Unocal", the *Washington Post, 7/5/2005; A01,*

As the issue wore on however, the Chinese government became increasingly reticent. “This is a commercial matter,” said a Chinese Ministry of Commerce spokesman “as a government department, there is no need to make any comment about his at this time.” After it became clear that the bid was unlikely to be accepted, the Chinese government heavily restricted news coverage of the issue. A central-government directive was issued to newspapers, websites and television stations to publish only approved Xinhua news agency accounts of the bid. Xinhua’s coverage of the issue was fact-based and relatively neutral.

Interestingly, the move was not intended to save the Chinese “face”, but rather to quell criticism of the United States before a meeting between President Hu Jingtao and President Bush. Li Xuguang, Professor of Journalism at Qing Hua University in Beijing thinks that the “Propaganda Department is trying to cool down the nationalistic anger caused by this…the government wants to have strong ties with the US despite this setback.”[26] This interpretation lends some support to the view that the CNOOC bid was not meant to be predatory, and that the Chinese government in fact did put its diplomatic ties with America before its economic interests in this case.

Despite the restriction on media coverage however, some commentary did appear. The *China Daily* wrote an editorial on August 8th entitled “Aborted takeover will also affect US”, noting that although CNOOC lost little in the process, the furor over the CNOOC bid would ultimately affect the US by signaling to investors that “American business is defined by political needs.”

Implications

[26] Matt Pottinger ,*Wall Street Journal. (*Eastern edition). New York, N.Y.: Aug 5, 2005, pg. A.7

More than the validity of the arguments *per se* against the CNOOC bid for Unocal, the ferocious opposition within Congress has the potential for far-reaching consequences. Its import lies primarily in what it signals to the global community and to China. Congress's legislative opposition to the bid showed that America is willing and inclined to conflate economics with politics, and to turn to protectionism. This might set the precedent for future protectionism. Ironically, instead of protecting American oil interests, the protectionism has the potential to actually harm them. Danel Yergin, president of Cambridge Energy Research Associates, an oil consultancy, said that "It's a tremendous precedent-setter for a government to interfere and declare that national security is at stake…"[27] This would have implications on American oil companies who have oil interests around the world. The US has consistently maintained that "free markets are the best guarantee for the future availability of energy supplies." [28] in response to situations when a supply crunch or high oil prices see some oil-producing countries like Russia or Venezuela pressure foreign oil companies while others like Saudi Arabia block foreign investment in their energy sectors. The political and legislative response to CNOOC flies in the face of America's free market stance, undermining it. These oil-producing countries can now justify similar actions in the future.

Perhaps more pertinently to the interest of American national security, the political opposition may signal to China that despite previous urging by America, its attempts at economic modernization and free trade are unwelcome in reality. David L. Goldwyn, former assistant secretary of energy in the Clinton administration sums it up: " What this misguided policy did was to say the United States will not advocate fair trade

[27] Jad Mouawad, "Foiled Bid Stirs Worry for US Oil", the *New York Times,* 08/11/2005
[28] Ibid

when it comes to American assets…that may push China into a more competitive stance rather than a more cooperative one."

<u>The Use of the Exon-Florio Law in the CNOOC-Unocal affair: A Precedent for Protectionism?</u>

Probably the main catalyst for CNOOC to drop its bid for Unocal was the demand for the invocation of Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act passed by President Reagan in 1998 under the Defense Production Act of 1950. The law allows for a federal interagency—the Committee on Foreign Investment in the United States (CFIUS), headed by the Treasury Department—review of any foreign "merger, acquisition or takeover" (whether hostile or friendly) that "threatens to impair" the "national security" of the USA. If a merger is found to threaten "national security", then the President can block the acquisition or require a divestment of a completed transaction.

