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Bloomberg Government Study »

China's State-Owned Enterprises Surge Ahead In Oil-Rich Canada

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JULY 26, 2012

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In January President Barack Obama denied a permit that would have allowed TransCanada to complete construction of the Keystone Pipeline.

ACTION»
The Obama administration has urged Transcanada to reapply for the permit as officials continue to analyze the costs and benefits of the pipeline. Republican presidential candidate Mitt Romney has promised to approve the construction of the pipeline on his first day in office.

IMPACT »
State-owned companies from China have invested more than $30 billion in acquiring Canadian oil and gas companies and assets from 2004-2011, more than companies from any other country. Further delay or denial of the construction of the pipeline may cement China's presence in Canada's energy markets.

A $15.1 billion offer on July 23 by Chinese energy company CNOOC to take over Canadian oil and gas company Nexen underscores the extent to which China's state-owned energy companies are targeting Canada's energy markets.

China's aggressive acquisition strategy in Canada is posing a foreign policy dilemma for President Barack Obama, who last January denied a permit to expand an oil pipeline from Alberta to refineries on the Gulf Coast. It suggests that if Canada can't find a way to sell its oil in the U.S., it has a ready and willing trading partner in China.

This Bloomberg Government Study examines the activities of China's state-owned energy companies in Canada's energy markets and the nature of their acquisitions. The study finds:

- Chinese cross-border merger and acquisition (M&A) activity reached $69 billion in 2011, up more than 500 percent since 2004. Almost half of the industry targets are related to basic materials or energy.
- Chinese state-owned enterprises have invested more in Canadian oil and gas companies than U.S. companies since 2004.
- The majority of Chinese merger and acquisition activity in Canada's energy sector is driven by three state-owned companies: CNOOC, PetroChina, and Sinopec.

The M&A activities of Chinese companies in Canada reflect two global trends that have taken shape since the late 1990's — the boom of newly found natural resources in the Western Hemisphere, and the competitive emergence of state capitalism in commodity markets.

The balancing act for the U.S. involves energy security, environmental safety and geopolitical power. The next area of competition between the U.S. and China may take place in the Americas, due to the vast amounts of oil found on this continent and the energy consumption of both countries.

INTRODUCTION

Two global trends have taken shape in energy markets since the late 1990's: the boom of newly found natural resources in the Western Hemisphere, and the rise of state capitalism in the commodity markets.

While the largest oil reserves in the world still lie in the Middle East, breakthroughs in recovery and extraction technologies have led to a rapid rise of newly discovered or accessible oil throughout North America, Central America and South America. Advances in deepwater drilling have led to the discovery and the development of millions of barrels of oil off the coast of Brazil. Horizontal drilling and hydraulic fracturing techniques have enabled the development of oil shales found in North Dakota, making the state one of the largest producers of oil in America. Technological advances in extracting oil from sandstone and sand have led to the discovery in Canada of the third largest oil reserves in the world.

The world's energy maps are being redrawn, says Amy Myers Jaffe, co-author of the book, "*Oil, Dollars, Debt, and Crises: The Global Curse of Black Gold*." In September of 2011 she said: "By the 2020s, the capital of energy will likely have shifted back to the Western Hemisphere, where it was prior to the ascendancy of Middle Eastern megasuppliers such as Saudi Arabia and Kuwait in the 1960s."[1]

State-owned enterprises, or companies partially owned by a national government, are making themselves felt in energy markets. Some, such as Saudi Arabian Oil Co. (Saudi Aramco) and Russia's OAO Gazprom, have existed for decades and control some of the largest oil and natural gas reserves in the world. There are growing concerns that governments in Asia, Latin America and elsewhere may actively participate in the commercial energy sector through state-owned enterprises to help secure natural resources for their own countries — at the expense of competing private-sector companies. One area of anxiety for private companies is the nationalization of resources. Argentina, for example, in April seized control of YPF SA, its largest crude oil producer, pushing out the Spanish owner, Repsol YPF SA.[2]

