
The CNOOC Case

In mid-2005 competing takeover bids for the Unocal Corporation, a US oil producer, spiraled into a political controversy that swept through Congress. The entire debate and the subsequent controversy over Dubai Ports World in early 2006 are examined at length in Graham and Marchick (2006). Here we summarize the battles, focusing on the China National Offshore Oil Corporation (CNOOC) case.

The American-owned Chevron Corporation and CNOOC both sought to acquire Unocal, hiring lobbyists to sway public opinion and political leaders. The Chinese company's opening bid for Unocal was \$18.5 billion, all cash; Chevron's initial bid was \$16.6 billion in cash and stock. However, the hurdles thrown up by a politically opposed Congress slowly eliminated CNOOC's advantage. In the end, Chevron prevailed, acquiring Unocal for its increased offer of \$17.8 billion, proposed on July 19, 2005 (Dorn 2005).

Just two days after the Chinese company made its opening proposal, on June 24, 2005, Representative William J. Jefferson (D-LA) circulated a letter through the House of Representatives demanding that President Bush and senior officials review the CNOOC bid. Throughout July 2005 Congress pushed bills that called for the bid to be reviewed and stopped, based on claims that the takeover would threaten both US national security and economic interests.

The claims stemmed from three central facts: CNOOC is a foreign company; the Chinese government controls it; and it has the unfair advantage of financial support from the Chinese government. In the end, congressional opposition created a high likelihood that CNOOC's bid would be delayed and possibly blocked altogether. On June 30, 2005, the

House passed nonbinding HR 344, sponsored by Representative Richard W. Pombo (R-CA), by a vote of 398 to 15, demanding that if Unocal entered into an agreement with CNOOC, “the President should initiate immediately a thorough review of the proposed acquisition, merger, or takeover.” With the administration declining to review CNOOC’s possible takeover until Unocal’s board accepted the bid, it became very difficult for CNOOC to ensure a smooth and quick takeover.

Faced with the administration’s inaction, Congress continued to assert its power by amending the Energy Policy Act of 2005 (HR 6) to include a provision calling for a one-time study “of the growing energy requirements of the People’s Republic of China and the implications of such growth on the political, strategic, economic, or national security interests of the United States.” The legislation allowed for 120 days for the report to be completed and presented to the president and Congress. Not until 21 days after the report was presented could a US organization that reviews investment in a domestic corporation “conclude a national security review related to an investment in the energy assets of a United States domestic corporation by an entity owned or controlled by the government of the People’s Republic of China,” thereby immobilizing the review process under way in the Committee on Foreign Investment in the United States (CFIUS) with respect to the proposed CNOOC-Unocal deal for a potential 141 additional days.¹ In response to the new law, CNOOC released a press release citing “unprecedented political opposition . . . creating a level of uncertainty that present[ed] an unacceptable risk to our ability to secure this transaction,” and on August 2, 2005, just eight days before the Unocal board was to vote on Chevron’s bid, CNOOC withdrew its offer, ensuring Chevron’s success.²

CFIUS Review

According to US law—the so-called Exon-Florio Amendment of 1988 to the Defense Production Act of 1950—if a foreign acquisition poses a possible threat to US national security, CFIUS is to review it.³ CFIUS is a Treasury-led committee with representatives from 11 other federal departments, including the Departments of Homeland Security, State, Commerce, and Defense. If CFIUS finds the perceived national security threat to have a factual basis, it conducts an investigation and can ultimately recommend that

1. Legislation is available at thomas.loc.gov.

2. See CNOOC, press release, “CNOOC Limited to Withdraw UNOCAL Bid,” August 2, 2005, available at www.cnoocld.com.

3. CFIUS was first created by executive order in 1975 but was given statutory powers by the Exon-Florio Amendment of 1988.

the president block the takeover. The process is supposed to be completed within 90 days.