The worries in Congress about a perceived threat to national security from the bid led to calls for the invocation of this law to block the deal. It was the primary tool that Congressmen used to indirectly, but effectively, prevent the deal from following through. Unocal shareholders had held out on CNOOC's better offer precisely because they feared regulatory roadblocks that the law entailed. CNOOC also withdrew its bid because of "political opposition" that most clearly and most tangibly manifested in the passing of the invocation of this law.

The law seems reasonable within a proper definition of "national security". However nowhere in the statute or regulations is there at all a definition of the term. The clearest guideline appears in a commentary to proposed regulations to clarify the scope and procedures for review—a review would be "clearly appropriate" in the acquisition of a company “that provides products or key technologies essential to the US defense industrial base”. This still fuzzy clarification means that the CFIUS retains the sole discretion in deciding in what way and what type of transactions threaten national security. The Treasury rejected the need to “adopt lists of products or services that might be considered essential to national security”, or lists which might not. It also does not publish past CFIUS reviews or comment on “important considerations” for the cases.[29]

In the past, the law has been primarily used in relation to technology-related mergers and acquisitions, and rarely has any transaction been barred. In February 1990 for instance, President George Bush intervened in an attempt by Chinese National Aero-Technology Import & Export Corp. (CATIC) for MAMACO Manufacturing Inc, a manufacturer of metal aircraft parts. CATIC was asked to divest in holdings in MAMCO based on classified information gathered by the intelligence agencies. Although one cannot be sure which way the CFIUS would have gone, it is clear that CNOOC does not as clearly threaten national security. Furthermore, CNOOC had been prepared to compromise substantially to ensure approval. CNOOC emphasized that 70 % of Unocal's current reserves are located in Asia, making sound business sense for the company. CNOOC chairman and CEO Fu Chengyu also affirmed that the oil and gas produced by Unocal in the U.S. will continue to be sold in the U.S., while the development of properties in the Gulf of Mexico would provide further supplies of oil and gas for American markets. He also stressed the commitment to retain the jobs of “substantially all Unocal's employees”, as opposed to Chevron's plan to lay off employees, especially in

[29] Daniel Spiegal; Andrew G Berg; James D. Southwick, “How Foreign Buyers can Avoid Exon-Florio Pitfalls (Defense Production Act of 1950)” ,*Mergers and Acquisition Journal*, March-April 1992 v26 : p40(5)

the US. CNOOC is "committed to fully integrating Unocal's strong management team and workforce into the combined company…(and) hopes and will endeavor to persuade members of Unocal's executive and operational management to join the management team of the combined company." [30]Most crucially however, CNOOC has indicated that it was open to discussing with CFIUS placing non-exploration and production assets under American management through arrangements that CFIUS has approved often in the past. It seems likely that CFIUS would have approved the deal. Furthermore, judging from past trends, very few of the deals filed with CFIUS in the past have been prohibited.

Statistics from the Organization for International Investment's state that,

- To date, more than 1500 notices have been filed with CFIUS;
- Twenty-five transactions required an investigation; importantly, four transactions have required investigations since September 11, 2001, more than the previous 10 years combined;
- Of the 25 investigations, 12 were sent to the President requiring a decision as to whether to block the transaction; and
- Of the 12 deals that were sent to the President, one was prohibited (In 1990, China National Aero Technology Import & Export Corp. was required to sell its interest in a Seattle-based aircraft component company Mamco Manufacturing Inc.).[31]

Ultimately however, the issue here is whether the call for the use of the law by Congress in the CNOOC case has set a precedent for the future invocation of this law, and whether it can and will be used as protectionist tool. The operative protectionism lies more in the review *per se* than in the decision ultimately made. For example, 13 transactions have been withdrawn without a decision in the past. In CNOOC's case, the withdrawal of its bid was made in the face of the review's potential as a regulatory roadblock (from the viewpoint of Unocal's shareholders) even before the review had begun. Moreover,

[30] CNOOC Limited media release, *Asia-Africa Intelligence Wire,* June 23, 2005
[31]http://www.ofii.org/

Congress has consistently taken a hard line. It has been dissatisfied with the interpretation of national security because it thinks it too narrow. Carolyn Barthlomew, from the US-China Economic and Security Review Commission, an influential Congress-appointed commission that reports directly to Congress and recommends legislative and administrative actions with regards to China and security, expressed that the CFIUS process "certainly looks like it could use substantial reform…the process needs a better and more expansive definition of national security. It needs transparency, and it could certainly use some Congressional oversight."

