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American Oil Interests in China

I. INTRODUCTION

On August 17, 1982, United States oil companies submitted bids to the government of the People's Republic of China (China) in order to participate in developing its offshore oil resources. This comment will discuss the historical, political and economic factors that have induced China to open its doors to foreign participation in its oil development. It will also analyze the current political developments of China's Oil Ministry and the Ministry's interactions with other Chinese governmental bureaus. Finally, the laws, regulations and the Chinese model contract which affect the way in which United States oil companies will do business in China will be discussed.

II. HISTORICAL, POLITICAL AND ECONOMIC FACTORS AFFECTING FOREIGN INVESTMENT IN CHINA

When the People's Republic of China was established in October, 1949, its government actively supported involvement with the outside world. However, China's leaders defined the term "outside world" narrowly, and consequently allowed only contacts with other communist regimes.¹ This limited involvement resulted in the establishment of strong military, technological and political links with the Soviet Union.² China also strengthened its economic ties with Communist-bloc nations by accepting foreign investment from the Soviet Union and Eastern Europe.³

However, China's intense involvement with the Soviet Union quickly disintegrated. Because of political and territorial disputes, China ended its dependence on the Soviet Union during the late 1950's and early 1960's.⁴ In 1960, China began to pursue a policy of "self-reliance" by reducing diplomatic, political and economic ties with major foreign countries.⁵

In the early 1960's, after the Great Leap Forward (1958-1960) failed to develop industrial growth,⁶ certain Chinese leaders, such as

1. A. BARNETT, CHINA'S ECONOMY IN GLOBAL PERSPECTIVE 2 (1981).

2. *Id.*

3. Rich, *Joint Ventures in China: The Legal Challenge*, 15 INT'L LAW. 183, 184 (1981).

4. BARNETT, *supra* note 1, at 3.

5. *Id.* at 4.

6. F. SCHURMANN, IDEOLOGY AND ORGANIZATION IN COMMUNIST CHINA 297 (1968).

Deng Xiaoping and Chen Yun, urged a more pragmatic and outward-looking policy.⁷ At that time, however, the most militant supporters of self-reliance were the top radicals in China's Politburo, and thus, self-reliance remained the dominant philosophy governing China's foreign policy.⁸ The emphasis on self-reliance reached its peak in the late 1960's during the Cultural Revolution.⁹

In the early 1970's, after the Cultural Revolution, several Chinese leaders, including Premier Zhou Enlai, Deng Xiaoping and Chen Yun, again argued for a more pragmatic foreign economic policy.¹⁰ As a result, the importation of technology and foreign trade increased fairly rapidly.¹¹ The trend toward broadening foreign economic relationships triggered strong opposition from top radicals who continued to emphasize the importance of self-reliance.¹² The resulting ideological conflict was not resolved until after Mao Zedong's death in September, 1976, and the subsequent purge of China's top radicals (the "Gang of Four") in October, 1976.¹³

The fall of the Gang of Four and the legitimization of pragmatic leadership under Chairman Hua Guofeng and Deng Xiaoping led to a more politically hospitable climate for foreign investment.¹⁴ This receptiveness was evidenced by the "Four Modernizations" program which was originally developed by Zhou Enlai and officially adopted by the Chinese government only a few weeks after the arrest of the Gang of Four.¹⁵ The program was implemented to modernize industry, agriculture, national defense, science and technology by the year 2000.¹⁶

Initially, the Four Modernizations program established unrealistic capital construction goals, which in turn created serious imbalances in the economy.¹⁷ The Chinese government modified the program

7. See generally, BARNETT, *supra* note 1, at 584-85 n.11.

8. *Id.* at 4.

9. *Id.*

10. *Id.* at 584-85 n.11.

11. *Id.* at 5.

12. *Id.*

13. *Id.*

14. See generally Rich, *supra* note 3, at 184 (Chairman Hua Guofeng promoted a "strengthening of socialist legality").

15. Bosco, *The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment*, 6 BROOKLYN J. INT'L L. 217, 217 (1980).

16. Brunsvold & Battle, *The Prospects of Joint Ventures in China*, 79 PAT. TRADE-MARK REV. 3, 4 (1981)(The Four Modernizations program is also referred to as the "New Long March").

17. *Id.* at 4.

and readjusted its priorities. It de-emphasized the need to expand the steel and construction industries, but continued to give high priority to the petroleum industry.¹⁸ However, since the Four Modernizations program is a recent policy direction, Western investors fear that China will again succumb to strong leftist political ideology, which would abolish the legislation designed to protect foreign investment.¹⁹

Abolishment of the Four Modernizations policy, however, is unlikely. The most significant political consideration is the signing of the United States-China Trade Agreement in July, 1979.²⁰ The agreement provides for reciprocal "most-favored nation" treatment between the two countries.²¹ In addition, China recognizes commercial contracts,²² accepts customary international trade practices such as price, quality, delivery and terms of payment,²³ and recognizes effective protection of patents, trademarks and copyrights.²⁴ China also has agreed to accept arbitration as a means of settlement of disputes.²⁵ The trade agreement is in force until February 1, 1983²⁶ and can be extended indefinitely for successive three-year terms unless China or the United States notifies the other party of its intent to terminate the agreement at least thirty days before the end of the term.²⁷

Other economic and political factors indicate that China's ideological policies favor foreign investment. Since the Chinese economy lacks the necessary capital and technology to reach the objectives outlined in the Four Modernizations program, China must rely on foreign investment to attain its goals.²⁸ Moreover, pressure along the Sino-Soviet borders and the Chinese leadership's desire to raise the standard of living also provide impetus for a stable foreign investment

18. *Id.*

19. Rich, *supra* note 3, at 186.

20. Agreement on Trade Relations, July 7, 1979, United States-People's Republic of China, 31 U.S.T. 4651, T.I.A.S. No. 9630.

21. *Id.* art. II, para. 1.

22. *Id.* art. I, para. 3.

23. *Id.*

24. *Id.* art. VI, para. 1.

