**Unconventional Attraction: Chinese SOEs Invest Heavily in U.S. Upstream**

In 2013, China invested $3.7 billion in the U.S. oil and gas sector, representing a substantial portion of total Chinese foreign direct investment (FDI) in the country. Of that, $3.2 billion was directed towards the unconventional sector, while billions more went on gas and unconventional oil in neighbouring Canada. North America has become China's top region for oil and gas deals, as companies seek out lower overseas regulatory and fiscal risk, as well as the latest technology.

The USA is a mature oil province, with mostly high cost oil and gas, which requires heavy investment and the most advanced technology. U.S. companies have become experts in unconventional production, reversing the country’s growing dependence on oil and gas imports. In import-dependent China, where unconventional reserves are estimated to be about double those in the U.S., state authorities are keen to replicate this success. By investing in the USA, Chinese companies hope to benefit from exposure to the new technology, as well as enjoying competitive returns on relatively low risk investments. Partnering up with Chinese companies provides U.S. operators – some of which have been hit by low gas prices related to the unconventional production boom – the capital needed to expand domestic operations, especially into more lucrative liquids-rich areas. In the longer term the deals could lead to partnerships outside the U.S., including in China.

Chinese investment in the upstream sector is dominated by major state owned enterprises (SOEs) – including CNPC, Sinopec, CNOOC, Sinochem, Shenhua and CIC – in contrast to a 30% state share across all investments in the U.S. in 2013. These companies have a mandate to expand abroad to secure resources and offset declining domestic hydrocarbon production, as well as to improve technology, and are backed by strong cash reserves and state credit and policy. Many western oil and gas majors, including BP, Chevron and Shell, which recently pulled out, are not heavily active in the U.S. unconventional sector, leaving something of a gap, particularly when it comes to big companies with deep pockets.

However, the U.S. attitude to investment by Chinese SOEs remains cautious, especially over technology transfer, but less sensitive than in some other sectors of strategic significance, such as telecoms. Both China and the USA are major energy consuming countries whose productive economies benefit from cheap energy, and as such share the goal of higher global oil and gas production. Intergovernmental initiatives through the Strategic & Economic Dialogue between the U.S. and China are helping encourage investment, and will be important in creating a framework for future collaboration in China or elsewhere overseas. Devon Energy, for example, has already said it expects to work with Sinopec in China, as it does now in the U.S.

If large deals are involved, Chinese companies need to be aware of public relations issues and political lobbying. Since CNOOC’s proposed $18 billion takeover of Unocal was blocked in 2005, deals have been lower profile, involving a Chinese firm buying a minority stake in a proven unconventional license area. Many deals are structured so that Chinese investors are prevented from obtaining proprietary information about fracking or other key aspects of the drilling process, although this is also often true for deals with non-Chinese overseas investors. Most deals also do not offer personnel exchange, and preclude control of production and sales, although investors should gain an insight into how to decide where to drill wells and how to set up the infrastructure around them, as well as forming a strong partnership for potential future opportunities.

There is also a rich and diversified labour pool available along with a strong regime of intellectual property rights protection and enforcement, which are both important for Chinese investors considering unconventional research and development programmes. However that is coupled with a highly combative legal sector, potentially requiring U.S. legal expertise and expenditure.

Recent acquisitions by Chinese companies include Shenhua Energy’s purchase of a minority stake in a Pennsylvania shale gas operation for $90 million in 2014, while in 2013 Sinopec bought a 50% stake in Chesapeake Energy’s Mississippi Lime formation $1.02 billion, and Sinochem bought a 40% stake in Pioneer Natural Resources’ Wolfcamp Shale for $1.7 billion. Also in 2013, just across the border in Canada, CNOOC bought conventional producer, Nexen, for $15.1 billion – the U.S. portion of which accounts for most of China’s investment in the country’s conventional sector in 2013. Other major joint ventures include Sinopec and Devon Energy, and CNOOC and Chesapeake Energy.