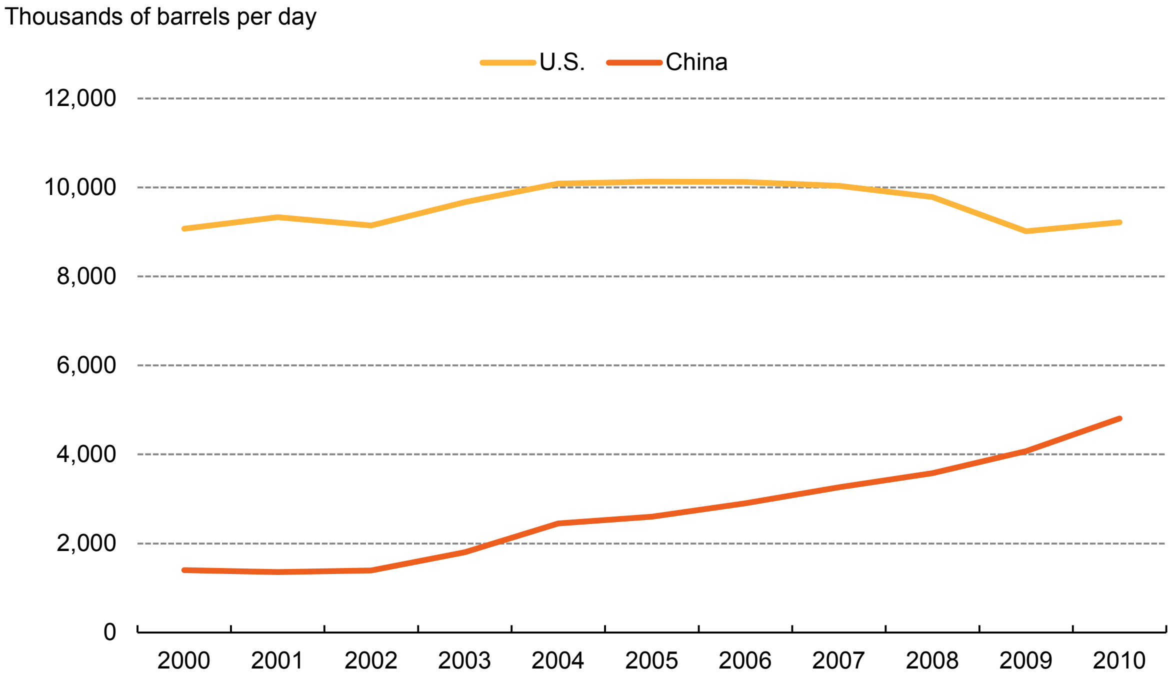
Another concern, which is the focus of this study, is government-supported acquisitions of natural resources in North American markets.

Canada, in particular, encapsulates both trends, newly found oil reserves and state capitalism. Canada's political stability, capital market transparency and vast reserves of natural resources make it an attractive source of oil and gas investments. Today Chinese state-owned enterprises are some of the biggest investors in Canada's oil and gas companies. The growing presence of state capitalism in the world's third-largest source of oil reserves serves as a backdrop while the U.S. determines whether to approve construction of the Keystone Pipeline.

SECTION 1: GLOBAL OIL SHIFT — SUPPLY AND DEMAND

The U.S. and China are the top two importers of crude oil. Chart 1 shows those countries in 2010, according to the Energy Information Agency (EIA).[3] In the past decade, China has risen from the seventh largest importer of oil to become the second largest, increasing the amount of oil it imported by 243 percent. U.S. imports of crude oil remained largely flat throughout the decade. Together the U.S. and China account for 32 percent of total crude oil imports.

Chart 1: China Rises to Second Largest Importer of Crude Oil (2000-2010)