Since 1988, more than 1,500 cases have been forwarded to CFIUS, about 10 percent of all foreign acquisitions. Of these, 25 have been investigated, with 12 sent to the president and 13 voluntarily withdrawn. Only one of those 12 cases sent to the president was blocked: In 1990 China National Aero Technology Import and Export Corporation was required to sell its aircraft component interest in Mamco Manufacturing, Inc.⁴

While the number of rejected takeovers seems small, many more deals have been blocked indirectly as potential purchasers voluntarily withdrew, believing that CFIUS would not approve the acquisition. CNOOC submitted its offer to CFIUS, but the administration indicated that a review would not commence until Unocal accepted the offer. By this ploy, along with the amended Energy Act, CFIUS and the administration were able to immobilize the proceedings: CNOOC needed CFIUS approval to make its offer viable and assuage the legitimate fears of Unocal shareholders and directors that a takeover might be blocked, but CFIUS initially refused to review the offer until it was accepted by Unocal.

Meanwhile, voices in Congress began calling for new standards and greater openness in the CFIUS review process. The amendment to the Energy Act illustrates not only Congress's political opposition to CNOOC but also its dissatisfaction with the CFIUS review process. Criticisms of the closed-door character of the CFIUS process, the narrow mandate of the national security test, and the exclusion of congressional views were key points in the debate. Among the proposed "reforms" are expanding the national security test to cover critical infrastructure; prohibiting foreign acquisition of critical infrastructure;⁵ requiring an additional 45-day review (after the initial 30-day review) if a foreign government is involved in the acquisition of a US firm; and notifying select members of Congress of CFIUS decisions before they are issued in final form.⁶ Defenders of the existing CFIUS mandate claim that putting "critical infrastructure" off limits to foreign investment would insulate wide sectors of the US economy from beneficial competition, that foreign governments often have a stake in competitive foreign firms, and that notifying CFIUS cases broadly to Congress will invite intense political lobbying in contested takeovers (see Graham and Marchick 2006). At this writing (May

4. See Bruce Stokes, "Tighter Control of Foreign Investment?" *National Journal*, July 23, 2005.

5. See "Oxley Says Hunter Likely to Seek Tough CFIUS Language Changes," *Inside US Trade* 24, no. 20, May 19, 2006, 1; "Blunt Bill Includes Less Onerous Notification Requirements," *Inside US Trade* 24, no. 19, May 12, 2006, 3.

6. In 2005, during the CNOOC debate, some Congressmen proposed that CFIUS should apply a "national economic interest" test, as well as a national security test, for foreign takeovers. This idea was dropped in 2006, during the course of legislative drafting.

2006), it is too early to tell how the congressional debate will turn out. The contest is between mild changes proposed by Congressman Roy Blunt (R-MO) and endorsed by Congressman Mike Oxley (R-OH); stronger measures (especially notification to a larger number of congressmen) pushed by Senator Richard Shelby (R-AL); and radical reforms (the critical infrastructure provisions) advocated by Congressman Duncan Hunter (R-CA).

While there was no definitive review of CNOOC's proposed takeover of Unocal, it appears there was little substance to the national security concerns that were publicly raised in 2005. A study undertaken by the US Department of Energy to analyze China's increasing energy demands, released in February 2006, found that foreign investments by China's national oil companies were not an economic threat to the United States (Evans and Downs 2006). Concern over subsidized finance was the best-reasoned objection, though at the time of the CNOOC bid, subsidized finance was not a legal ground for rejecting a foreign acquisition. Moreover, in the 2006 congressional review of the CFIUS mandate, the leading proposals relegate subsidized finance at most to a factor in evaluating a takeover bid that involves the participation of a foreign government

The thrust of the national security and national economic interest objections voiced in 2005 was that CNOOC would dispose of energy production according to directions from the Chinese government, not market forces. While the People's Republic of China owns 70 percent of CNOOC,⁷ the extent of government control and influence was never determined. CNOOC repeatedly affirmed that its purchase of Unocal was based on "purely commercial objectives." To allay concerns, Fu Chengyu, the chairman and chief executive officer of CNOOC, promised that substantially all of the oil and gas produced in the United States would continue to be sold in the United States and that CNOOC planned to retain virtually all of Unocal's employees.⁸