25. *Id.* art. VIII, para. 2.

26. *Id.* art. X, para. 1, 2. Under art. X, para. 1, the agreement came into force on Feb. 1, 1980, for a term of three years. However, under art. X, para. 2, the agreement was automatically extended for an additional three-year term when neither China nor the United States notified the other of their intent to terminate the agreement at least thirty days before the end of the original term, Feb. 1, 1983.

27. *Id.* art. X, para. 2.

28. Bosco, *supra* note 15, at 219.

policy.²⁹

The attempt to attract foreign investment may be seen as a move by Deng Xiaoping and his supporters toward economic realism.³⁰ Deng's statements and actions at the Chinese Communist Party's Twelfth National Congress indicate that more pragmatic and moderate philosophy will become the country's guiding ideology into the twenty-first century.³¹ The Twelfth Congress planned to rewrite the Party Constitution to guarantee that there would not be a repetition of past leftist mistakes.³²

Thus, the purpose of the Twelfth National Congress is to consolidate the changes of the last few years and ensure long-term stability.³³ With this stability, China seeks to create a hospitable ideological climate for foreign investment as part of their modernization strategy.

III. OFFSHORE OIL AND FOREIGN INVESTMENTS

Necessitated by its policy of self-reliance, China's development of offshore resources from the late 1960's through mid-1976 was based on a "do-it-yourself" approach.³⁴ By 1978, after several years of research and the purchase of over \$500 million of equipment, China had completed very little serious offshore exploration and had only experimented with offshore production in the Pohai Gulf.³⁵

During the same period, industrial oil consumption in China grew rapidly, spurred on by the development of China's onshore Northeast fields.³⁶ Now, however, the reserves in these fields are diminishing³⁷ and crude oil production has steadily declined since 1979.³⁸

While crude oil production has declined, the demand for it is expected to rise sharply in the next decade. China will need increasing oil supplies for motor fuel and the continued development of

29. *Id.*

30. Note, *Foreign Investment in the People's Republic of China: Compensation Trade, Joint Ventures, Industrial Property Protection and Dispute Settlement*, 10 GA. J. INT'L & COMP. L. 233, 234 (1980).

31. L.A. Times, Aug. 30, 1982, at A1.

32. L.A. Times, Sept. 2, 1982, at A16.

33. L.A. Times, *supra* note 31, at A1.

34. BARNETT, *supra* note 1, at 480.

35. *Id.*

36. Taylor, *Energy Conservation*, 9 CHINA BUS. REV., Feb. 1982, at 12, 14.

37. Clarke, *China's Energy Plan for the 80's*, 8 CHINA BUS. REV., May-June 1981, at 48, 51.

38. Taylor, *supra* note 36, at 14.

petrochemicals, synthetic fibers and plastics.³⁹

Recognizing that critical energy shortages will impede the country's economic plans, Chinese leaders have reassessed the previous strategy of self-reliance and have reformulated China's energy policy.⁴⁰ The leaders realize that without foreign assistance, the exploitation of offshore oil resources would be unacceptably slow.⁴¹

The decision to invite foreign investment is not based solely on the desire for rapid development of crude oil resources. One of the major economic reasons for inviting foreign investment is China's need for massive imports of advanced foreign technology to achieve the Four Modernizations by the end of this century.⁴² However, China lacks sufficient foreign capital and credit to finance these imports.⁴³ By inviting foreign oil companies to invest in the Chinese oil industry, China will obtain badly needed foreign capital⁴⁴ and will increase its hard currency earnings with which it may purchase foreign technology.⁴⁵

In addition to providing foreign capital, offshore drilling will reduce China's energy vulnerability in the event of Soviet actions against China's largest onshore facility, Daqing, located near the Sino-Soviet border.⁴⁶ Offshore drilling will also enable China to assert sovereignty over disputed areas in the South China Sea while preventing exploration by other countries claiming ownership of the areas.⁴⁷ Finally, foreign oil company offshore participation as

39. It has been estimated that if oil production does not grow steadily by 1990, China will have to decrease oil consumption from its present rate of 40 million tons to an estimated 13 million tons in 1990 in order to achieve an economic growth rate of six percent during 1985-1990. *Id.*

40. Note, *Legal Aspects of Sino-American Oil Exploration in the South China Sea*, 14 J. INT'L L. & ECON. 443, 449 (1980)(retitled as GEO. WASH. J. INT'L L. & ECON.).

41. BARNETT, *supra* note 1, at 481.

42. Note, *supra* note 40, at 447. The Chinese government is committed to the success of the offshore projects as a symbol of its Four Modernizations program. Thus, Beijing is carefully shielding U.S. oil companies and their offshore oil projects from Chinese political retaliation for U.S. import quotas on Chinese textiles and the U.S. stance on the Taiwan problem. Woodard, *The Drilling Begins*, 10 CHINA BUS. REV., May-June 1983, at 18 [hereinafter cited as *The Drilling Begins*].

43. Note, *supra* note 40, at 447.

44. Brunsvold & Battle, *supra* note 16, at 4.

45. Brown, *Tough Terms for Offshore Oil*, 9 CHINA BUS. REV., July-Aug. 1982, at 34.

46. Note, *supra* note 40, at 447.

47. Other countries claiming ownership of disputed areas are Japan, Taiwan, South Korea, Vietnam, Malaysia, Indonesia, Brunei and the Philippines. Beijing has carefully limited its survey and contract areas to undisputed coastal areas to avoid international disputes. Harrison, *Conflicting Offshore Boundary Claims*, 10 CHINA BUS. REV., May-June 1983, at 57. Despite Beijing's efforts, however, U.S. survey operations have exacerbated Sino-Vietnamese relations. Hanoi issued a warning to foreign oil companies that they must bear the consequences of their actions. Commentators have suggested that the positioning of U.S. firms near these contested areas was politically motivated by the Chinese, since U.S. involvement effectively merges U.S. and Chinese interests in the event of a conflict between China and Vietnam. Note, *supra* note 40, at 457, 458 nn.96-97.

