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Review Commission

National Security Dimensions of the Possible Acquisition of
UNOCAL by CNOOC and the Role of CFIUS

Before the House Committee on Armed Services

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Mr. Chairman, members of the Committee, it is an honor to appear before you to testify on the issues of national import raised by the possible acquisition of Unocal, a significant United States private energy company, by CNOOC, a largely-state-owned oil company in the People's Republic of China.

There are several questions I believe are appropriate to ask in examining this proposed takeover of a private American oil company by an entity controlled by the government of China, and in determining what should be the appropriate response under the Constitution and the law by the Executive branch and the Congress. I will address the nature of this proposed transaction, the Chinese strategic approach to energy and its implications for U.S. security, and the role of the Committee on Foreign Investment in the United States – generally short-handed “CFIUS” – in regulating such transactions.

1. What is the nature of the proposed transaction involving the CNOOC's takeover bid for UNOCAL?

This proposed transaction gives every appearance of being an effort by the Chinese government to take over a private American oil company. This is true despite the rhetoric of the Chinese Foreign Ministry that this is just a commercial deal and therefore China “demands” that the Congress get out of the way.

CNOOC is one of three Chinese state-owned oil companies created by the Chinese government to “go out and get oil for China.” They are hunting around the world for reserves of oil, gas, tar sands and other energy related assets to acquire. It is important for Congress to be aware of some facts about CNOOC:

First, CNOOC is 70 percent owned by the Chinese Government.

Second, the company was created by the government of China in 1982 to be a joint venture partner with foreign oil companies exploring for offshore oil reserves. It is

considered to be one of the top 50 state-owned companies, a place of high privilege in the Chinese government hierarchy.

Third, the CEO of the company, Mr. Fu Chengyu, happens also to be the party secretary of CNOOC.

Fourth, the purchase of Unocal was approved by the State Council, China's cabinet, and the governor of the State Central Bank helped assemble the financial purchase package. The company has elite access to large cash reserves held by the Chinese government.

Fifth, the loan package for the acquisition is heavily subsidized. Seven billion dollars came from CNOOC's parent, China National Offshore Oil. Of that amount, \$2.5 billion dollars is interest free, and the rest is a 30-year loan at 3 percent. The parent company, China National Offshore Oil, is 100 percent owned by the Chinese government, and Mr. Fu is also the CEO of the parent company. Mr. Fu was appointed to both posts by the Communist Party of China. Six billion more dollars came from a State-owned bank, an exceptionally large figure. Without this generous state-guided credit, CNOOC, a company worth \$22 billion, could not possibly offer \$18.5 billion for an acquisition of this type. Mr. Fu has been quoted as saying that he might sweeten the offer, which seems quite possible given his access to rich, and virtually unlimited, Chinese government coffers.

One has to ask: Why is the Chinese Government willing to spend so much money to buy this company? By any conceivable standard, the U.S. government should see and treat this proposed transaction as a non-commercial transaction with other motivations and purposes. If it affects the national security of the United States, intervention by the U.S. government must be seriously considered.

- China's lack of reciprocity on investment opportunities

China restricts US investments. In key sectors like energy, China requires foreign firms to form joint ventures with Chinese companies; equity ownership of Chinese firms by foreigners is restricted to a minority share. In other words, the U.S. government cannot go to China and buy SINOPEC or CNOOC. It isn't allowed. Nor could a private U.S. corporation make such a purchase.

Furthermore, there are additional obstacles to investment, including Chinese pressure on companies to hand over key technologies as a cost of entry into China, and treatment of foreign firms in ways that are less favorable than treatment of domestic firms (e.g., foreign firms cannot sell corporate bonds, or accept venture capital investment, or sell equity).

Given that there is nothing in the rules of the WTO regarding investment policy, the U.S. government should consider the benefits of establishing a national foreign investment policy under which -- based on the principle of fair play -- if the U.S. government or a U.S. corporation cannot buy a majority interest in a country's company, then the

government of or a company from that country can't buy a majority interest in a U.S. corporation.

-- Strategic and political questions

The proposed acquisition of UNOCAL by CNOOC is the largest international transaction so far attempted by China. UNOCAL holds reserves extending from the Gulf of Mexico to the Caspian region to Southeast Asia, as well as in Africa, Europe, and South America. Its acquisition would double CNOOC's worldwide reserves of oil and gas. UNOCAL's energy assets are estimated to be 1.75 billion barrels of oil and oil equivalents reserves, and another 1.5 billion barrels of undeveloped oil and gas fields.