Evaluation of the Case

Ignoring these statements, it is worth considering a worst-case scenario: suppose that CNOOC preferentially directed all of Unocal's production to China, selling none of it on the world market. Economists widely regard the oil market as the most fungible commodity market that operates on a global scale. Fungibility means that if certain oil supplies are artificially

7. See Jerry Taylor, "CNOOC Bid for UNOCAL No Threat to Energy Security," *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

8. See CNOOC, press releases, "Statement by Fu Chengyu, Chairman and CEO of CNOOC Limited," June 24, 2005, and "CNOOC Limited to Withdraw UNOCAL Bid," August 2, 2005. Available at www.cnooltd.com.

channeled to one destination, other oil supplies will be redirected, filling any market that previously relied on the channeled supplies. If the oil market is indeed fungible, then Unocal production hypothetically directed to China under CNOOC's management would simply replace other imports that would have gone to China otherwise. Since overall global supply would remain the same, the price of oil would not be affected. CNOOC might absorb a financial loss by selling below world price to Chinese customers, but there would be little impact on the rest of the world. The fungibility assumption might be questionable if Unocal was a major supplier like BP or Exxon-Mobil, but Unocal accounts for only 0.2 percent of global oil production,⁹ seemingly far too small a share to significantly affect the world oil market.

Furthermore, 70 percent of Unocal's reserves are located in Asia and are largely committed under long-term contracts to serve the Asian region.¹⁰ Unocal's production in the United States accounts for less than 1 percent of US domestic consumption and is most profitable when sold in the United States.¹¹ For CNOOC to artificially channel much of Unocal's production to China, it would need to invest in new infrastructure, break contracts, receive permission from other governments, and incur revenue losses. Even if CNOOC pursued this course, the amount of energy produced from Unocal's reserves would not be large enough to affect global prices or supply conditions. Even in a worst-case scenario, the global supply available for the United States would not be materially affected. In short, there does not appear to have been a national security or economic interest case against CNOOC's proposed takeover of Unocal.

Arguments were also made that CNOOC's acquisition of Unocal may have relinquished technology vital to US national security. There is no indication that Unocal possessed any proprietary technology that was not already available to CNOOC through private vendors, contractors, and other sources. While Unocal's knowledge of deep water drilling off the Gulf of Mexico is of great value, spreading such expertise could result in greater oil production worldwide, benefiting all consumers. Furthermore CNOOC was willing to relinquish the Gulf of Mexico assets if that step would secure US approval of the transaction.¹²

Finally, Chevron also claimed that since CNOOC's offer was financed by low-interest loans from the government, it had an unfair nonmarket

9. See Taylor, in *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

10. Quote of Fu Chengyu in *People's Daily Online*, July 26, 2005. Also see Patrick Barta and Matt Pottinger, "Why CNOOC May Not Be Such A Big Threat," *Wall Street Journal*, June 30, 2005.

11. See Taylor, in *Free Trade Bulletin* no. 19, Cato Institute, July 19, 2005.

12. See Russel Gold, "China Still Has to Prove It Can Close Deal," *Wall Street Journal*, July 21, 2005.

advantage. Since the existence or extent of this advantage was never investigated, it cannot be quantitatively evaluated. As noted, under the current Exon-Florio Amendment, subsidized finance is not a reason to block a takeover. In prior cases evaluated by CFIUS, the cost of capital, whether debt or equity, was never considered in evaluating whether a takeover should be blocked. However, the Unocal episode clearly raises the question of whether subsidized finance should be a reason to block future takeovers.¹³ A closely related question is whether foreign government control should be a reason to block future takeovers. As the legislative debate has evolved in 2006, subsidized finance may eventually be listed as a factor that CFIUS should consider but only when evaluating a takeover that involves a foreign government. Subsidized finance does not, at this writing, appear to be a concern in purely private takeover bids. Both Senator Richard Shelby (R-AL) and Congressman Roy Blunt (R-MO), the congressional leaders in the CFIUS debate, agree that foreign government takeovers merit extra consideration—an additional 45-day review (beyond the normal 30-day CFIUS review). They differ, however, on the size of the foreign government stake that, as a threshold, triggers the extra review. Whatever the outcome of this debate, it appears that a new process will be mandated before the next hotly disputed case arises.

