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# Where Will the Dragon Roar Next?



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# Where Will the Dragon Roar Next?

In an ironic twist of resource nationalism, the China National Offshore Oil Corporation's (CNOOC) audacious bid to acquire Unocal in 2005, was denied by a wave of political concern in Washington about a Chinese state company seeking to buy a U.S. oil and gas independent. Since then, resource nationalism has become an even more dominant feature in the energy landscape, while Chinese national oil companies (NOC) have become noticeably more low profile in their overseas expansion.

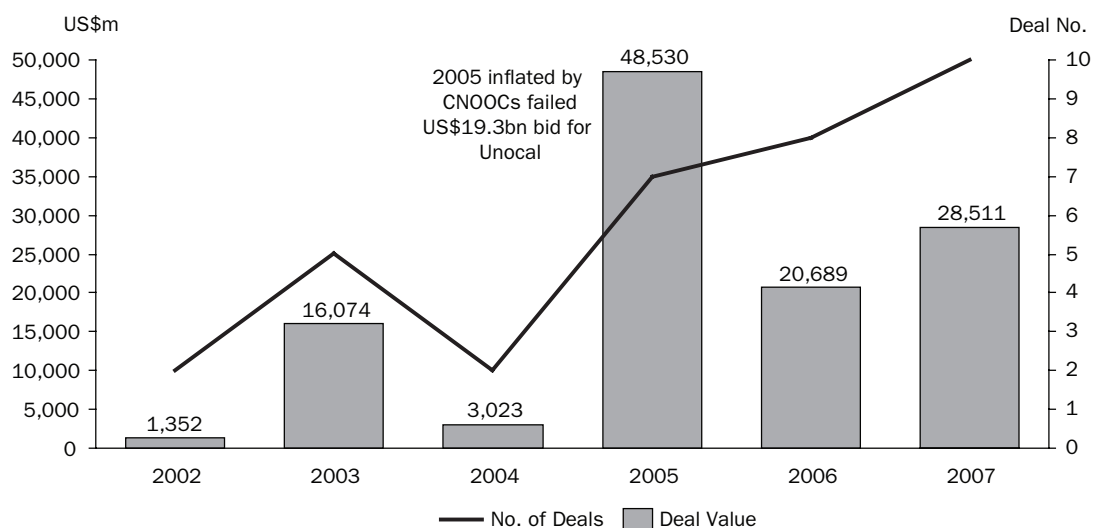
In Booz Allen Hamilton's previously published viewpoint on the lessons learned post-Unocal, we highlighted the need for CNOOC to have a more transparent and

clearly articulated acquisition strategy. A broader look across the NOCs indicates that they have been active in mergers and acquisitions (M&A) in recent years, with the Chinese companies making significant inroads in places such as Africa and Russia. While they still face some significant issues going forward, it is no longer a question of *if* the Chinese NOCs will pose a formidable challenge to the IOCs but *when*. As Chinese ambitions mount, 2008 could be the year for a strategic shift in the balance of power in the upstream sector.

## The NOCs are getting busy again

Since the Unocal episode, NOC acquisitions have generally avoided headline-grabbing news (with a few notable exceptions, such as Gazprom's increased stake in Shell's Sakhalin 2 project). It is true that

**Exhibit 1**  
M&A Deals for the NOCs (2002–2007)



Note: Deals cover values of US\$500 million or greater and include only E&P, O&S, and drilling. European NOCs not included in deal figures  
Source: Bloomberg

the Chinese NOCs have in part focused on domestic growth, as well as international expansion. According to industry commentators, domestic exploration and development spend across CNOOC, China Petroleum and Chemical Corporation (Sinopec), and PetroChina, grew from US\$12.6 billion in 2004 to US\$21.5 billion in 2006 (a 70+ percent increase).

