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How Are Texas Oil And Gas Cos. Faring In China?

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China has long been a part of the global expansion plans of many oil and gas companies. The sheer size and growth in China's energy sector over the past few decades demands attention, as do the energy policies of the government of the People's Republic of China to influence the development of the energy sector. According to a U.S. Energy Information Administration February 2014 report,[1] China is the largest producer and consumer of coal in the world (accounting for approximately half of global coal consumption) and the second largest oil consumer in the world (after the United States). In 2011, coal supplied 69 percent of China's total energy consumption, followed by oil at 18 percent, hydroelectric sources at 6 percent, natural gas at 4 percent and nuclear power and other renewables each accounting for about 1 percent.

While China has long relied on coal to power its economy, the PRC government has announced a number of times in recent years its intention to reduce its reliance on coal, which could bode well for producers (and suppliers and servicers to such producers) of alternative energy sources, including oil and natural gas. For example, in September 2013, the PRC's State Council announced its intention to reduce the proportion of coal in the country's energy consumption mix to less than 65 percent by 2017.[2] The PRC government has also passed a number of policies in recent years to support the development of alternative sources of energy. For example, according to a September 2014 paper by former U.S. Under Secretary of Energy David Sandalow, Jingchao Wu, Qing Yang, Anders Hove and Junda Lin, as members of a research team led by Columbia Unviersity's Center on Global Energy Policy, titled "Meeting China's Shale Gas Goals," the PRC government has in recent years supported shale gas production through a number of policies, including production incentives, accelerated permitting, improved infrastructure and technology innovation.[3]

In the midst of the growth and transformation of the energy industry in China in recent years, how have foreign oil and gas companies fared in China and what are the major challenges and opportunities facing them in China in the years ahead? In order to shed some light on the first question, I reviewed the two most recent annual reports on Form 10-K filed with the U.S. Securities and Exchange Commission[4] for all of the oil and gas companies listed in the *Houston Business Journal's* list of the 100 largest Houston-based public companies (based on fiscal year 2013 revenue), which list was included in the July 25-31, 2014, issue of the *Houston Business Journal*.

Based on a review of these annual reports, for fiscal year 2014, 12 of the oil and gas companies in the Houston Top 100 disclosed that in 2014 they had operations in China and/or generated revenues from sales into China (as is discussed below, though, two of these companies have since sold their China operations). Among these 12 companies, only three disclosed in their annual report the amount of sales from their China operations in recent years. The table below summarizes the revenues derived from the China operations for these three companies for each of the last three years:

Company	2012		2013		2014	
	Revenues from China operations	Percentage of Company's Total Revenues	Revenues from China operations	Percentage of Company's Total Revenues	Revenues from China operations	Percentage of Company's Total Revenues
	(in millions of US dollars)	*(percentage)*	*(in millions of US dollars)*	*(percentage)*	*(in millions of US dollars)*	*(percentage)*
National Oilwell Varco, Inc.[i]	$533	3.1%	$1,007	5.2%	$1,905	8.9%
ConocoPhillips[ii]	$1,499	2.6%	$2,120	3.9%	$1,701	3.2%
Newfield Exploration Company[iii]	$86	5.5%	$69	3.7%	$39	1.7%

[i] *See* National National Oilwell Varco, Inc.'s annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 95. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/1021860/000095012315003051/d859582d10k.htm.
[ii] *See* ConocoPhillips's annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 135. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/1163165/000119312515059281/d869001d10k.htm.
[iii] *See* Newfield Exploration Company's annual report on Form 10-K for the fiscal year ended December 31, 2014, pp. 102-04. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/912750/000091275015000009/nfx201410-kv2.htm.

Among the 12 oil and gas companies in the Houston Top 100 that disclosed that they had business or operations in China in 2014, seven were oil and gas service and equipment companies (representing approximately one-third of all oil and gas service and equipment companies listed in the Houston Top 100) and five were oil and gas exploration and production companies (representing approximately one-fourth of all oil and gas exploration and production companies listed in the Houston Top 100). In addition, although they are not the subject of this article, it is worth noting that two Houston Top 100 companies, and one operating segment of a Houston Top 100 company, are chemical companies that have operations in China and/or generate revenues from sales into China.

PRC governmental regulations restricting foreign investment in certain sectors of the oil and gas industry impacted what kind of oil and gas companies have been able to enter and maintain a presence in China. For example, in China, foreign investment in the oil and gas exploration and production industry generally must take the form of an equity joint venture or cooperative joint venture, with the foreign oil and gas company's interest being limited to a minority stake. In addition, according to the EIA February 2014 Report, whereas onshore oil production in China is mostly limited to China's national oil companies, international oil companies have been granted more access to deep water offshore projects and more technically challenging gas fields.[8]

Among the five E&P companies from the Houston Top 100 which had business or operations in China in 2013 and 2014, two have sold their China businesses. Specifically, during 2014, Anadarko Petroleum Corporation sold its China subsidiary for $1 billion[9] and Noble Energy Inc. sold its China assets for $186 million[10]. According to its SEC filings, Noble Energy Inc.'s sales of its China assets was part of a larger noncore asset divestiture program, which allows it to allocate capital and human resources to higher value and higher growth areas.[11] Similarly, Anadarko Petroleum Corporation chairman, president and CEO Al Walker commented that the sale of Anadarko's China subsidiary "accelerates the recognition of value from a non-operated legacy asset and continues to demonstrate our commitment to active portfolio management."[12] According to its SEC filings, Newfield Exploration Company had intended to divest its China business, but in December 2014, after not being able to obtain an acceptable offer for its China business due to the considerable decline in commodity prices, the company decided to retain its China business.[13] ConocoPhillips and EOG Resources Inc. are the other two Houston Top 100 E&P companies that have business or operations in China. Among these five Houston Top 100 E&P companies, only ConocoPhillips and Newfield Exploration Company disclosed in their annual reports on Form 10-K the revenues generated from their China operations (see the table above for details).

