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Learning from failure: China’s overseas oil investments

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Political Risk Management: Chinese NOCs

To understand Chinese NOCs' political risk management, one must understand the origins of these companies. China's three major oil companies – China National Petroleum Corporation (CNPC), China Petro-chemical Corporation (Sinopec) and China National Offshore Oil Corporation (CNOOC) – were all part of the all-encompassing former ministries of petroleum and chemical industries. It was only in the late 1980s that the Chinese government decided to move toward a system based on companies and rooted in the marketplace. Previously enjoying administrative and market privileges, companies were now expected 'to earn a living' and 'to be competitive', according to Zhou Qingzu, CNPC's chief economist (Yergin 2011: 202). In the midst of adjusting to this massive cultural change, Chinese NOCs faced very difficult challenges at home: artificially low retail prices of crude set by the government, a massive workforce, ageing oil fields, and low reserves-to-production (R/P) ratios. By 1993, Chinese NOCs' petroleum production could no longer meet the country's growing oil demand. As a result, China became a net oil importer. A Chinese oil expert reported that 'from an industry point of view, we felt very ashamed. It was a loss of face. We couldn't supply our own economy (Yergin 2011: 202).

1993–2002: Early Endeavours

If Chinese NOCs were to become more competitive and develop supplies to serve China's future growth, they had to 'go out'. The reserves they needed were overseas but so, too, were the risks. Fortunately for the Chinese NOCs, the difficult exploration and production (E&P) environment in China had reared adventurous explorers. In 1993, with limited funds and little overseas experience, Chinese NOCs took their first steps abroad, acquiring minor stakes in Canada and Peru. Small projects followed in several countries, including Ecuador, Kazakhstan, Malaysia, Mongolia, Russia, Sudan, Thailand and Venezuela.

After stepping out from under Beijing's wings, Chinese NOCs were forced to deal with the risks they encountered overseas. Previous lack of exposure to these risks combined with little experience operating overseas culminated in Chinese NOCs' rather unsophisticated risk management during the first phase of their internationalization (1993–2002). With respect to political risks, Chinese NOCs opted not to tailor their responses to different forms of risk, but instead applied a 'one-size-fits-all' approach primarily rooted in the development of good relations with well-connected individuals.

The Chinese NOCs' preference for developing good relations can be partly explained by the priority given to building personal relationships in China. The Chinese customarily build personal relationships (*guanxi*) of mutual trust and obligation to develop business relationships. This requires a lot of time, money and effort, which is why it is preferable to focus on a select few. Suffering from 'mirror imaging' – assuming that those we assess think, behave, and understand their interests as we do – (Bremmer and Keat 2009: 175) Chinese NOCs concentrated on political elites, whom the Chinese believed could protect and facilitate deals by themselves. However, just because communist party and government leaders (both national and regional) have undisputed control over major decisions that affect China's oil and gas industry, this does not mean that leaders in other countries operate under the same set of incentives, constraints and perceptions.

In addition to developing good relations, Chinese NOCs have entered into joint ventures with governments and strategic investors like Pluspetrol in Peru (1993) and Petronas, ONG Videsh and Sudapet in Sudan (1996). However, Chinese NOCs have not applied this political risk mitigation strategy consistently. In fact, whenever possible, they have tried to secure sole control of the reserves. A case in point is CNPC's acquisition of the Caracoles and Intercampo oil fields in Venezuela (1997). This suggests that the decision of Chinese NOCs to join Joint Ventures[1] was more an external imposition than the product of a thought-out political risk mitigation strategy.

The same can be said about production-sharing agreements. Chinese NOCs signed several PSAs in this early internationalization phase mostly because they were operating in countries where PSAs had emerged as the main type of petroleum contracts. PSAs were not, at least not initially, the favoured form of oil contract signed by Chinese NOCs, or for that matter by IOCs, as oil reserves remain in the hands of the local governments and/ or national oil companies.

After securing access, focus then shifted to the short-term needs of the project – mostly technical and geological. Chinese NOCs tapped into their surplus work-force and cheaper Chinese suppliers to minimize the costs of production. Political risk insurance was viewed as an expensive superfluity as were all efforts to understand, gather intelligence and/ or accommodate the interests and concerns of the societies in which they operated (Anonymous 2). Chinese NOCs at the time operated under the belief that no great benefit would accrue from securing support amongst local stakeholders because they were believed to have little influence, like their Chinese counterparts ('mirror-imaging' bias). Furthermore, local realities were too complex and daunting and there was nothing that the resource-poor and inexperienced Chinese NOCs could actually do to impact them. Failed projects, expropriations and other potentially negative events were doomed to occur but the NOCs were willing to absorb that risk because the alternative was much worse: Chinese NOCs not having access to new profit-generating operations and to the reserves needed to replenish their dwindling domestic resource base.

[1] A Joint Venture (JVs) is a partnership between two companies or between a company and the government. It is a common form of agreement in the oil and gas sector where a foreign IOC partners with the national oil company. Oil and gas exploration is risky and costly, so JVs are a way to spread the risk while sharing technology, expertise and infrastructure costs.