Nonetheless, international M&A activity across the broader NOC group is steadily increasing. As illustrated in Exhibit 1, NOC deal values peaked in 2005 (mostly due to CNOOC's bid for Unocal) and have since recommenced an upward trajectory with cumulative deal values reaching nearly US\$120 billion in the period between 2002 and 2007. To put this into broader context, NOC upstream transactions represented some five percent of total global M&A deal values in 2002, peaked at nearly 33 percent in 2005, and declined to 15 percent in 2007.

As for the Chinese dimension to this activity, their NOCs have been particularly active in Africa and have fairly recently established a strategic foothold in the Russian exploration and production (E&P) market. With regard to the latter, Sinopec acquired Udmurtneft for US\$3.5 billion from TNK BP in 2006. The acquisition was undertaken in conjunction with Rosneft and illustrated the growing cooperation between Russia and China in the energy sector. The acquisition was dictated more by broad strategic goals than physical oil supply, as China hopes the venture will open the door to future deals and energy trade between the two countries.

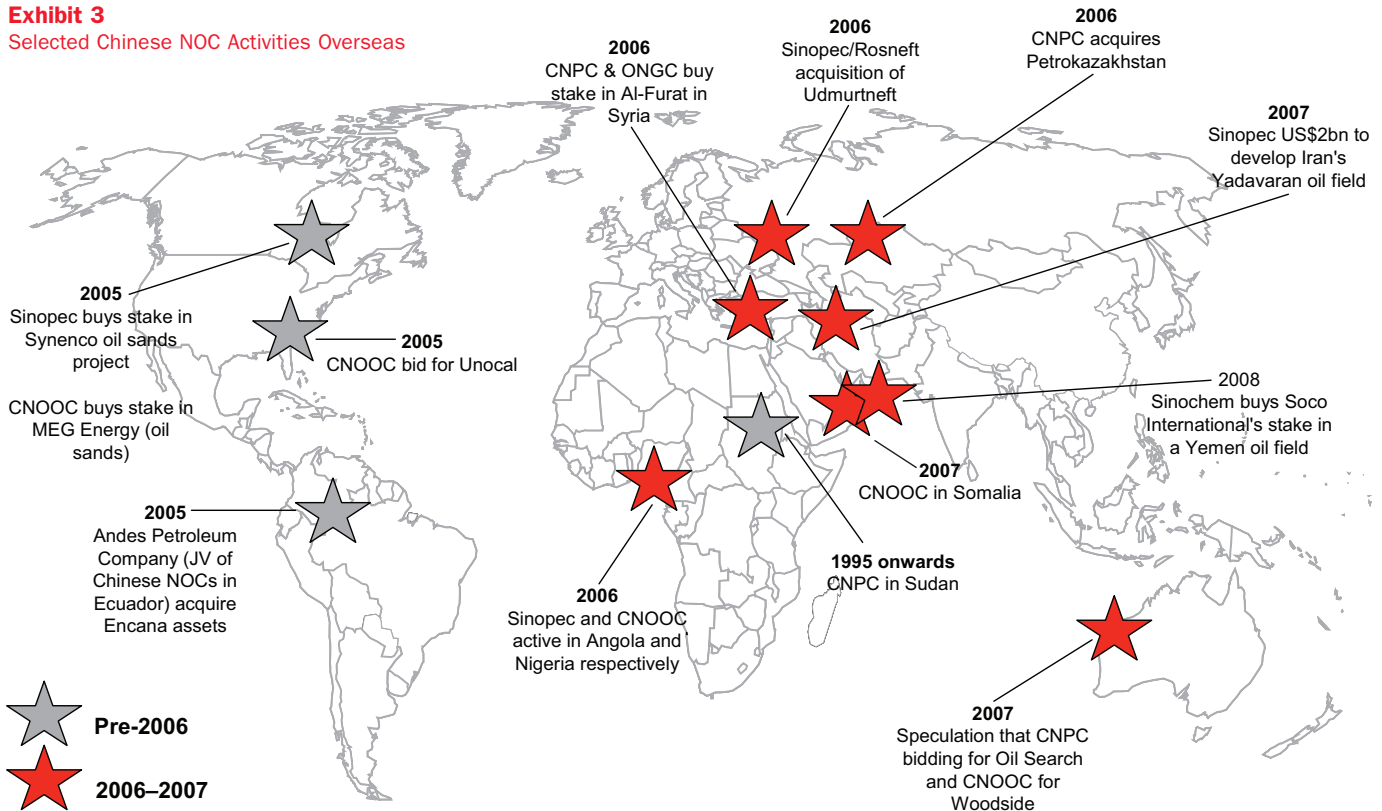
However, President Putin's Government decision not to allow China Oilfield Service (COSL), an offshore drilling services company, to buy a US\$70 million majority stake in STU (TNK BP's oil producing unit) in 2008,