Whereas recently some Houston-based E&P companies are refocusing their resources away from China and back to the United States, there did not appear to be any similar general strategic change of direction away from China among the seven oil field services and equipment companies from the Houston Top 100 which were operating in China in 2014. Some of these oil field services and equipment companies appear to have had satisfactory business and financial results in recent years. For example, from 2012 to 2014, National Oilwell Varco Inc.'s revenues from China increased from approximately $533 million in 2012 to approximately $1.9 billion in 2014, rising from 3.1 percent of the company's 2012 revenues to 8.9 percent of the company's 2014 revenues.[14]

The other six oil field services and equipment companies from the Houston Top 100 which were operating in China in 2014 (i.e., Cameron International Corporation, Dril-Quip Inc., Baker Hughes Incorporated, Halliburton Company, McDermott Internationa Inc. andSchlumberger NV) did not disclose in their annual reports on Form 10-K the revenues generated from their China operations.

One of the reasons why a higher percentage of Houston-based oil and gas service and equipment companies are present in China (relative to their Houston-based peers in the upstream, midstream and downstream sectors) is that there appears to be relatively less PRC regulation restricting their business and investment opportunities in China. In addition, while China has shown openness to work with foreign companies in various sectors of the oil and gas industry (including E&P and oil and gas services and equipment), some industry observers believe that, in some circumstances, oil and gas services and equipment companies are attractive business partners because China's national oil companies are able to obtain from them various sophisticated equipment and services while at the same time retain a higher degree of autonomy and control over the process of the development of the petroleum resources. In addition, the PRC government has encouraged the sale into China of certain oil and gas industry equipment through various tax incentives. On this, Weidong Wang, a corporate partner at Grandall Law Firm, a China-based law firm with experience in oil and gas law and cross-border transactions involving Chinese and foreign companies, observes that "in an effort to support the exploration, development and production of crude oil and natural gas in China, the Chinese government has provided tax incentives to companies which are engaged in the oil and gas industry, in the form of customs duty and VAT exemptions. These tax incentives are available for the importing into China of certain equipment and products which either are not produced by local manufacturers or surpass locally produced products according to certain performance/quality measures. To qualify for these tax incentives, the products must be imported for the purpose of developing oil and gas projects in certain geographically designated areas in China."

Some China observers note that, while the PRC government continues to restrict foreign investment in a number of segments of the oil and gas industry in China, there are indications that some of these restrictions may be relaxed in the future. On this, Seth Williams, chief executive officer of Zhongmen Group, a China-focused transaction advisory firm, observes that "the regulatory environment in China is increasingly supportive of direct foreign participation across the Chinese economy and this increased openness, coupled with China's large market potential, should attract new entrants from international companies looking to build a long-term market presence in China. The bilateral investment treaty currently being negotiated by the two countries is expected to add additional clarity regarding specific opportunities that might emerge for foreign participants in China's energy industry."

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[1] The untitled report can be viewed on the U.S. Energy Information Administration's website at: http://www.eia.gov/countries/cab.cfm?fips=ch.

[2] *See* Edward Wong, "China's Plan to Curb Air Pollution Sets Limits on Coal Use and Vehicles", *The New York Times*, September 12, 2013.

[3] *See* David Sandalow, Jingchao Wu, Qing Yang, Anders Hove and Junda Lin, "Meeting China's Shale Gas Goals", September 2014 Working Draft for Public Release, pp. 21-22. The report can be viewed at: http://energypolicy.columbia.edu/sites/default/files/energy/China%20Shale%20Gas_WORKING%20DRAFT_Sept%2011.pdf.

[4] The issuers' respective annual reports on Form 10-K can be viewed on the SEC's website at:

http://www.sec.gov/.

[5] *See* National National Oilwell Varco, Inc.'s annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 95. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/1021860/000095012315003051/d859582d10k.htm.

[6] *See* ConocoPhillips's annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 135. This annual report can be viewed on the SEC website at:http://www.sec.gov/Archives/edgar/data/1163165/000119312515059281/d869001d10k.htm.

[7] *See* Newfield Exploration Company's annual report on Form 10-K for the fiscal year ended December 31, 2014, pp. 102-04. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/912750/000091275015000009/nfx201410-kv2.htm.

[8] *See* EIA February 2014 Report.

[9] *See* Anadarko Petroleum Corporation's annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 11. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/773910/000077391015000012/apc201410k-10k.htm.

[10] *See* Noble Energy, Inc.'s annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 57. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/72207/000007220715000007/nbl-20141231x10k.htm.

[11] *See id.* at p. 5.

[12] February 17, 2014 press release of Anadarko Petroleum Corporation. The press release can be viewed at: http://investors.anadarko.com/phoenix.zhtml?c=80451&p=irol-newsArticle&ID=1900532.

[13] *See* Newfield Exploration Company's annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 6. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/912750/000091275015000009/nfx201410-kv2.htm.

[14] *See* National National Oilwell Varco, Inc.'s annual report on Form 10-K for the fiscal year ended December 31, 2014, p. 95. This annual report can be viewed on the SEC website at: http://www.sec.gov/Archives/edgar/data/1021860/000095012315003051/d859582d10k.htm.