It should be noted that Chinese takeover of these assets will introduce or increase Chinese political influence in all the regions where UNOCAL assets are located, some of which are of political and strategic importance to the U.S., displacing the influence of an American company with American standards. Among UNOCAL's assets are offshore platforms in Cook Inlet, Alaska, and the Gulf of Mexico that are in close proximity to important U.S. national strategic facilities and infrastructure.

There have been public reports that Unocal possesses certain technologies, including those for deep sea exploration and drilling, that have national security implications and should not be transferred to China. The U.S.-China Commission has not conducted an inquiry on this matter, but it is very important for this to be considered carefully by Congress and as a part of a CFIUS investigation. We believe the key national security problem involves the taking of an important US energy company by a foreign government, the Chinese practice of hoarding oil that would divert those supplies from global market, the enhanced political influence of that government in region important to the US, and the precedent it would establish for further Chinese acquisitions of energy assets.

These facts have raised a question about the extent to which China's motivation for purchasing UNOCAL, in addition to its energy considerations, has other bases

-- Questions of precedent

If it were to be deemed not in the American national security interest to block this acquisition, the question that must be asked is what level of energy acquisition would be too high to allow the Chinese to go forward. If Unocal reserves are judged to be too "modest", what level is too much? Where do we draw the line? There is a great deal at stake in this transaction beyond the bounds of the specific Unocal purchase. Would it signal a surge of Chinese takeover attempts, many of which have worrisome national security, broadly defined to include national economic and national energy perspectives? Or, if it is rejected, would that rejection signal the beginning of a thorough national review of what are and are not permissible targets for Chinese takeover attempts; and what kinds of reciprocity should we require from Chinese national policy on investments in their economy? Certainly, if this transaction were allowed, it would set a precedent that could guide future transactions.

-Chinese government lobbying practices in the U.S.

It has been widely reported that CNOOC has hired many high-powered lobbyists and high-priced public relations consultants in Washington, D.C. to attempt to influence the American political process and develop support for its takeover bid. Whenever a foreign government is mounting a campaign to try to influence the American decision-making process, I believe Congress has a right and a need to know just how much that government is spending for that purpose, and whether American officials have been placed in conflict-of-interest situation regarding this activity. I believe it is important for Congress to examine this issue in the CNOOC-UNOCAL case.

2. What is Chinese state strategy regarding energy, and what problems does it raise for the United States and the world energy market?

The Chinese treat energy reserves as assets in the same way a 19th century mercantilist nation-state would. Its goal is to acquire and keep energy reserves around the world and secure delivery to China above and beyond any market considerations. To do this it is willing to pay above marketplace premium prices in order to gain exclusive control over oil and gas. China believes it can only achieve energy security through direct control of reserves. This hoarding approach direct conflicts with the efforts of the US and other countries in the International Energy Agency to develop fungible, transparent and efficient oil and gas markets.

This simply is not a market-based transaction. China is not a market economy – that's a legal fact and an interpretation that China agreed to as part of its accession to the World Trade Organization. They are aggressively fighting this definition and were able to force the Bush Administration to discuss this issue as part of bilateral talks.

The Chinese have used state-owned oil companies to acquire fields and assets in many countries, including those sanctioned by the U.S. It has moved to be a major energy partner with Iran. Sinopec has purchased a 50% stake in a major oil field, the Yadavaran oil field and signed a \$70 billion deal to buy Iranian oil and gas over the next three decades. As a quid pro quo, China complicates international pressure on Iran regarding nuclear weapons development, and has given Iran advanced missile technology.

Another Chinese company, the China National Petroleum Corporation has invested heavily in the Sudan, and now takes 50% per of Sudan's oil exports. In return China has blocked UN Security Council action against Sudan's genocidal practices.

China has signed a deal with Venezuela, whose leader is anti-American, and one of the top three suppliers to the American market. China will develop 15 oil fields and buy 1.44 billion barrels of oil a year. China is reported to be considering upgrading a pipeline

through Panama to the Pacific to ensure its security of supply, an uneconomical proposition, and illustrates the premium it is paying for enhanced control of the oil.

There are many other examples of China's paying premium prices, and making uneconomical, questionable investments to secure supplies. This includes an uneconomical pipeline to directly export Kazakhstan crude directly into China, bypassing the open market. China is also attempted to persuade Russia to route a pipeline from Siberia directly to China, rather than to the Pacific port of Nakhodka, where the oil would be available to the world market.