Returning to the Unocal drama, at the end of the day Chevron was more successful at lobbying Congress and marshalling public opinion than was CNOOC. In part this was because Chevron had the “home court advantage” of a political environment that was already irritated with China over a variety of issues ranging from the renminbi exchange rate to textile imports. By effectively building on a platform of tense relations, Chevron was able to win the takeover battle in the arena of congressional and public opinion. Unocal shareholders and the board of directors turned out to be secondary players.

Who really benefited from the Unocal showdown? The potential consequences are not ideal. For Chevron and the US business community, the precedent of blocking foreign investment is not favorable to promoting free trade and investment on a global basis in all sectors, including oil. Unocal shareholders were forced to accept a lower bid. Will other shareholders here and abroad face the same fate? Regarding US energy policy generally, it may not be the best strategy to block Chinese investment in US energy supplies as the United States simultaneously urges other countries to open their oil reserves to US exploration (e.g., Mexico). As for China’s energy demands, stopping the CNOOC bid did not quell the core

13. As China continues to subsidize international investments, other countries, such as India, are likely to follow suit in order to successfully compete, potentially undermining the current open world oil market system. One possible solution is to encourage China to participate in international agreements that attempt to monitor and control such predatory financial practices (Evans and Downs 2006).

issue of China's growing demand for energy. If the US government does not allow China to invest in the United States, there will be one less reason for China to heed US objections against doing business with rogue states, such as Iran and Sudan.

Dubai Ports World Case

Shortly after the CNOOC case faded from the headlines, Dubai Ports World, based in Dubai (part of the United Arab Emirates), sought to acquire the Peninsular and Oriental Steam Navigation Company (P&O), a British firm, for \$6.8 billion. P&O's main assets were terminal facilities owned or leased in various ports around the world, including facilities at six US ports. The senior civil servants sitting on CFIUS approved the sale in November 2005, and it was set to close in March 2006. The civil servants regarded the transaction as sufficiently routine that they briefed neither political officials nor Congress. However, another company, Eller, which was battling convoluted civil litigation in London against P&O, alerted several congressmen in early 2006, and by February 2006, full-throated opposition erupted from Capitol Hill. President Bush and his cabinet members tried to quell the protest without success.

Three charges were mounted against the Dubai Ports World takeover: first, that Dubai had served as an organizational locale for some of the terrorists involved in the attacks of September 11, 2001; second, that Dubai Ports World is largely owned by the government of Dubai, and specifically the emir; and third, that, as a matter of principle, neither US port facilities nor other critical infrastructure should be owned by foreign persons, public or private.¹⁴ Faced with overwhelming opposition in Congress, including an adverse 62 to 2 vote in the House Appropriations Committee, Dubai Ports World conceded on March 9, 2006, stating that it would sell the US port facilities acquired from P&O to a US-controlled firm.

Conclusion

In the aftermath of the CNOOC and Dubai Ports World cases, in 2006, Congress began to review the authorizing legislation for CFIUS. The major changes under discussion were summarized earlier. While it is too

14. Many US port and airport facilities as well as other establishments that might be deemed "critical infrastructure" are already owned or controlled by foreign firms—some, such as Citgo, with government participation. This fact was not widely known in Congress or the public at large before the Dubai Ports World case.

early to tell how the congressional debate will play out, it seems certain that US policy toward international investment will henceforth be examined through a tightly focused lens of national security. In the process, the historic US orientation toward open borders, for investment as well as trade, may well be redefined. Any changes are likely to put an extra spotlight on investments in the United States by Chinese as well as Middle Eastern firms.

Rightly or wrongly, the US emphasis on national security is seen abroad as a protectionist detour; after all, in both the CNOOC and Dubai Ports World cases, the acquired company eventually was bought by a US rather than a foreign firm. For its part, however, the United States has accused China of preferential treatment of its own firms, lodging complaints with the WTO regarding China's semiconductor and automobile industries, among others. The next chapter takes up this issue.