compared to onshore participation will limit foreign social interaction and influence.⁴⁸

China's leadership decided to initiate a crash program to rapidly develop offshore oil resources.⁴⁹ In mid-1978, China invited foreign oil companies to send representatives to Beijing to discuss conducting seismic surveys of China's major offshore areas.⁵⁰ By autumn of that year, numerous American companies, including Union Oil of California, Atlantic Richfield, Exxon, Phillips Petroleum, Standard Oil, Pennzoil, and Mobil, were negotiating for the right to conduct seismic surveys.⁵¹ Many Japanese and West European companies, including the Japanese Petroleum Exploration Corporation, the Japan National Oil Corporation, Idemitsu Kosan, British Petroleum, Deminex (West Germany), ELF Aquitaine (France), ENI (Italy), Saga Petroleum (Norway) and the Royal Dutch Shell Group, were also negotiating for survey rights.⁵² These negotiations involved a 400,000 square kilometer area off China's coastline ranging from the Straits of Taiwan in the north to the Tonkin Gulf in the south.⁵³

In mid-1979, the Chinese signed an agreement for seismic survey rights along the Chinese coast with six American companies: Exxon, Mobil, Arco, Phillips Petroleum, Chevron/Texaco and Amoco.⁵⁴ These companies were assigned six major blocks from south of Taiwan to south of Hainan, and are the main operators in surveying most of the South China Sea.⁵⁵

The survey agreements were unique in many respects.⁵⁶ For example, the agreements provide for direct privity between the American oil companies and the China National Oil and Gas Exploration and Development Corporation (China National Oil).⁵⁷ In

48. Note, *supra* note 40, at 447.

49. BARNETT, *supra* note 1, at 481.

50. *Id.*

51. *Id.*

52. *Id.*

53. Note, *supra* note 40, at 450.

54. BARNETT, *supra* note 1, at 483.

55. *Id.*

56. Note, *supra* note 40, at 453.

57. *Id.*

previous foreign trade transactions, the Chinese only authorized the appropriate Foreign Trade Corporations (FTCs) to sign agreements.⁵⁸ FTCs are organizations within the Ministry of Foreign Trade which act as contractual middlemen for the Chinese end user.⁵⁹ By making China National Oil, the end user, a direct party to the agreement, problems involving contracts lacking real parties in interest are obviated.⁶⁰

Another unique feature of the Survey Agreement, one that is rare for American oil companies, is that survey costs are to be borne completely by the American participants.⁶¹ Normally, exploration and development contracts awarded by a host country encompass exploration, development and sometimes downstream marketing.⁶² The Survey Agreement, however, only conferred the right for an oil company to conduct seismic surveys within a designated block. In exchange for these surveys, China merely promised to put up certain blocks for competitive bidding.⁶³ None of the American oil companies had contractual guarantees to subsequent exploration and exploitation contracts.⁶⁴ The American oil companies were also contractually obligated to (1) use their most advanced equipment and technology in completing the surveys, (2) provide all raw field data and processed data with interpretations within eight months of its acquisition, (3) pay a 3.5 percent service fee, (4) provide specialized training for Chinese personnel, and (5) provide \$10 million in sub-contracts for Chinese vessels and crews.⁶⁵ In addition, six original American companies had to deliver survey data to early and late participants who signed a "Participation Agreement" with China.⁶⁶ The Participation Agreement conferred the same rights as those given to the original participants except that the early and late participants had none of the management, supervisory or decision-making rights of the original participants.⁶⁷ While participation by early and late participants did involve sharing survey costs with the

58. *Id.*

59. *Id.* at 453-54.

60. *Id.* at 454.

61. *Id.*

62. *Id.*

63. *Id.* at 459-60.

64. *Id.*

65. *Id.*

66. *Id.* at 455-56.

67. *Id.*

original participants,⁶⁸ it created more competition when the bidding for exploration contracts began in August, 1982.

American oil companies' willingness to commit capital investment without exploration guarantees is a significant departure from traditional oil industry practice.⁶⁹ The companies' decision to enter into agreements that so dramatically favored the Chinese may have resulted from a gentleman's agreement—that original participants would receive preferential treatment when China awards the exploration and development contracts.⁷⁰ The six original American parties have been informed that they will have the opportunity to match the highest bid submitted for the area where a particular company conducted its surveys. If the original foreign party is willing to match the bid, then that party will be awarded the final exploration contract.⁷¹ These understandings are not included in the formal documents and probably constitute parol evidence, inadmissible in United States courts.⁷² However, the Chinese have been known to rely on extra-contractual understandings in business transactions.⁷³ Thus, it is highly likely that the original participants will have the major advantage when final bidding occurs.⁷⁴

Some delays have occurred in Beijing's deadlines for opening the bidding process.⁷⁵ While seismic reports were being submitted from 1980 to 1981, the oil companies were making enormous efforts to educate the Chinese about the intricacies and details of offshore oil contracts.⁷⁶ This was difficult since China has tried to compress into only three years the preliminary studies that have taken other developing countries thirty years to produce.⁷⁷ Moreover, the Chinese had to draft laws on petroleum resources and taxes before United

68. *Id.* at 456. The American companies that did decide to participate as early or late participants were: Cities Service, Hunt-Sedco, Murphy Oil, Occidental, Pennzoil, Shell, Texas Eastern, Union Oil and Allied Chemical's Union Texas Asia Offshore. Foreign company participants include: Ampol (Australia), AGIP (Italy), Cliff Oil (U.K.), Deminex (West Germany), Hispanoil (Spain), INA (Yugoslavia) and the Royal Dutch Shell Group. BARNETT, *supra* note 1, at 484.

69. Note, *supra* note 40, at 461.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. BARNETT, *supra* note 1, at 484.