**Exhibit 2**  
Chinese NOCs in Africa

Date	Target	Buyer	Value (US\$m)	Comment
November 2007	Two Nigerian offshore blocks	CNOOC	900	CNOOC rumoured to be considering buying stakes, each of 49.8% and held by Shell. Eni owns the remaining 50.2% in each block
June 2007	Exploration rights granted in Somalia	CNOOC	–	CNOOC's deal with Somalia's government gave it exploration rights in the north Mudug region
June 2006	Stakes in three deepwater oil blocks (Angola)	Sinopec (China Petroleum & Chemical Corp.)	692.2	Sonangol Sinopec International (SSI) JV won stakes including a 50% interest in BP's Greater Plutonio development area in Block 18 offshore Angola
January 2006	Oil prospecting licence 229 in Nigeria	CNOOC	60	CNOOC bought a 35% working interest in the license to explore offshore
January 2006	Nigerian offshore oilfield	CNOOC	2,268	CNOOC acquired 45% interest in Nigeria's Akpo field
1995-present	Sudan	China National Petroleum Corporation	–	CNPC in JV (Greater Nile Operating Company). Has interests in both upstream, midstream (pipeline built) and downstream (refinery built)

Source: Booz Allen Hamilton analysis

### Exhibit 3 Selected Chinese NOC Activities Overseas



Source: Booz Allen Hamilton analysis

suggests the Russian oil sector will remain a difficult market to crack.

In contrast, the Chinese NOCs have a longer history and more established presence in Africa. China National Petroleum Corporation (CNPC) has been active in Sudan since the mid 1990s with operations right across the value chain from E&P to refining. CNOOC also bought stakes in Nigerian offshore exploration acreage, and Sinopec, via a joint venture with Sonangol, acquired stakes in three deepwater blocks in offshore Angola (see Exhibit 2 for more detail).

As a result, Africa's importance as a major exporter of oil to China has grown dramatically in recent years. In 2006, Africa was the second largest source of Chinese oil imports (the Middle East tops the list) and represented nearly a quarter of oil imports.

The Chinese government's role in facilitating these deals is well documented. It has offered significant infrastructure investments in exchange for exploration rights. Incentives range from grants and bank credits

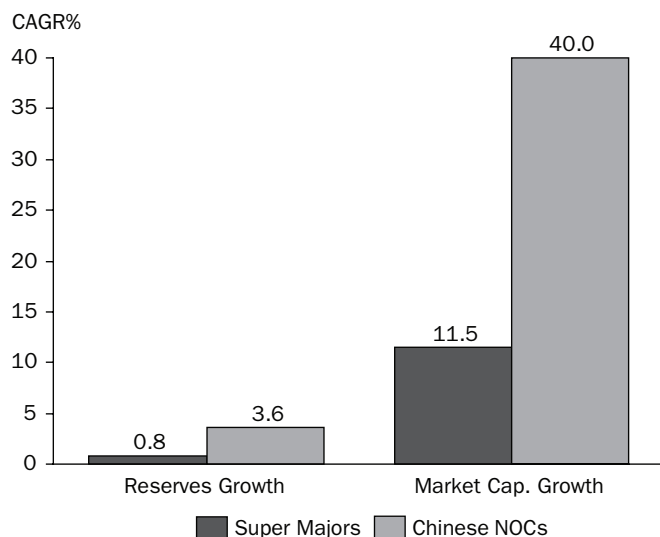
for telephone networks, power stations, and road and school building to military aid such as financing the purchase of some US\$250 million of military aircraft for Nigeria. This approach is not always successful (CNPC's offer to invest US\$2 billion in Nigeria to build a refinery in exchange for oil blocks ultimately proved fruitless), but on balance the strategy has worked well. Moreover, this aid is largely without conditions tied to improving socio-political goals such as democracy, transparency, and human rights. The international oil companies (IOC) are hard pressed to compete with this level of influence.

