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CNOOC Bid for Unocal No Threat to Energy Security

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An $18.5 billion bid by a Chinese energy company to acquire the American gas and oil firm Unocal has sparked a strong but misguided reaction on Capitol Hill. On June 30, the House passed a resolution by 398 to 15 expressing national security concerns about the acquisition of Unocal by the China National Offshore Oil Corporation (CNOOC), an energy company 70 percent of which is owned by the Communist government of China. On July 13, the House Armed Services Committee held a hearing that raised the decibel level several notches, with members especially vocal about the impact of the proposed deal on America's "energy security."

But fears that such a transaction would harm national security by making the United States more dependent on foreign oil or that the proposed transaction threatens to somehow provide China with an "oil weapon" are ill-founded. In short:

Energy independence provides no economic protection against supply disruptions abroad and no guarantee that supplies will be secure in the future. America's vulnerability to oil supply disruptions is primarily related to how much oil we consume, not where the oil we consume happens to originate.

America need not worry about access to international oil supplies. Embargoes or supply diversions cannot keep oil out of U.S. ports, and there are plenty of sellers in world oil markets. Only a naval blockade could prevent America from buying all the oil it needs from international oil markets.

Unocal's reserves are not large enough to provide CNOOC with significant market power in the global oil economy.

Because China is a net oil importer, it has every incentive to maximize production and none to curtail production. Accordingly, American and Chinese interests in the oil market coincide.

Dependence on Foreign Oil Is Not an Economic Problem

It's doubtful that American oil imports would increase as a consequence of a CNOOC-Unocal merger. That's because Unocal's domestic oil assets are small (58,000 barrels of oil production a day, which translates into 0.8 percent of U.S. production from petroleum liquids and 0.3 percent of to U.S. petroleum consumption)[1] and are most profitably sold to the U.S. market.

Even were Unocal's U.S. oil assets diverted elsewhere, it would have no effect on America's vulnerability to oil supply disruptions abroad. That's because it makes no difference from an economic standpoint whether the oil we consume is produced domestically or from foreign sources.[2] Moving oil around the globe is so cheap and easy that a shortage of oil anywhere in the world increases the price of oil everywhere in the world. That's why the oil price shock set off by the Iranian Revolution in November 1978, increased the price of oil in Great Britain just as much as it increased the price of oil in Japan. It didn't matter that Great Britain was energy independent at the time and that Japan was 100-percent reliant on imports. The only way to render America invulnerable to oil supply disruptions abroad would be to stop using petroleum products altogether or, alternatively, ban all imports and exports of oil, gasoline, and the like.

Moreover, removing our economy from international energy markets in a quest for independence would make America more vulnerable to supply disruptions for two reasons. First, it would be easier for terrorists to disrupt energy production if the sources of supply are geographically concentrated rather than dispersed. Second, if a domestic disruption were to occur and a trading infrastructure were not in

place, we would not be able to avail ourselves easily of supplies elsewhere.

Finally, oil imports do not increase the pressure on oil prices. Rather, they relieve the pressure. America imports oil because it's cheaper than producing that oil here at home. Trade reduces domestic prices for all services and commodities.

Physical Access Is Not a Problem

The pre-OPEC oil market was characterized by long-term contracts between producers and consumers with little oil available in secondary markets. Accordingly, physical access might once have been a reasonable concern.[3] The modern oil market, however, has been radically transformed. Robust spot and future markets exist for oil and refined petroleum products. Long-term contracts are rarer, and contract prices are relatively transparent. Accordingly, physical access is no longer a legitimate concern for consuming nations.[4] As Richard Gordon, professor emeritus of mineral economics and former director of Pennsylvania State University's Center for Energy and Mineral Policy Research, puts it: "Basic economics indicates that no shortages will arise as long as prices are uncontrolled. The question is the price needed to eliminate the shortage."[5]

That explains why any diversion of Unocal production toward Chinese domestic markets is irrelevant from an economic standpoint. Unocal production redirected towards China would simply displace imports from other suppliers. Those displaced imports would re-enter the world market with no net effect on global supply.