75. *Id.*

76. Green, *The Offshore-Oil Race*, 8 CHINA BUS. REV., July-Aug. 1981, at 55, 56.

77. *Id.*

States companies could feel comfortable concluding negotiations.⁷⁸

Nevertheless, the pace of events in offshore oil development has accelerated rapidly since February, 1982.⁷⁹ The accelerated pace was the result of several factors, including the enactment of the Foreign Enterprise Tax Law and its accompanying regulations, effective January 1, 1982.⁸⁰ In addition, the long awaited petroleum regulations were released on February 10.⁸¹ United States companies had been waiting for those two major steps to conclude negotiations.⁸²

China has also attempted to eliminate some of the bureaucratic entanglements that have handicapped offshore oil development decisions. In May, 1982, the Chinese leadership reorganized the Petroleum Ministry.⁸³ The Minister of Petroleum, Kang Xien, was "kicked upstairs" as a State Councilor⁸⁴ and replaced by Metallurgy Minister, Tang Ke.⁸⁵ Tang's appointment as Minister of Petroleum was a domestic political compromise which indicates China's sensitivity to foreign oil companies and their concerns.⁸⁶ Tang Ke strongly advocates using foreigners in China's resource development⁸⁷ and his appointment is seen as a move by Chinese leaders to assuage the fears of foreign oil executives as they begin to bid on offshore oil blocks.⁸⁸

Finally, to aid the accelerated pace of offshore oil development, China has attempted to eliminate some of the tension between various Chinese ministries. Article 4 of the Petroleum Regulations states that the Petroleum Ministry is the competent authority in charge of the exploitation of offshore petroleum resources in cooperation with foreign

78. *Id.*

79. Green, *Offshore Business*, 9 CHINA BUS. REV., May-June 1982, at 17 [hereinafter cited as *Offshore Business*].

80. Nordberg & Price, *People's Republic of China: New Income Tax on Foreign Enterprises*, TAX MGMT. INT'L J., July, 1982, at 8.

81. *Offshore Business*, *supra* note 79, at 17.

82. Green, *supra* note 76, at 56. After years of detailed negotiations, Arco signed a production sharing agreement in September, 1982, six months after the Foreign Enterprise Tax Law and the Petroleum Regulations were enacted. Certain non-U.S. companies, Japan National Oil, ELF Aquitaine, and Total Chine, a subsidiary of Compagnie Française des Petroles, signed agreements with China in 1980, prior to the enactment of these regulations. *Arco's Deal With China Is A Tough Act To Follow*, BUS. WK., Oct. 4, 1981.

83. Clarke, *China's Organizational Revolution*, 9 CHINA BUS. REV., July-Aug. 1982, at 27, 29.

84. *Id.* at 29.

85. *Id.*

86. *Id.*

87. *Id.* at 32.

88. *Id.*

enterprises.⁸⁹ Moreover, the China National Offshore Oil Corporation (CNOOC), established in February, 1982,⁹⁰ has full authority over offshore development⁹¹ and most likely will report directly to the Ministry of Petroleum.⁹²

There are still potential conflicts among various ministries that may slow offshore oil development. When the Ministry of Petroleum was reorganized in May, 1982, analysts expected the Ministry of Geology to be dissolved or downgraded⁹³ to avoid infighting between the two ministries. However, during this time the functions of the Ministry of Geology were actually expanded.⁹⁴ It remains to be seen whether future conflicts between the two ministries will cause delays in reaching agreements with foreign oil companies.

Delays may also occur because CNOOC's authority to enter into contracts is subject to approval by the Foreign Investment Commission.⁹⁵ The Foreign Investment Commission is a department of the newly formed Ministry of Foreign Economic Relations and Trade (MOFERT) which merged China's former Foreign Investment Control Commission, Import-Export Commission, and the ministries of Foreign Trade and Economic Relations with Foreign Countries.⁹⁶ The new ministry has one-third less staff than the organizations it replaced and two-thirds fewer departments. The general purpose of the reorganization is to raise efficiency and cut red tape.⁹⁷ The reorganization is a definite improvement over China's previous Ministry of Foreign Trade, which was often cumbersome and slow.⁹⁸ However, although MOFERT will not be involved in direct negotiations,⁹⁹ its final authority to approve CNOOC offshore oil

89. Regulations of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation With Foreign Enterprises art. 4 (1982), *reprinted in* BEIJING REV., Feb. 22, 1982, at 14 [hereinafter cited as Petroleum Regulations].

90. *Offshore Business*, *supra* note 79, at 17.

91. Petroleum Regulations, *supra* note 89, art. 5.

92. CNOOC replaces CNOGEDC which handled offshore oil operations under the Ministry of Petroleum prior to February, 1982, and is now reduced to an onshore company. *Offshore Business*, *supra* note 79, at 18.

93. Clarke, *supra* note 83, at 32.

94. *Id.* The Ministry of Geology is responsible for the "protection, efficient exploitation, and multipurpose utilization of mineral resources." Apparently, the Ministry of Geology will continue to take part in the development of some reserved offshore oil blocks.

95. Petroleum Regulations, *supra* note 89, art. 6.

96. Ludlow, *China's New Foreign Trade Structure*, 9 CHINA BUS. REV., May-June, 1982, at 30.

97. *Id.*

98. Green, *supra* note 76, at 56.

99. Ludlow, *supra* note 96, at 31.

exploration and development contracts may still hamper negotiations and slow production schedules.

The current timetable is based on China's February 15, 1982 call for bids covering four major areas in the northern part of the Yellow Sea and its March 15, 1982 call for bids covering the southern part of the Yellow Sea and the Gulf of Tonkin.¹⁰⁰ When China invited foreign oil companies to come to Beijing to pick up bid packages,¹⁰¹ representatives from twenty-one U.S. firms¹⁰² arrived in Beijing on May 10 to receive a package that included the offshore petroleum regulations, a model contract, a bid proposal form, and tax laws.¹⁰³ Twenty consortia and individual companies submitted 102 bids on 43 contract areas.¹⁰⁴ The Chinese spent six months evaluating the bids and in February and March of 1983, invited oil companies to Beijing for contract negotiations.¹⁰⁵ CNOOC officials estimate rapid negotiations. While oil company executives are wary of these predictions,¹⁰⁶ most foreign oil companies expect to sign contracts before the end of 1983, and to begin operations in the first quarter of 1984.¹⁰⁷

IV. APPLICABLE LAWS AND THE MODEL CONTRACT: THEIR IMPACT ON CONTRACT NEGOTIATIONS

When China offered its bidding package to foreign oil companies on May 10, 1982, three important documents to the negotiating process were placed in the package. They were the model contract, the offshore petroleum regulations and the Foreign Enterprise (F.E.) Tax Law.