Source: EIA

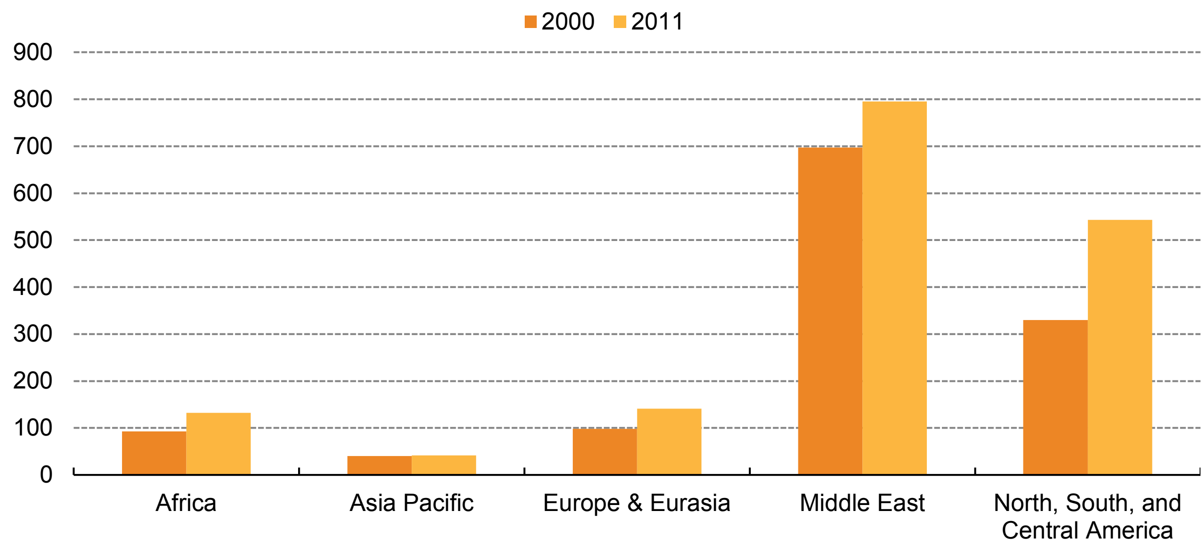
China's demand for oil is expected to continue, along with other emerging industrial nations' appetites. According to the International Energy Agency (IEA), China and other nations outside of the 34-member Organization for Economic Cooperation and Development will lead incremental global demand for oil during the next 22 years.[4] The IEA projects that Chinese consumption of oil will overtake U.S. oil consumption by 2035.

There have also been notable shifts in the location of proven oil reserves, with a rapid increase in estimates in the Western Hemisphere since 1998. Brazil's total proven oil reserves have almost doubled, increasing to 15.1 billion barrels in 2011 from 8.5 billion barrels in 2000, driven in large part by advances in deep-water drilling technologies. Venezuela is estimated to have 297 billion barrels of oil, the most of any country in the world, according to BP's latest Statistical Review of World Energy.[5] (Saudi Arabia is second with 265 billion barrels.)

Chart 2 shows that proven oil reserve estimates for North America, South America and Central America have increased by 65 percent from 2000 to 2011.

Chart 2: Proven Oil Reserves

Barrels in billions

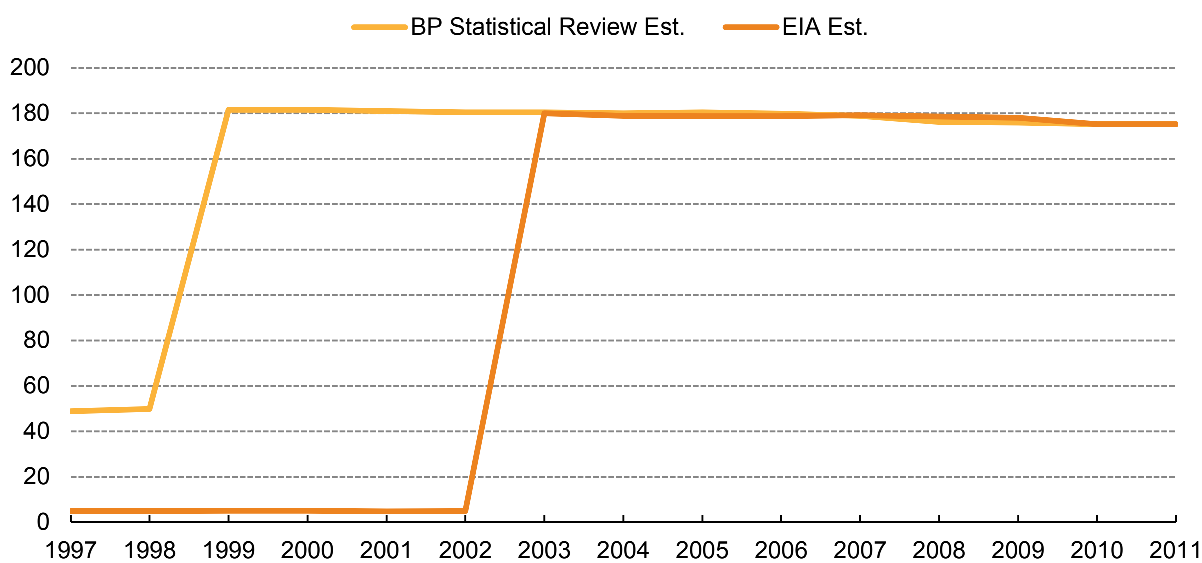


Source: BP Statistical Review of World Energy 2012

Canada, as a result of rich deposits of oil sands in the Province of Alberta, has emerged as another Western Hemisphere country with large reserves of oil. Chart 3 shows a consensus estimate that Canada has 175 billion barrels of oil reserves, the third highest in the world.