Not surprisingly, the Chinese NOCs have flourished in this environment compared to their IOC counterparts. Given their increased international activity (see Exhibit 3), the Chinese NOCs' reserves base and more noticeably their market valuation have grown at a much faster and impressive rate than the Super Majors (see Exhibit 4).

#### Challenges for growth remain

Despite this progress, the Chinese NOCs face a series of obstacles they will not find easy to overcome. Firstly,

**Exhibit 4**  
Super Majors/Chinese NOC CAGR Growth Rates in Oil and Gas Reserves and Market Capitalisation 2002–2006



Note: Super Majors are BP, Chevron, ConocoPhillips, ExxonMobil, Shell, and Total. Chinese NOCs are CNOOC, Petrochina (listed E&P subsidiary of CNPC), and Sinopec.  
Source: Bloomberg, Booz Allen Hamilton analysis

they still need to reinforce their technology expertise, particularly regarding deepwater. In the case of the attempted Unocal acquisition, the need for deepwater expertise was a main driver for CNOOC. However, it is worth noting that as the NOCs gain experience in offshore West Africa, it is likely their expertise will become home grown, as was the case for Petrobras, which is now a leader in deepwater drilling.

Secondly, there is a perceived lack of capability to handle the mega infrastructure projects. With regard to large capital intensive programs such as liquefied natural gas (LNG) and gas-to-liquids (GTL) projects, host governments still prefer to negotiate with the IOCs that have the scale and technology to manage these projects efficiently and competently. Admittedly, their track record of success is not unblemished—witness the cost overruns experienced by Eni as the operator of the consortium developing Kashagan or Shell’s budgetary challenges in Sakhalin 2.

Thirdly, the Chinese have to contend with growing rivalry from other NOCs. For example, they have a somewhat mixed relationship with their Indian counterparts. In January 2006, India and China signed a memorandum of understanding on joint exploration, production, and acquisition of oil and

natural gas resources in developing countries. Since then, there have been several examples of successful collaboration, such as the Oil and Natural Gas Corporation (ONGC) and CNPC jointly winning a bid to acquire a 50 percent stake in Omimex de Colombia, in addition to them jointly winning a bid to acquire 37 percent of Petro-Canada’s stake in the al-Furat oil and gas fields in Syria. However, rivalry for international assets is never far from the surface. In 2003, ONGC was close to clinching a multimillion deal in Nigeria for a 50 percent stake in an offshore hydrocarbon block, but the Chinese muscled into the negotiations and snatched away the deal by promising a billion dollar investment to modernise the Nigerian rail network. In December 2007, the Chinese government protested against ONGC’s exploration in two offshore deepwater Vietnamese blocks, describing the activity as “illegal” because the two blocks were in the disputed area of the South China Sea. Similarly, Russia’s Gazprom entered the fray in the latter part of 2007, by announcing it was targeting Nigeria for future investments in gas to the tune of US\$2.5 billion.