A. *The Model Contract*

Notwithstanding the fact that China needs to expand its petroleum output to achieve the Four Modernizations, the terms of the model

100. *Offshore Business*, *supra* note 79, at 17.

101. *Id.*

102. *Id.*

103. *Id.* Companies had a fixed 100-day period from May 10 to Aug. 17 to formulate bid proposals.

104. *The Drilling Begins*, *supra* note 42, at 18.

105. *Id.*

106. *Id.* The drop in world crude oil prices and the general recession in the petroleum industry may harden the negotiating stance of the oil companies, leaving CNOOC with the difficult task of extending negotiations or giving in on basic terms.

107. *Id.* However, the foreign oil companies' predictions may be overly optimistic since the CNOOC office in Beijing has a limited staff and probably cannot negotiate more than four or five contracts simultaneously. In the unlikely event that CNOOC quickly signs contracts for all forty-three contract areas, the logistics involved in drilling operations and the limitations on supply base facilities will preclude rapid acceleration of drilling activity.

contract underscore China's determination to be in control of offshore development.¹⁰⁸ Because China's legal ties with the West are relatively new, the Chinese have proceeded cautiously and with a solid commitment to certain principles.¹⁰⁹ These principles reflect China's desire to expand its own technological base rather than build a dependence on foreign technology to exploit its resources.¹¹⁰ Ideally, the Chinese would like a contract flexible enough to accommodate any detrimental changes.¹¹¹

Generally, United States oil executives feel that the model contract is unique when compared to agreements with other countries,¹¹² and contains certain provisions that will be difficult to negotiate.¹¹³ However, the model contract is considered workable as long as these certain provisions are satisfactorily negotiated.¹¹⁴

While part of the model contract may come under negotiation, the contract is clearly open for bidding on three major points: (1) the "work program," which includes the foreign company's schedule for exploration, development and the number of wells; (2) the "factor bid," which determines the production profit percentage the foreign company will receive; and (3) "other contributions," which the foreign company is willing to make to China's offshore oil program or to other sectors of the Chinese economy.¹¹⁵

108. Brown, *supra* note 45, at 34.

109. *Id.*

110. *Id.*

111. *Id.* at 34-35.

112. *Offshore Business*, *supra* note 79, at 17. The model contract incorporates aspects of the Indonesian, British, Brazilian, and Norwegian contract models. It contains elements of a joint venture and a production sharing agreement. *Id.* The aspect of a production sharing agreement whereby the foreign oil company is allowed a certain free share of the annual production after recovery of costs is particularly attractive to the Chinese because it involves the importation of necessary capital equipment without an outflow of scarce foreign exchange. Note, *supra* note 40, at 469.

113. Brown, *supra* note 45, at 35.

114. The model contract is being used by the Chinese as a basic legal framework. Because of its applicability to all foreign oil companies involved in offshore oil exploration, the contract's function is similar to that of a legislative enactment. Goodwin, *The Evolving Legal Framework*, 10 CHINA BUS. REV., May-June, 1983, at 43. However, a statute governing contractual joint ventures between foreign companies and Chinese entities that involve co-production (as with oil companies) and thus are not covered under the July 8, 1979 Joint Venture Law, will most likely be adopted in the near future. The statute will list the contents of contracts for co-production, and in future arrangements involving co-production, will reduce the flexibility that characterizes present co-production agreements. *Id.* at 46.

115. Brown, *supra* note 45, at 35. Larger companies may offer financing as their contribution in this area. *Id.*

1. The work program

Under the work program, the foreign partner is expected to put up all capital and bear all risks during exploration.¹¹⁶ The company that is awarded a contract has a set term in which to explore the area.¹¹⁷ For an area less than 2,000 square kilometers, the term is five years, and for an area equal to or larger than 2,000 square kilometers, the term is seven years.¹¹⁸ The terms are divided into stages.¹¹⁹ For example, there are three stages in the seven year term, consisting of three years, two years, and two years. After each of the first two stages, the company must relinquish twenty-five percent of the contracted area.¹²⁰

This provision has two purposes. As a performance guaranty, it forces the foreign company to act quickly to determine which areas it will relinquish and which it will reserve for further exploration.¹²¹ As an escape mechanism, it gives the foreign company the right to withdraw from the agreement after each stage is completed if it is discouraged by its findings or high production cost projections.¹²²

Once an area has been explored and targeted for development, CNOOC and the foreign company will jointly participate in the development and production phases and China will contribute capital for expenses.¹²³ At this time, when an area has been determined to be commercial, CNOOC will have ninety days to contact the foreign company in writing if it chooses not to participate or if its participation will be less than fifty-one percent.¹²⁴ If CNOOC does choose to participate, CNOOC and the foreign company will jointly develop the area, CNOOC bearing fifty-one percent of the cost and the foreign party, the remainder.¹²⁵ At the same time, the foreign company will have ninety days to submit a development plan.¹²⁶ Thus, the foreign company will be in the difficult position of arranging financing for the development stage before it receives any notice from CNOOC

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.* at 37.

advising it of CNOOC's involvement and consequently, the extent of the foreign company's participation.¹²⁷