That also explains why an oil embargo against the United States is incapable of preventing oil imports from reaching U.S. ports. Once oil leaves the territory of a producer, market agents dictate where the oil goes, not agents of the producer. The globalization of oil markets ensures that the United States will always have access to oil, whether oil producers like it or not.[6]

The 1973 oil embargo proves the point.[7] As MIT's Thomas Lee, Ben Ball Jr., and Richard Tabors observe regarding that experience, "It was no more possible for OPEC to keep its oil out of U.S. supply lines than it was for the United States to keep its embargoed grain out of Soviet silos several years later. Simple rerouting through the international system circumvented the embargo. The significance of the embargo lay in its symbolism."[8] Granted, "there were short-term supply disruptions," but "the only tangible effect of the embargo was to increase some transportation costs slightly, because of the diversions, reroutings, and transshipments necessitated."[9]

MIT oil economist M. A. Adelman agrees: "The 'embargo' of 1973–4 was a sham. Diversion was not even necessary, it was simply a swap of customers and suppliers between Arab and non-Arab sources.… the good news is that the United States cannot be embargoed, leaving other countries undisturbed."[10]

Unocal Provides Little Ammunition for an "Oil Weapon"

Unocal is a relatively minor player in world crude markets. Its worldwide operations produced a total of 169,000 barrels of petroleum liquids in the first quarter of 2005,[11] or 0.23 percent of global oil production.[12] Accordingly, CNOOC would not gain any real market power in world oil markets were it to acquire Unocal.

Some have expressed concern that China hopes to gain such market power through the incremental acquisition of reserves and through concessions for development rights from producer states. Although we cannot discern with certainty what Chinese intentions might be, we should recognize that there are simply not enough non-OPEC reserves available to CNOOC to challenge OPEC's position as the marginal producer in world oil markets—the position that brings with it market power. Concessions from producers do not translate into control over oil assets, as both the United States and Great Britain discovered to their chagrin between 1960 and 1980.[13]

The fact that China is a net importer of petroleum means that the Chinese economy is best served by low oil prices. If we posit that the Chinese government is interested in a stronger and not a weaker Chinese economy, we can safely assume that Chinese control of oil assets will result in maximum production.

This is important because the only sense in which an "oil weapon" can be said to exist is in the economic damage that can be done to consuming nations by a supply reduction engineered by producers. Accordingly, were the Chinese government—through CNOOC or whomever—to deploy an "oil weapon," its use would harm the Chinese economy as much if not more than it would harm the United States economy. That's because it requires more oil to produce a unit of GDP in China than in the United States and because the Chinese economy is less able to efficiently adjust to price shocks than is the United States economy.[14]

Relatedly, if the Chinese tried to hoard oil to keep it out of American hands (either by stockpiling inventory or shutting down production), it would drive up oil prices for consumers everywhere—Chinese and American alike—and do more harm to the Chinese economy than to the American economy. Simply put, deployment of a Chinese "oil weapon" would backfire on the Chinese.

Conclusion

A reasonable understanding of how international oil markets actually work in practice is sufficient to dismiss the worries of those who fear Chinese control of oil-producing assets or long-term contracts with producer states.[15] Although national security analysts have historically worried about "access," those fears are no longer reasonable.

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1. Bernard Gelb, "Unocal Corporation's Oil and Gas," Congressional Research Service, RS22182, July 1, 2005, p. 2.
2. Energy analysts on both the political Left and Right agree on this point. For instance, see Pietro Nivola, "Energy Independence or Interdependence?" *The Brookings Review* 20, no. 2 (Spring 2002): 24–27, and Michael Toman, "International Oil Security: Problems and Policies," Issue Brief 02-04,

Resources for the Future, January 2002. The contention that energy independence doesn't matter is also the orthodox view among academic energy economists. See for instance M. A. Adelman, *The Genie out of the Bottle: World Oil Since 1970* (Cambridge, MA: MIT Press, 1995).

3. Analogies have been made between the Japanese drive for oil in the 1930s and 1940s and the present Chinese interest in international oil assets. That analogy is a poor one. The only reason that the Japanese government had to worry about access to oil was because that government went to war with every country that operated major oil production facilities.

4. Chantale LaCasse and Andre Plourde, "On the Renewal of Concern for the Security of Oil Supply," *Energy Journal* 16, no. 2 (1995): 13–14; Hossein Razavi and Fereidun Fesharaki, *Fundamentals of Petroleum Trading* (Westport, CT: Preager, 1991); and Philip Verleger, *Adjusting to Volatile Energy Prices* (Washington: Institute for International Economics, 1993).