The U.S. also offers opportunities for Chinese companies keen to export the country’s newfound energy riches to China. China’s sovereign wealth fund China Investment Corp. (CIC) invested $500 million in 2012 in Cheniere Energy’s planned LNG export project. Similarly, Sinopec and Huadian have purchased stakes in Canadian projects aimed at exporting LNG to China from Canada, from 2018, while there are also plans to convert cheap gas to methanol for use as a feedstock for the Chinese petrochemical sector. The U.S. energy sector is even attracting interest from Chinese non-energy companies. Beijing-based Goldleaf Jewelry, for example, is paying $665 million for a 95% share in ERG Resources - one of the few examples of Chinese private investment in the U.S. upstream.

Other reasons to invest in the U.S. include exposure to a competitive marketplace that rewards efficiency and productivity, while insisting on rigorous compliance with complex rules and regulations. Among those regulations, Chinese investors should be aware of U.S. competition law, which penalises state subsidies or other behaviour that distorts market competition. Regulators monitor the operations of foreign firms carefully to ensure that they abide by U.S. law.

Free market policies mean oil and gas prices achieved in the U.S. are market determined, with most crude priced against the West Texas Intermediate (WTI) benchmark, and gas against Henry Hub or another regional benchmark. Gas prices have been well below international and domestic Chinese levels over recent years due to high unconventional production. Despite being an inland benchmark, WTI reflects international crude levels, albeit tending towards a growing discount due to rising domestic unconventional production.

Similarly, wholesale and retail petroleum and natural gas prices are also market driven, and carry relatively low taxes. While it is not yet legal to export crude from the U.S., petroleum products are allowed, and exports have been rising, especially to Europe. Pipeline gas exports are allowed, and several LNG terminals are now also licensed to export LNG, giving investors plenty of options on trading and flexibility in operation.

Oil and gas company investors need to be aware of federal, state and local laws, which help give rise to regional variations in investment climate. For example, the southern U.S. states tend to have lower gas and electricity prices, lower tax rates and relatively weak labour unions, while some states have tax breaks or incentives for unconventional development. China and the USA also have very different accounting systems and management methods, but the fact that America is used to investors from all over the world is an advantage for Chinese companies, as is the multi-ethnic nature of the country.

As the big state-owned Chinese oil and gas companies become more established in partnership with U.S. operators, more opportunities could be generated for smaller, private support and service companies from China. This will be particularly important if the major state companies are to successfully recreate the U.S. unconventional oil and gas experience back in China, where the absence of a support infrastructure and services sector has been a major constraint on development.

The U.S. market offers access to the rest of North America. Most of CNPC and Sinopec’s biggest investments on the continent have been in Canadian oil sands projects. The North American Free Trade Agreement (NAFTA) means all of these Canadian investments are accessible to Chinese suppliers based in the U.S. The same applies to the Mexican market, which is currently undergoing major reform and liberalisation, creating many opportunities for well-placed investors across the US border.

Because of the recent global economic downturn, there have been opportunities to acquire business assets at lower valuations in the U.S., although this has lessened as the economy has rebounded, especially given high corporate earnings over recent years. Similarly, while opportunities were created by low gas prices linked to high unconventional supply, the gas market has now rebounded somewhat, helped by a switch to liquids-rich drilling and the promise of more higher-priced LNG exports.

**Private Capital Favours Downstream**

Away from the strategic upstream sector, there are more opportunities for private Chinese investment in the mid and downstream. Langfang-based ENN Group, for example, is aiming to build a network of LNG stations serving the trucking industry. New opportunities of this sort often arise as a result of a change in relative prices driven by free market forces, with gas prices now below oil fuels, which has prompted many vehicles to switch.

ENN still opted to team up with a local partner, however, and initially faced difficulties finding one, before signing up to a $50 million deal with Utah-based CH4 Energy Corp. The joint venture is called Transfuels, operates as Blu LNG, and plans to set up 50 stations, rising to 500 eventually. Blu is combining its hydrocarbon investments with a foray into renewables, including proposed projects in partnership with Duke Energy, and a $5 billion solar facility and manufacturing plant.

The U.S. ranks highly in indices of overseas investment confidence. Once market entry is achieved, there is little potential for disruption or complication in what is a physically and legally secure environment. This, combined with cutting edge technology, competitive returns and ample hydrocarbon resources, makes the USA a prime choice for overseas Chinese oil and gas investors.