2. The x factor

The factor bid by the foreign company takes effect once a targeted area goes into commercial production. The commercial production period begins once a total of 100,000 tons of oil or 100 million cubic meters of natural gas has been extracted.¹²⁸ Once an area starts commercial production, output is divided between the parties according to a complex formula for a term of fifteen years, extendable to thirty years.¹²⁹ The formula used to divide output is as follows: 17.5% of output goes to China (12.5% consisting of a royalty with a 5% Industrial Consolidated and Commercial Tax); 50% of output is "cost oil," which goes first to recover operating costs, second to exploration costs, and finally to development expenditures; the remaining 32.5% of output is divided into "share oil" and "allocable profit oil."¹³⁰ This is calculated according to an x factor bid by the particular oil company. The share oil goes directly to China.¹³¹ The remaining profit oil is split 51/49% between China and the foreign company.¹³²

The x factor works to make a division between share oil and profit oil on the basis of the amount of oil produced. The division is made on seven tiers¹³³ so that the percentage split for the first million tons would be determined by the first tier x factor, the second million tons would be split according to the second tier x factor, and the remaining tiers would be split according to their respective x factors. The result is that where more oil is produced, less will be allocated to profit oil.¹³⁴

Surpluses in the output allocated to cost oil will be transferred to profit oil, which is shared by China and the foreign company.¹³⁵ Additionally, while exploration and development costs are being recovered, CNOOC can take over operation only by mutual

127. *Id.*

128. *Id.* at 35.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.* at 36.

134. *Id.*

135. *Id.* However, the foreign company must have fully recovered its investment for any assets used in implementing the petroleum contract, before CNOOC can unilaterally take over operations. Petroleum Regulations, *supra* note 89, art. 22.

agreement.¹³⁶ Once exploration and development costs are recouped, however, CNOOC has the right to take over operations by unilateral decision.¹³⁷

The profit oil that the foreign company does retain can be sold on foreign markets.¹³⁸ These oil profits need not be remitted to the Bank of China (BOC), and thus, the BOC will not set exchange rates or limit the amount of hard currency that can be repatriated.¹³⁹ However, CNOOC does reserve the right to limit the destination of the crude oil.¹⁴⁰

3. Other contributions

Foreign companies have no objections to the profit formula.¹⁴¹ If a reasonable bid is accepted, foreign participants will receive a fair share.¹⁴² However, foreign oil companies are concerned with other aspects of the model contract.

The provision in the model contract regarding technological contributions will cause problems for all foreign oil companies.¹⁴³ The model contract provides that the foreign company must transfer *all* technology, including data design and software gathered during exploration, to China without charging royalties.¹⁴⁴ Certain industry observers feel that the contract would obligate a United States oil company to release technology that is not in its China operations.¹⁴⁵ These observers argue that designs which are patented or copyrighted by other companies would possibly be covered by the contract.¹⁴⁶ Such a possibility would conflict with the Reagan Administration's concern over the United States' loss of technology and its efforts to tighten restrictions on technology transfer.¹⁴⁷ The United States Department of Commerce is taking a closer look at all applications for China and rejecting large numbers of them.¹⁴⁸ The United States' policy in this area is destined to create additional

136. *Id.* at 35.

137. *Id.* at 36.

138. *Id.*

139. *Id.* at 37.

140. *Id.* at 36.

141. *Id.*

142. *Id.*

143. *Id.* at 37.

144. *Id.*

145. *Id.*

146. *Id.*

147. Wall St. J., Oct. 12, 1982, at 32.

148. *Id.*

problems when United States oil companies negotiate the technology transfer provision in the model contract.

Control is another important issue that foreign companies will want to carefully negotiate. The model contract calls for the creation of a Joint Management Commission (JMC) composed of representatives from CNOOC and the foreign company.¹⁴⁹ The JMC will be chaired by a CNOOC representative and will have control over everyday operational decisions as well as planning and budgeting decisions.¹⁵⁰ Some companies fear that, without clarification of the committee's functions, JMC's control could hinder operations and create additional costs.¹⁵¹

B. The Petroleum Regulations

Apart from the model contract, United States oil companies foresee problems with certain guidelines in China's Offshore Petroleum Regulations. The Regulations provide that foreign companies must give preference to Chinese personnel¹⁵² at international wage rates,¹⁵³ train Chinese personnel, and keep the percentage of Chinese personnel steadily rising in all phases of exploration and development.¹⁵⁴

United States companies are worried about the shortage of skilled Chinese laborers and the fact that training Chinese personnel could be prohibitively expensive, especially if training were to take place in the United States.¹⁵⁵ In addition, the companies must pay specific international wage rates as compared to lower labor costs in other

149. *Id.*

150. *Id.* The JMC's decision-making powers include determining whether oil fields are commercially viable, approving major expenditures, and appointing expert groups to investigate exploration operations. Denny, *The Quest for Control*, 10 CHINA BUS. REV., May-June, 1983, at 26.

151. The JMC structure gives the Ministry of Petroleum and CNOOC authority to approve major policy and procurement decisions. Since the JMC can be convened any time, at the request of either party, the Chinese will be involved in all decisions of consequence. Denny, *supra* note 150, at 26.

152. Petroleum Regulations, *supra* note 89, art. 12.

153. Brown, *supra* note 45, at 37.

154. Petroleum Regulations, *supra* note 89, art. 12.

155. Woodard, *Supplying Offshore Services*, 9 CHINA BUS. REV., Mar.-Apr., 1982, at 9, 13. Proposals have been submitted to CNOOC regarding a combined training institute, based in southern China and utilizing foreign faculty and trainers. Although the institute could cost 15 to 20 million dollars per year to operate, it is a cost-effective alternative to individual company training programs. *The Drilling Begins*, *supra* note 42, at 4.

parts of the world.¹⁵⁶ Moreover the Chinese government will retain a higher percentage of the salary given to laborers than the percentage usually retained by other countries.¹⁵⁷ These enormous disparities between Chinese wages and those of laborers in other countries could cause tension and morale problems for United States companies.¹⁵⁸