#### Options for growth

Given these challenges that the Chinese NOCs face, what are their options for growth? Certainly, relatively small and low-profile corporate acquisitions are probably still on the radar. These would include several of the smaller Australian E&P companies, especially those with a portfolio spanning gas-rich Asian assets and operations in Africa and the Middle East for example. In late 2007, CNPC was rumoured to be considering a US\$5 billion bid for Oil Search. The Australian listed company has substantial gas reserves in Papua New Guinea, which given Chinese aspirations to grow LNG imports would be very attractive. Oil Search also has production interests in Yemen and Egypt and exploration concessions in Yemen, Egypt, Libya, Iraq, and Tunisia. Some of the latter countries would complement very nicely Chinese activities in the region.

Changes in the share ownership structure of Santos (which has a market capitalisation of about US\$6 billion) are likely to make the Australian independent a potential acquisition target. The current 15 percent shareholder cap on individual share holdings will be

removed later this year, opening the door to potential Chinese bidders. With its focus on LNG growth (it has a stake in Darwin LNG as well as interests in PNG LNG) and portfolio of Asian exploration assets, Santos would be an interesting acquisition for the Chinese.

Similarly, there has been some market speculation about a potential bid for Woodside by CNOOC. However, given the market capitalisation (US\$32 billion) of this, the largest Australian independent, the political sensitivity of such a transaction would preclude any future deal potential.

Aside from a direct acquisition, purchasing a strategic stake in a company might be a more subtle option for China to consider. Chinalco's recent intervention in BHP Billiton's bid for Rio Tinto suggests China Inc. is tempering its enthusiasm for acquisitions with sober sophistication. The state-owned aluminium group Chinalco bought a nine percent stake in Rio to disrupt its takeover by BHP, because China is worried about the implications a combined group would have regarding iron ore exports. Chinalco's approach has circumvented political sensitivities across a number of dimensions. Chinalco's bid was not hostile, because it bought into Rio Tinto's British holding company, which is less sensitive than the group's Australian shares. It also has a Western partner—Alcoa of the U.S.—to provide some cover. Finally, its purchase is a fait accompli, which suggests the possibility of a serious backlash is mitigated.

In light of this development, where might the Chinese NOCs focus their attention? Certainly a strategic stake in some of the small Australian independents might be an alternative. A similar approach to a major oil field services company would certainly address their technology gap in the long term, but political sensitivities, particularly with U.S.-based companies, might prevent such a move.

In terms of building deepwater expertise, the Chinese might alternatively consider strategic collaboration with a state-owned counterpart that boasts proficiency in this area. The Brazilian oil and gas company, Petrobras, would be an obvious candidate given its deepwater record. In fact, Sinopec (in 2004) and

CNPC (in 2005) signed cooperation agreements with Petrobras on onshore and offshore oil exploration and production in Brazil, China, and other parts of the world. There is still potential to expand the scope of this collaboration.

#### **Watch this space—is something coming?**

Clearly the Chinese NOCs have learnt some lessons over the past few years. They remain active in terms of M&A, but have assumed a much lower profile. The bulk of their international operations are generally off the Western media's radar. Nonetheless, there are signs that their ambitions continue to grow. Their foothold in Russia and recent speculation about potential bids for Australian E&Ps are testament to their desire to expand. However, these ambitions are much more sensitive to the politics of public opinion and consequently, the NOCs' aspirations are more tempered, and their methods increasingly more sophisticated. As a result, their corporate targets are likely to be more modest, in the US\$5–10 billion market capitalisation bracket. Moreover, outright acquisitions might be deferred in favour of more strategic stakes with a long-term view.

Certainly, it is difficult to envisage the Chinese NOCs pursuing intrepid acquisitions of the political and financial scale of Unocal. However, their aversion to the media spotlight might not exclude bolder initiatives in the medium term. Displacing an IOC incumbent in a politically volatile emerging market is not an unfeasible scenario when the NOC brings technical expertise, financial incentives, and no qualms regarding the corporate social responsibility imperatives with which Western oil companies grapple.

Going one step further, how long will it be before we see Chinese NOCs competing for acreage in the mature strongholds of the IOCs, such as the Gulf of Mexico? The year 2008 could be the time when the dragon roars again.

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