Chinese mercantilist energy practices affect American political interests in many regions. An example is Indonesia, where if CNOOC locks up Unocal's gas holding in Indonesia, there would be a threat to regional security. Taiwan buys 60% of its imported natural gas from Indonesia. Would the Chinese continue to permit such exports to Taiwan, or cut them off and pose a challenge to the Taiwanese economy? (Japan and South Korea also purchase significant quantities of Indonesian gas.)

3. Can Chinese Energy Practices Have a Long Term Impact on the US Economy and national Security?

The Commission believes it is critical to persuade China to abandon this mercantilist spree to lock up attractive energy supplies wherever it can, and instead participate in the IEA to plan for sharing of oil in the case of supply disruptions, and to participate in the open market buying of its supplies and begin relying on free markets to promote energy security for everyone.

4. The CFIUS process appears to be the sole means for the U.S. government to consider and act on this transaction, and reject it if necessary.

First, it appears from the face of the statute that a full 45-day investigation of this matter must be undertaken. The statute states that “The President...shall make an investigation in any instance in which an entity controlled by or acting on behalf of a foreign government seeks to engage in any...acquisition, or takeover....” The plain words of the statute appear to leave no option but for a full investigation to be undertaken.

Second, the question is whether energy security is part of national security as defined by the Statute would bring this transaction into its orbit. The statute itself does not name energy security as a specific category to be examined. However, the language adopted by the Managers of the Conference Report in the Congress on this bill leans in the direction of broad interpretation of the term “national security” As stated in the Regulations explaining the Administrations interpretation of the statute, “Although neither the statute nor the Conference Report defines national security, the conferees explain that it is to be interpreted broadly and without limitation to particular industries. (Conference Report at 926-927)...Generally speaking, transactions that involve products...important to U.S. national defense requirements will usually be deemed significant with respect to the national security. The UNOCAL deal certainly appears to fit into the scope of the statute under the term “national security.”

Third, the Commission has pointed out that there are serious flaws in the CFIUS statute. The statute was written without due consideration for transparency of the activities of CFIUS, and did not give itself appropriate oversight powers, requiring reports of its decisions and underlying rationales for those decisions, to the appropriate Committees of the Congress – including, this Committee. Such oversight is clearly overdue.

The statute was enacted pursuant to the Congress’ Constitutional powers under Article I, which enumerates the Legislative Powers, Section 8, which gives sole power to the Congress “to regulate Commerce with foreign Nations...” This is power exclusive to the Congress, and is not shared, according to the constitution, with the President. The Congress, therefore, which delegated to the Executive, via this statute, the authority to investigate transactions with foreign nationals and entities, can alter the statute in such a way to require the power be shared with the Congress, or, for that matter, take back the power for itself.

Fourth, Mr. Chairman, since 1988, CFIUS has reviewed some 1530 transactions, and only one has been rejected through Presidential determination. We are aware that some transactions have been withdrawn when it appeared that CFIUS would block them, but we have no way of assessing the record of CFIUS over these many years because Congress has not availed itself of an opportunity to review the detailed record. We believe that a historical review is in order and should be conducted by the Congress.

Mr. Chairman we suggest that a more aggressive oversight system surely will be needed if the Chinese accelerate their buying spree into the American economy, a behavior perhaps being encouraged by American investment advisors to the Chinese government. Such a buying spree is now made possible by a large stash of US dollars in the 6-700\$ billion range, which can be used for such activities.

Fifth, the Chinese have asked for CFIUS to provide an advisory opinion on this matter. We do not believe the statute provides for advisory opinions. We think that CFIUS should review this takeover if it ever becomes ripe, that is if a transaction looks like it will be consummated. On August 11th, the shareholders of Unocal will vote on whether the CEVRON offer, which has been agreed up by both the CHEVRON and Unocal boards, will be agreed to. Only if that vote opens up the possibility of a takeover by CNOOC, should CFIUS begin its review. At that point, we believe an investigation is mandatory. Any effort by CFIUS to get involved in this affair prematurely could affect the bidding process and put the government in the improper position of affecting the outcome. A CFIUS review should not become a tool to impact on the decision of a Board or the shareholders as to the appropriateness of a transaction. If additional competing bids were to be made by other players, would each be eligible for a review?

Lastly, as you may note in the letter we have written to you on this matter, the Defense Production Act was amended in 1992 to require a Quadrennial Report from the President on the very matters, which are of concern to the Committee in this hearing. After a first report was delivered in 1993, the Executive has neglected to fulfill its legal requirement, and the last report is 9 years overdue. That would be a valuable report to have if it was done right.