China's Offshore Petroleum Regulations also contain provisions requiring foreign companies to give preference to (1) Chinese design corporations for master and engineering designs,¹⁵⁹ (2) Chinese manufacturing and engineering companies for facilities (platforms, buildings, artificial islands, etc.),¹⁶⁰ (3) Chinese equipment and materials,¹⁶¹ and (4) Chinese subcontracting services for prospecting, well-drilling, diving, helicopters, vessels and onshore bases.¹⁶²

Although the Petroleum Regulations state that foreign companies need use only the above-mentioned services if they are competitive in price, efficiency, and service, the Chinese will enforce these preference clauses through certain devices.¹⁶³ Exploration contracts and operational agreements will be combined for each successful bidder, thus forcing the bidding companies to use Chinese rigs, services, and supplies.¹⁶⁴ In addition, foreign equipment and chemicals may be denied customs clearance if the Chinese feel they already have or could develop adequate supplies of these materials.¹⁶⁵

Oil companies fear that these preference clauses could lead to unreasonable delays if Chinese companies prove to be

156. Total Chine, Japan National Oil and ELF Aquitaine are using Chinese jack-rigs staffed predominantly by Chinese crew and rig hands. Wages paid to Chinese rig hands are more than double the current rate in Southeast Asia, with less than ten percent going to the worker. *The Drilling Begins*, *supra* note 42, at 23.

157. *Id.*

158. *Id.*

159. Petroleum Regulations, *supra* note 89, art. 18.

160. *Id.* art. 19.

161. *Id.* art. 20.

162. *Id.* art. 21.

163. Woodard, *supra* note 155, at 11. Japan National Oil, Total Chine and Arco have already begun using their traditional suppliers and service companies, most likely because China cannot produce materials or services that conform to industry standards. *The Drilling Begins*, *supra* note 42, at 21. However, the majority of these companies signed agreements before the Petroleum Regulations were enacted. Since China has a strong interest in developing its own technological base, it is almost certain these preference clauses will be enforced more stringently in the future.

164. Woodard, *supra* note 155, at 12.

165. *Id.*

unreliable.¹⁶⁶ Additional delays could occur if every purchase and subcontract needs to be approved by the JMC and other Chinese organizations.¹⁶⁷ Since offshore drilling operations run on a tight twenty-four hour schedule, chronic delays caused by Chinese subcontractors and bureaucratic red tape would increase exploration and development costs.¹⁶⁸

The preference clauses could also complicate already existing relationships between foreign companies and their customary suppliers and subcontractors.¹⁶⁹ This could result in forcing foreign subcontractors to use Chinese equipment, services and labor for part or all of their operations in China.¹⁷⁰

Despite these problems, the Petroleum Regulations have reassured United States companies in one area. The regulations state that the Chinese government will protect investments made by foreign companies and that profits may be repatriated.¹⁷¹ In addition, any assets purchased and built by the foreign company in implementing the petroleum contract will become the property of CNOOC but only when the foreign company has fully recovered its investment in those assets.¹⁷²

C. *The Foreign Enterprise Tax Law*

One of the most important issues that concerned United States companies was whether income taxes paid in China could be credited against United States taxes.¹⁷³ If the Chinese tax were not credited against United States taxes, the threat of double taxation would cause many United States companies to withdraw from the Chinese theater.¹⁷⁴

Fortunately, China took tremendous care in structuring its

166. Brown, *supra* note 45, at 37. Foreign oil companies have adopted a number of approaches in attempting to work within the framework of the preference clause. One approach is to enter into a licensing agreement. Another approach is to form a joint venture, either between U.S. and Chinese entities or Hong Kong and Chinese entities. Goodwin, *supra* note 114, at 44. These joint ventures qualify for "preference," usually granted to Chinese organizations seeking to sell services and equipment. In fact, CNOOC has already established two such joint ventures, one with Dresser Atlas Company of Houston and one with the Geophysical Company of Norway. Denny, *supra* note 150, at 27.

167. Brown, *supra* note 45, at 37.

168. Woodard, *supra* note 155, at 11.

169. *Id.* at 12.

170. *Id.*

171. Petroleum Regulations, *supra* note 89, art. 8.

172. *Id.* art. 22. Rental equipment provided by any third party is excluded from CNOOC ownership.

173. Woodard, *supra* note 155, at 13.

174. *Id.*

corporate income tax to be covered by the United States foreign tax credit.¹⁷⁵ During the enactment of the Federal Enterprise Tax Law and its accompanying regulations, officials of the United States Treasury and private tax practitioners advised the Chinese regarding the creditability of their taxes for United States tax purposes.¹⁷⁶ As a result of this concern, the United States Internal Revenue Service issued a private letter ruling stating that three major taxes under the F.E. Tax Law are creditable against United States income taxes.¹⁷⁷

The primary Chinese tax is an income tax computed at progressive rates on amounts of taxable income.¹⁷⁸ The central income tax reaches a top level of forty percent.¹⁷⁹

The Regulations implementing the Chinese Foreign Enterprise Tax Law also contain provisions for the calculation of taxable income similar to United States tax principles.¹⁸⁰ Taxable income is determined by reducing gross sales or income by the cost of goods sold; selling, operating, and administrative expenses; and discounts, allowances, sales taxes and refunds.¹⁸¹ Regulation article 26 states that foreign oil companies will be deemed to have received income at the time the crude oil is divided according to the model contract.¹⁸² Moreover, the amount of income is computed on the basis of a price that is adjusted periodically in accordance with the market price for crude oil of comparable quality.¹⁸³ Discussions with Chinese officials indicate that the market price referred to in article 26 is the international market price.¹⁸⁴

In addition to the central income tax, a local income tax of ten

175. *Id.*

176. Nordberg & Price, *supra* note 80, at 14.

177. Private Letter Ruling 8238037 [¶4614(82)] (1982), *reprinted in* Nordberg & Price, *supra* note 80, at 14.

178. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises of 1982 art. 3, *translated in* TAX MGMT. INT'L J., July, 1982, at 18.