Congress has also pushed to expand the Exon-Florio review. These expansions have included "increasing the president's authority to place conditions on foreign acquisitions of US firms", extending the review to include joint-ventures, and "imposing additional burdens on foreign banks." [32] In 1993, the "Byrd Amendment," amended Section 721 required an investigation in cases where:

1) The acquirer is controlled by or acting on behalf of a foreign government; <u>and</u>

2) The acquisition "could result in control of a person engaged in interstate commerce in the U.S. that could affect the national security of the U.S.[33]

In late 1990s, Japanese company Fanuc withdrew its bid for a 40% stake in Moore Special Tools inc, a producer of special machine tools used in for making nuclear weapons in the face of intense Congressional criticism even after an agreement had been

[32] Daniel Spiegal; Andrew G Berg; James D. Southwick, "How Foreign Buyers can Avoid Exon-Florio Pitfalls (Defense Production Act of 1950)" ,*Mergers and Acquisition Journal*, March-April 1992 v26 : p40(5), p9

[33] U.S. Department of Treasury, Office of the Assistant Secretary International Affairs, Office of International Investment, "Exon-Florio Brief."

reached which would exclude Fanuc from sensitive information, and even *after approval by CFIUS*.

Further still, the Exon-Florio provision has the inherent potential as a protectionist tool and can be wielded as against unsolicited offers. In 1990, Norton Co. (a manufacturer of abrasives and advanced engineering materials) responded to an attempted acquisition by British conglomerate BTR PLC by securing 120 signatures from members of Congress asking the Bush administration for a full CFIUS review. Compounded by the relative willingness of Congress seen from current trends for invoking this provision, the Exon-Forio provision might very well prove to be another weapon in the arsenal of protectionist tools.

<u>Implications of the failed CNOOC bid in the face of China's growing energy needs</u>

Ironically, Congress' opposition to the CNOOC-Unocal deal on the basis of national security concerns could have been injurious to the very same objective it sought to protect. Oil consumption in China has doubled in the last 10 years, jumping 15% in 2004 from 2003 alone. China is not shrinking—it needs to continually seek out new resources. This means that its need for resources might compete directly with America's. It is already substantially invested in Canada and is now involved in the energy market in Africa, Latin America, and the Persian Gulf and is extending into central Asia.

The furor over the CNOOC bid might signal to China that it is better off investing elsewhere with fewer regulatory roadblocks. China's continual and growing need for energy resources, coupled with its inherent relative lack of inhibition to cooperate with less than democratic states, means that she is likely to collaborate with these countries—"pariah states" in Washington's eyes—for energy resources. Indeed, if American companies had no qualms in the past working with similar regimes, then there is no reason to assume the Chinese will be more inhibited. American oil companies for instance have had a long presence in Central Asia. Afghanistan is significantly important to the development of Caspian oil resources because it is the shortest route to the Gulf from the gas resources from Northern and Western Central Asia. The one American oil company that had the closest ties to the Taliban was none other than Unocal. According to author Ahmed Rashid, who wrote in *Corporations, national security and war profiteering: The great game: Oil and Afghanistan,* Unocal "took their leaders on junkets to their home bases, gave them substantial help in the form of office equipment, and medical supplies to many of their leaders." [34] Unocal also set up a training school for the Taliban in Kandahar. Rashid claims that Unocal wanted to build a pipeline from Turkmenstein through Afghanistan to Pakistan and then India which was supported by the Pentagon and the State Department.