Chart 3: Estimates of Proven Oil Reserves in Canada

Barrels in billions



Source: BP Statistical Review of World Energy 2012, EIA

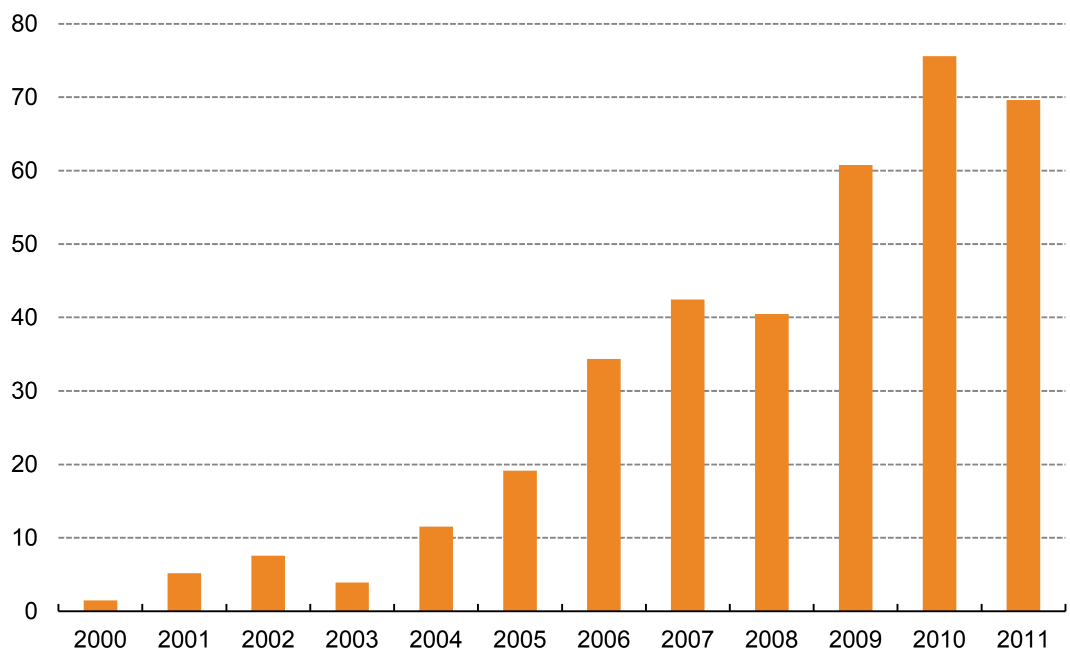
SECTION 2: CHINESE CROSS-BORDER MERGERS AND AQUISITIONS

China joined the World Trade Organization (WTO) in 2001.[6] As its economy opened up and continued to grow, Chinese companies started to compete globally. In 2004, Premier Wen Jiabao pushed for Chinese companies to compete more aggressively abroad, saying, "the Chinese government encourages more enterprises to go global."[7]

One aspect of that growth are mergers and acquisitions outside Chinese borders. Chart 4 shows total cross-border M&A activity by acquiring companies based in China. The figures include the deal value of two primary transactions: 1) acquisitions by takeover, and 2) acquisitions of other companies' assets through their divestitures. In 2004, the total deal value of these cross-border acquisitions was $11.5 billion. By 2010 they reached a peak of $76 billion, an increase of 556 percent.

Chart 4: Chinese Ramp Up Cross-Border Mergers and Acquisitions (2000-2011)