179. *Id.* Some subcontractors explored the possibility of establishing offices in special economic zones (SEZ) in order to be subject to a special tax rate of fifteen percent instead of the higher tax rate under the F.E. Tax Law. The Chinese have rejected this approach on the basis that the purpose of the reduced tax rates in the SEZ is to help to develop these zones, not to create a tax haven for U.S. companies. Goodwin, *supra* note 114, at 45, 46.

180. Nordberg & Price, *supra* note 80, at 10.

181. *Id.*

182. Regulations for the Implementation of the Income Tax Law of the People's Republic of China Concerning Foreign Enterprises of 1982 art. 26, *translated in* TAX MGMT. INT'L J., July, 1982, at 19, 22-23 [hereinafter cited as Tax Regulations].

183. *Id.*

184. Nordberg & Price, *supra* note 80, at 12.

percent is imposed on the same taxable income.¹⁸⁵ Thus, the foreign company's revenue from its sale of crude oil will probably be taxed at a maximum rate of fifty percent under the F.E. Tax Law.¹⁸⁶

A third tax (a withholding tax) imposes a twenty percent tax on all dividends, interests, rentals, royalties and other Chinese sources of income obtained by foreign enterprises which do not have "establishments" in China.¹⁸⁷ However, the withholding tax is not applicable to foreign oil companies since Regulation article 2 defines an establishment to include sites for the exploitation of natural resources which will necessarily be maintained by the companies.¹⁸⁸ Therefore, income which would otherwise be subject to the withholding tax instead will only be taxed under the central and local income taxes with a maximum rate of fifty percent.¹⁸⁹

The Tax Regulations also provide that reasonable exploration expenses incurred by an oil company may be amortized over a period of not less than one year.¹⁹⁰ These expenses may be amortized against income from an oil or gas field that has already begun commercial production.¹⁹¹ During the development phase, expenditures must be capitalized and amortized over at least a six year period.¹⁹²

185. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises of 1982 art. 4, *translated in TAX MGMT. INT'L J.*, July, 1982, at 18.

186. Brown, *supra* note 45, at 36. It is difficult for some supply and equipment subcontractors to compute income on a net income basis due to the large capital costs of their equipment and the difficulty of allowing depreciation and other deductions to the different countries where the equipment is used. These subcontractors may choose to utilize a "deemed profit" approach whereby they pay a certain percentage (probably ten percent) of their gross income, or they may elect to pay taxes on a net income basis. The major oil companies will pay taxes only on a net income basis. Goodwin, *supra* note 114, at 44.

187. The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises of 1982 art. 11, *translated in TAX MGMT. INT'L J.*, July, 1982, at 19.

188. Tax Regulations, *supra* note 182, art. 2, at 20. However, financial institutions, supply and service companies, and other foreign entities without establishments in China are subject to the withholding tax. Goodwin, *supra* note 114, at 45.

189. The twenty percent withholding tax is applicable to any dividends, interests, rentals, royalties, etc., of any Chinese source income that is not attributable to the business of a taxpayer's Chinese establishment. See The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises of 1982 art. 11, *translated in TAX MGMT. INT'L J.*, July, 1982, at 18. Income taxed at this twenty percent rate is not subject to the progressive rates of the central income tax. *Id.* art. 1, *translated in TAX MGMT. INT'L J.*, July, 1982, at 18. For instance, if a foreign company receives rental income from the lease of equipment in China, the rental income would be taxed at twenty percent, not the progressive tax of the central income tax, if the lease is unrelated to the business operations of the foreign enterprise in China. Nordberg & Price, *supra* note 80, at 9.

190. Tax Regulations, *supra* note 182, art. 22.

191. *Id.*

192. *Id.* art. 18, at 22.

Amortization begins from the month in which an oil field starts production.¹⁹³ All of the expenditures are capitalized and amortized on an overall basis.¹⁹⁴ Thus, all expenditures are capitalized and treated as having the same useful life regardless of their type.¹⁹⁵ Although not expressly stated in the Regulations, the Chinese have confirmed that if a field is abandoned, the remaining unamortized expenses may be used to offset income from other fields.¹⁹⁶

D. *The Industrial Consolidated and Commercial Tax*

A consideration of applicable tax laws should also take into account China's Industrial Consolidated and Commercial Tax Law. This tax is 5 percent of the 17.5 percent of output off the top that goes to China¹⁹⁷ which is not creditable against U.S. income taxes.¹⁹⁸

V. CONCLUSION

Because of China's history of foreign domination by countries during the nineteenth and early twentieth centuries, along with its current policy of self-reliance, China is determined to maintain extensive control over offshore drilling of its oil resources. As a result, the original survey agreements and model contract dramatically favor the Chinese. It remains to be seen whether U.S. companies will be able to negotiate favorable conditions in those few areas (i.e., the work program, the x factor, company control, technology transfer) that the Chinese have left open for negotiation.

Phillips Petroleum Company's Chairman, William C. Douce, feels that "China is in no position to insist very far" in upcoming contract talks.¹⁹⁹ Yet, many of his rivals are worried that the concessions Arco has made to China when it signed its agreement in September, 1982, will leave them at a disadvantage.²⁰⁰ Arco has settled for less favorable terms than ones China signed in 1980 with

193. *Id.* art. 16, at 21.

194. *Id.*

195. Nordberg & Price, *supra* note 80, at 12.

196. *Id.*

197. Brown, *supra* note 45, at 35.

198. Woodard, *supra* note 155, at 13.

199. *Arco's Deal With China Is A Tough Act To Follow*, *supra* note 82, at 43. However, the overall success ratio of early drilling programs along the Chinese continental shelf is very encouraging, indicating that indeed, China is in a position to insist upon tough terms. *The Drilling Begins*, *supra* note 42 at 19.

200. *Id.*

Japan National Oil, ELF Aquitaine, and Compagnie Française des Pétroles.²⁰¹

China's hard negotiating stance, in addition to Arco's major concessions, will result in long and difficult negotiations before contracts with other oil companies are signed. If Arco's negotiating results are any indication, these companies may find that they must do business the way China wants them to, or not at all.

Loretta D. Rich

201. *Id.*