China already has well-established relations with many of these "rogue nations" Last October for instance, Beijing concluded a $70- billion agreement giving Chinese companies a 51% stake in the Yadavaran oil field, Iran's largest onshore field. The state-held China National Petroleum Corp. has a 41% stake in Petrodar, a major Sudanese oil consortium. Sudan's production is expected to reach 500,000 barrels a day in 2005. China has also struck a deal with Myanmar. In addition, there are also suspicions that China has offered arms and other defense technology in exchange for oil and gas rights in select countries. Given this recent slap in the face by American politicians, such "oil

[34] *Multinational Monitor,* Nov 2001, v22, p20

diplomacy" [35]methods of acquiring energy resources might well become more viable for the Chinese than fair play.

Case Study: China in Russia

China is also looking towards other kinds of energy to diversify its sources and is looking most notably at natural gas. Natural gas is set to account for 8 per cent to 10 per cent of China's total energy consumption by 2020 from the current level of less than 3 per cent. Industry analysts predict however that China is estimated to fall short of natural gas needs by some 80 billion cubic meters by 2020. To avoid that end, China has begun its search.

China's largest oil and gas producer, CNPC is now in talks with OAO Gazprom, the world's biggest natural gas producer based in Moscow, to export gas to China through a cross-border pipeline. It will have an annual capacity of as much as 30 billion cubic meters (bcm) a year. The two companies are looking at between 20 bcm and 30 bcm for each project. The Russian firm is also in talks with China's third-largest oil and gas producer, China National Offshore Oil Corp (CNOOC), about supplying liquefied natural gas (LNG) to its LNG terminals. Currently most of Gazprom's LNG supplies go to the United States. The Gazprom senior official also showed keen interest in a partnership with PetroChina and Sinopec in any potential LNG project.

Conclusion

In the final analysis, it can be seen that the CNOOC bid for Unocal would in no way threaten US national security. The CNOOC acquisition for Unocal would be inconsequential, indeed irrelevant to any possible play out of tension between the two

[35] "Giving China a Bloody nose"

countries. The problem however, seems to be that the CNOOC issue is seen by most politicians in the context of China's broader geopolitical agenda. There are long-held beliefs that the Chinese regime continues to be at ideological odds with America while longstanding contentious issues such as Taiwan and human rights form the bulwark of congressional distrust towards China. The crux of the matter is that these perennial suspicions are now buttressed by China's dramatic economic development and growth as a superpower. The US fears about CNOOC likely stem from a perception of the bid as signaling future trends, and reflects a growing and genuine suspicion of China's modus operandi.

To the extent that the political outcry was ultimately in response to this particular bid, the outcry was thus unjustified and exaggerated. However, to the extent that the CNOOC issue has brought clearly to our attention the disconnect between the two countries' productive economic engagement and their security rivalry, it has offered a thankfully innocuous opportunity to evaluate the long-term prospects for US-China relations.

Whether the CNOOC bid for Unocal was a legitimate concern or not, the problem of competition for limited energy resources remains. A viable solution is to engage China as a responsible member of the global energy community. It is to allow China to have a vested and shared interest in the common goal of continually searching for new and renewable alternatives to our currently limited resources. Without the fear that energy resources will be cut off from her—with a sense of energy security—China will be more willing to work within the rules of the game that we want her to play by.

China is currently doing what America has always wanted it to—it is engaging the world. In fact, China can only become a more open and less hostile country if America, and the rest of the world, allows it to do so by opening their doors to Chinese investment. Demanding that China opens its markets while blocking the “Red Menace” access to ours is unreasonable. Instead of pushing China away from the global marketplace in her capacity as a legitimate trade partner, and towards the fringes of rogue economic trade as a pariah state, we should endeavor to deepen and strengthen our trade relationship with her. With her interests tied up closely with ours, economic stability, national security, and ultimately, international peace are possible.