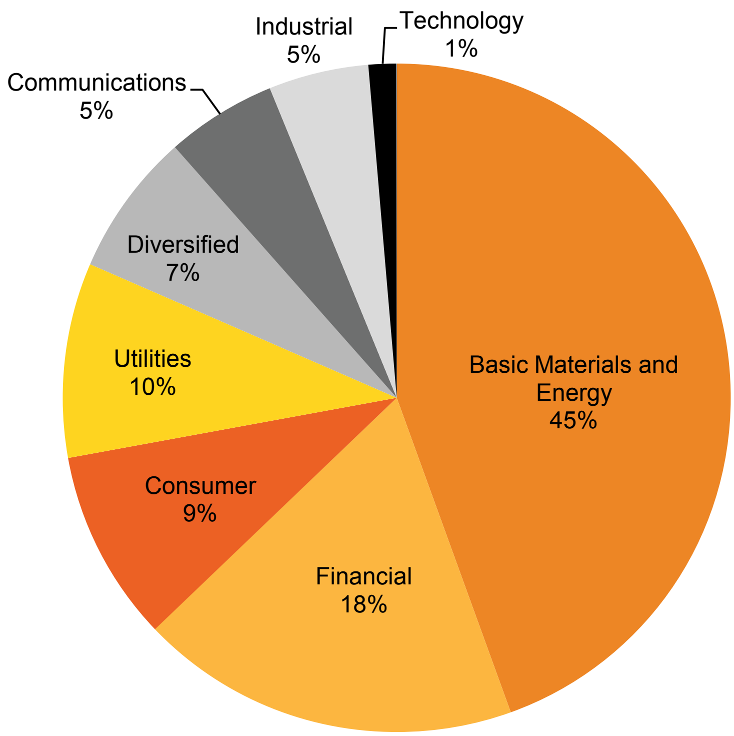
Dollars in billions



Source: Data compiled by Bloomberg Government

Chinese companies focused largely on acquiring hard assets, such as oil, gas and other basic materials. Chart 5 shows that basic materials and energy made up almost half of all Chinese cross-border M&A targets, when measured by deal value.

Chart 5: Chinese Cross-Border M&A by Target Sector (2004-2011)

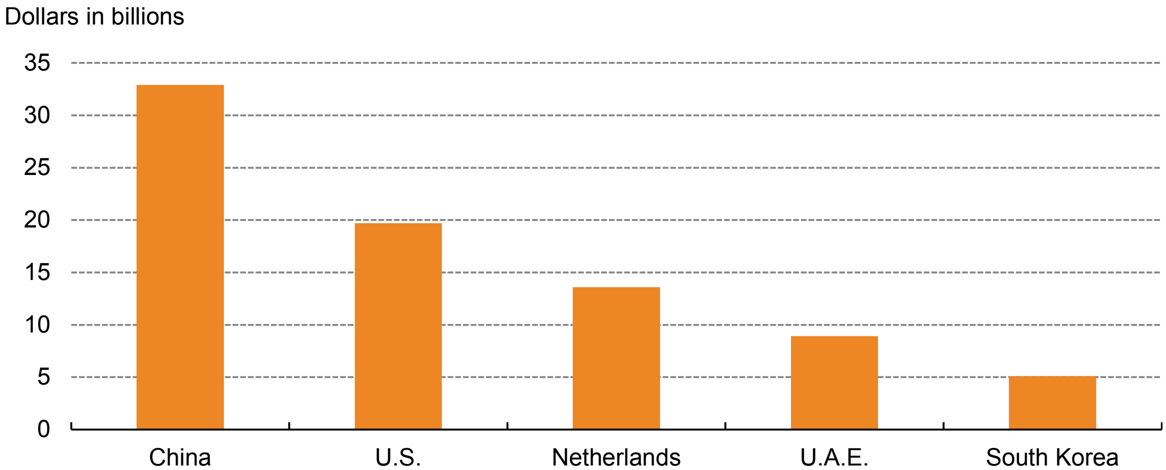


Source: Data compiled by Bloomberg Government

SECTION 3: CHINESE OIL AND GAS ACQUISITIONS IN CANADA

China's energy demands have led to a number of deals that span the globe. Chart 6 shows the top acquirers of Canadian oil and gas assets by country. Companies from China acquired more Canadian oil and gas companies, in terms of announced deal value, than companies from any other nation.

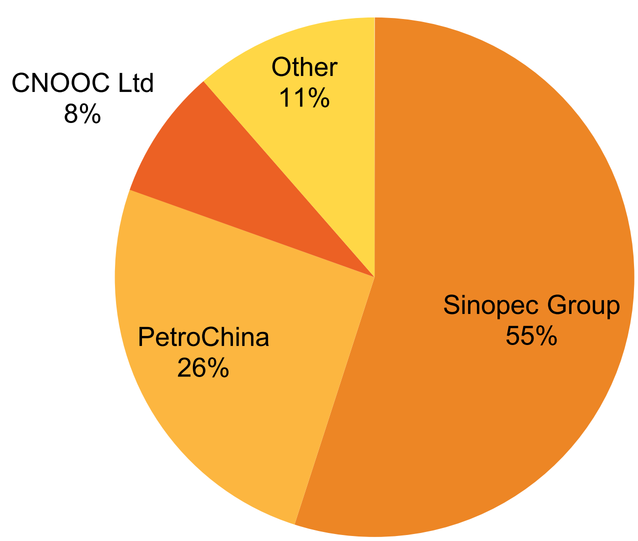
Chart 6: Chinese Companies Race for Canada's Oil and Gas Assets (2004-2011)



Source: Data compiled by Bloomberg Government

Almost all of the Chinese energy acquisitions were conducted by three state-owned enterprises: CNOOC Ltd, PetroChina Co. Ltd., and Sinopec. Chart 7 shows that the three companies account for 89 percent of total oil and gas acquisitions by Chinese companies in Canada.

