



## Paying up is not Enough

By CK Wong 2005.12.08

<http://www.ck-wong.ca/china/paying%20up%20is%20not%20enough%2020051208.pdf>

### Introduction

I have put this in front of everything. The following is my disclaimer:

- This is not a stock recommendation.

The purpose of this article is to articulate how China works with independent Chinese entrepreneurs. Those who help China in the past will be rewarded handsomely. Also I would like to add another disclaimer that I do not imply China will retaliate on who hurt the country in the past.

This article singles out the special treatment Husky Energy received from China. I do not believe Husky Energy is a unique case. I believe Husky could be the bridge to balance the single Canadian major trading partner (i.e., American) situation. It is triggered by the second contract CNOOC awarded to Husky for deepwater oil exploration. [1] [2] [3]

### A History of Preference

In 2002, Husky signed a contract with CNOOC to explore the South China Sea. The following is quote from Husky's 2004 annual report:

The Company has been successful in building from our production base at Wenchang in the South China Sea. Since acquiring an interest in Wenchang in 2002, Husky has acquired six exploration blocks in the South China Sea and the East China Sea, and is well positioned with good exploration prospects near major markets in China.

In August, we signed a petroleum contract with the China National Offshore Oil Corporation for the 29/26 exploration block in the South China Sea, located 300 kilometres southeast of Hong Kong. Under the terms of our contract, Husky will drill an exploration well on the block, the timing of which is subject to rig availability.

We plan to drill two exploration wells on our 23/15 and 23/20 blocks in the shallow water Beibu Gulf in 2005. The blocks are

located 450 kilometres southwest of Hong Kong, near Hainan Island.

During this period, other oil companies have to pay a much more heavy 'admission fee'. ExxonMobil, BP, and Royal Dutch/Shell Group have invested more than \$1 billion in the three top domestic oil companies--China National Offshore Oil (CNOOC), PetroChina, and Sinopec--and between them, Shell and BP plan to open hundreds of gas stations in south China. [4]

### **New Contract**

On December 6, 2005, it is announced that a new contract has been signed between Husky and CNOOC. Under the agreement, CNOOC and Husky will jointly explore the deepwater bloc in first half of 2006. The project is funded by Husky. If the production is viable, CNOOC will have the right to 51% of the interest. This is the second deepwater exploration contract awarded to Husky since last year. CNOOC also holds two other contracts with two American companies Devon and Kerr-McGee. Both have not started any work.

According to VP of CNOOC at Shenzhen Branch, Duan Cheng Gang, CNOOC has the money to finance the drilling but they lack the technologies.

### **Money is not enough to join the China Club**

China has many foreign partners from many sectors. The most recent success was the Airbus. By signing 100 Airbus A300 series, Airbus will consider to set up an assembly in China which will help to lay the foundation of China's aerospace industry. Japan and Korea have been continuous helping the microelectronics. Cisco, Alcatel and Juniper help out on the network technology. The weakest link is the most demanding sector: energy. So far China does not treat Western investor on a level play field. In order to play in the China field, they have to pay the admission fee. At indicated above, it could be a little bit heavy. Other example, to play in the RMB capital market, basically, the American capital merchants has to offer their US\$ to China and share the risk of highly volatile capital market.

It may not work even you have a long term relationship. Shell has over 100 years of engagement with China. Even after the liberation of the China by the Communist Part, they did not sever the relationship. When UK officially recognized the Communist Government, a lot of trading followed. Until more recently, I believe the investment in China must have 51% interest owned by the Chinese government.

One company I could single out is Husky which is owned by Chinese entrepreneur Li Ka Shing who built his financial empire from scratch in Hong Kong. His empire expanded from plastic flower to network, banking and energy all over the world. He is also known to be one of the most patriotic entrepreneurs.

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Other than patriotic and long term relationship, Husky does have some strength that China could leverage.

- Based on the company's knowledge on the modern oil development technology, it will help China to develop the on-shore and off-shore oil projects. Should there be any gaps, Husky could be the middleman to source the required skill to get the job done.
- Husky has developing its oil sand projects. The result has expanded its reserve. When needed, the new oil supply could be offered to China.
- Refinery is a key component to delivery the consumer product. The growth of Husky's refinery would help it to fine tune its know-how.
- New sources of energy project such as the ethanol manufacturing could play a key role to assist China to reduce the greenhouse effect. Although grain to ethanol may not be a good idea for China because of food import situation but there could be other alternative arrangement. This could be either selling ethanol to China to reduce the sulfur dioxide emission or develops the conversion of hay to ethanol. Rice and wheat are the major staples of Chinese. The hay harvested could be used to generate ethanol.
- Should Husky diversify to other alternative energy source such as wind or solar, I could believe Husky will be the agent of knowledge transfer or exchange to jump start China's alternative energy program.

## Conclusion

Husky is an interesting company. It started out as a local small producer at the west. Li's family grows it to an international operation with wall to wall of right decision. For example, Imperial Oil decides to stop building any refinery while Husky continues its upgrader and refinery projects which will not just saving money but to ensure moving the oil to the consumer market. Katrina incidence has demonstrated the shortage of refinery that impacting North America. In the near future, when the oil sand production is pushing to close half a million barrel per day per site, it is close to the king oil field production volume of the Saudi. While Saudi production is declining but it does not mean end. The growth of the Chindia's oil appetite will translate to high demand on refinery capacity. China will trust any oil company to the extend that they are comfortable. The comfort level will be for sure much higher if you have the chairman sitting in the core of political power.

More important the moral of the story is that it will take more than money to buy into China's market.

## Resources

[1] [AOL News - CNOOC, Husky To Explore Oil In Deepwater South China Sea](http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853_FORTUNE5.htm)  
[http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853\\_FORTUNE5.htm](http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853_FORTUNE5.htm)

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- [2] [CNOOC, Husky To Explore Oil In Deepwater... - Dec. 6, 2005](http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853_FORTUNE5.htm)  
[http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853\\_FORTUNE5.htm](http://money.cnn.com/services/tickerheadlines/for5/200512061715DOWJONESDJONLINE000853_FORTUNE5.htm)
- [3] [People's Daily Online -- CNOOC, Husky sign deepwater oil exploration contract in South China Sea](http://english.people.com.cn/200408/16/eng20040816_153303.html) [http://english.people.com.cn/200408/16/eng20040816\\_153303.html](http://english.people.com.cn/200408/16/eng20040816_153303.html)
- [4] Husky 2004 Annual Report Page 42
- [5] Business Week Online: China Hungry for Energy  
[http://www.businessweek.com/magazine/content/01\\_52/b3763120.htm](http://www.businessweek.com/magazine/content/01_52/b3763120.htm)