5. Richard Gordon, "Energy Intervention after Desert Storm: Some Unfinished Tasks," *Energy Journal* 13, no. 4, (October 1992).

6. M. A. Adelman represents the overwhelming consensus among economists on this point: "Rarely has a word [access] been so compact of error and confusion. Nobody has ever been denied access to oil: anyone willing to pay the current price could have more than he wanted. One may assume what he likes about future demand, supply, and market control, and conclude that the future price will be high or low, but that price will clear the market in the future as in the past. The worry about 'access' assumes something queer indeed: that all of the producing countries will join in refusing to sell to some particular buyer—for what strange motive is never discussed … it takes only one other country, with a desire for gain, to cure this irrationality." M. A. Adelman, *The World Petroleum Market* (Baltimore: Johns Hopkins University Press, 1972), p. 260.

7. There have actually been three attempts by Arab states to target embargoes against certain Western states: 1956 (targeted at Britain and France), 1967 (targeted against the United States, Britain, and West Germany), and 1973 (targeted against the United States and the Netherlands). All failed to reduce imports into the targeted countries. For a political and economic history of those embargo episodes, see A. F. Alhajii, "Three Decades After the Oil Embargo: Was 1973 Unique?" *Journal of Energy and Development* 30, no. 2 (2005): 1–16.

8. Thomas Lee, Ben Ball Jr., and Richard Tabors, *Energy Aftermath* (Boston: Harvard Business School, 1990), p. 17.

9. Ibid., p. 30. See also Edward Fried, "Oil Security: An Economic Phenomenon," in Oil and America's Security, Edward Fried and Nanette Blandin, eds. (Washington: Brookings Institution, 1988), pp. 56–59. Although many think the gasoline lines, high prices, and shortages were due to the embargo, they were not. For a brief review of the real causes of the above, see Jerry Taylor and Peter VanDoren, "An Oil Embargo Won't Work," *Wall Street Journal*, April 24, 2002. For a more extensive discussion, see Alhajii and Adeleman, *Genie out of the Bottle*.

10. M. A. Adelman, "Limiting Oil Imports," Hearing before the Subcommittee on Energy Regulation, U.S. Senate, 96th Congress, 1st Session (Washington: Government Printing Office, 1980), p. 86, cited in Robert L. Bradley Jr., *The Mirage of Oil Protection* (Lanham, MD: University Press of America, 1989), p. 140.

11. Petroleum liquids include crude oil, condensate, and natural gas liquids. Production data from Robert Wright and Nancy Murachanian, *2005 Net Production Outlook*, Unocal Corporation, April 28, 2005, cited in Bernard Gelb, "Unocal Corporation's Oil and Gas," Congressional Research Service, RS22182, July 1, 2005, p. 2.

12. Global oil production was 73,301,000 barrels a day in the first quarter of 2005.

13. M. A. Adelman, *The Genie out of the Bottle: World Oil Since 1970* (Cambridge, MA: MIT Press, 1995), and *The World Petroleum Market* (Baltimore: Johns Hopkins University Press, 1972).

14. Charles Wolf, K. C. Yeh, Benjamin Zycher, Nicholas Eberstadt, and Sung-Ho Lee, *Fault Lines in China's Economic Terrain* (Santa Monica, CA: Rand Corporation, 2003), pp. 105–116. For a review of the nature of the impact that oil supply shocks have on the economy, see Donald Jones, Paul Leiby, and Inja Paik, "Oil Shocks and the Macroeconomy: What Has Been Learned Since 1996," *Energy Journal* 25, no. 2 (2004): 1–32, Robert Barsky & Lutz Kilian, "Oil and the Macroeconomy Since the 1970s," National Bureau of Economic Research, Working Paper no. 10855, October 2004; and James Hamilton, "What is an Oil Shock?" *Journal of Econometrics* 113 (2003): 363–98.

15. For good treatises on the matter, see Adelman, *Genie out of the Bottle*, and Francisco Parra, *Oil Politics: A Modern History of Petroleum* (New York: I.B. Tauris, 2004). For a somewhat briefer and more accessible discussion, see U.S. General Accounting Office, "Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products," GAO/RCED-93-17, March 1993. This author is unaware of any alternative perspective regarding the operation of world oil markets in the academic literature that is at odds with the perspective offered in this paper.