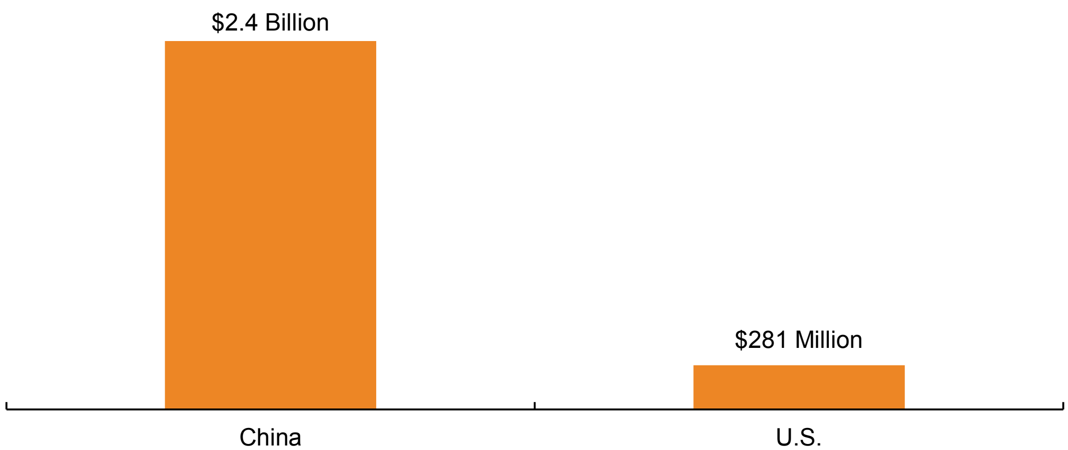
Chart 7: Top Chinese Oil and Gas Acquirers in Canada (2004-2011)



Source: Data compiled by Bloomberg Government

This is significant for several reasons, including market access and energy security. A concern for U.S. companies and policy makers is that the state-owned enterprises have the financial backing from the their parent government which gives them an advantage over U.S. counterparts. While some of the financial information Chinese companies disclose is opaque when compared with U.S. or Canadian companies, the M&A transaction data shown in Chart 8 indicates that Chinese companies on average are participating in larger deals than their U.S. counterparts.

Chart 8: Average Deal Value of Acquisitions of Canadian Oil and Gas Companies (2004-2011)



Source: Data compiled by Bloomberg Government

CONCLUSION

The rapid expansion of oil and gas development in North America, particularly Canada, has spurred intense competition for those assets between U.S. companies and major state-owned companies in China. While access to oil reserves is a top priority for U.S. oil companies, it's become a primary objective of the government of China. PetroChina recently overtook Exxon in oil production in 2011.[8]

During the past decade, China's top three state-owned energy companies have dramatically increased their M&A activity in Canada in size and scope. Unlike Venezuela and Argentina, which have nationalized their major oil operations, or Brazil, whose state-owned Petrobras Brasilero SA dominates the market, the business-friendly political environment in Canada makes it more attractive to energy investors. Here, too, competition from state-owned enterprises cuts across a number of policy areas, including foreign affairs. The next region of resource competition between the U.S. and China may take place in the Americas, due the vast amounts of oil that has been found on this continent and the increasing energy consumption demands of both countries.

The Keystone Pipeline decision may mark the first in a series of energy security policies the U.S. will have to consider as the Western Hemisphere continues to find and produce more of the world's oil and gas.

» ABOUT THE ANALYST

Vijay Sankaran is a financial analyst for Bloomberg Government. Prior to Bloomberg, he was a managing director of a political risk firm, Dome Advisors, where Sankaran advised institutional investors on policy and political developments. Earlier in his career, he was a political risk analyst at Deutsche Bank. He earned his MBA from Columbia University.

ENDNOTES

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