

Chinese oil sector: new development and opportunities for Russian-Chinese cooperation

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The article studies major changes of the institutional structure of the Chinese oil sector. Analysis of the institutional environment revealed, that despite the official openness to foreign investment, Chinese government still maintains significant control over the downstream sector and has enough economic instruments to restrict foreign presence if needed. However, a number of problems, which can not be solved under the current system, bring to a conclusion, that the Chinese oil sector is on the transition period now and in the longer perspective it will be reformed and become more attractive for foreign (including Russian) investments.

Key words: Chinese oil sector, Russian-Chinese oil cooperation, foreign investment

1. INTRODUCTION

China is one of the fastest developing countries in the world. Annual growth rate of PRC for the last 20 years were around 10%, i.e. GDP doubled every 7,5 years. During the crisis, in 2008 and 2009 Chinese economy growth rate exceeded all forecasts reaching 9.6 and 8.7% respectively, and it is expected that in the nearest future China can overpass Japan and become the second-largest economy in the world [1]. PRC targets to double its GDP by 2020, but its further growth to a large extent will be determined by the energy sector, which still remains the bottleneck of the Chinese economy.

During the last few decades in order to provide energy security Chinese authorities has fundamentally restructured oil industry. However high economic growth rates, creeping industrialization and urbanization, growing population and many other factors continue to aggravate energy problem and press the government to find new ways of securing oil supply.

There are three key trends in Chinese oil industry transformation. The first one is establishment of new corporate structures; their listing on international stock markets and activation in the sphere of oil exploration, extraction, refin-

ing and marketing. The second one is introducing flexible combination of market-based pricing system and government control over the industry. The third trend is developing oil cooperation with foreign countries and companies, attracting foreign investment and developing international transport projects. In all three spheres China gained a certain experience, which should be taken into account when strengthening Russian-Chinese energy cooperation.

2. CHINESE OIL INDUSTRY

2.1 Creation of the new corporate structures

By 1970-80 there were quite a lot of problems inhere in socialist command economy, such as deficit of natural and financial resources, low working efficiency, high costs, overgrown bureaucracy. At the beginning of 1980 in the framework of adopting “reforms and openness” policy, Chinese authorities proceeded with radical restructure of the oil sector.

In order to separate business activity from the government’s regulatory function three national oil companies were created. Initially each of them was specializing on a certain market segments (CNPC and CNOOC were responsible for exploring and extracting on shore and off shore resources respectively, while Sinopec was engaged in downstream operations). However by the end of 1990, challenged by the coming market opening and the need to compete on the international market, striving for its competitive capacity increase, the companies initialized the process of vertical integration. CNPC began to acquire refining facilities (now the company controls around 45% of China’s refining capacity), while Sinopec extended its operation to the upstream (it controls 10% of the sector’s assets). [2]

To reform oil sector and raise domestic supply, China needed huge amount of investment. Budget financing would have had exacerbate a problem of oil companies’ low efficiency, and

at the beginning of 2000 the government decided to restructure and list NOC: companies raised billion of dollars by selling 15% (Sinopec, CNPC) and 27.5% (CNOOC) of its shares.

2.2 Pricing and institutional reforms

After its establishment, three national oil companies were delegated mandate of the previously existed ministries. After listing on stock markets, these companies had to fulfil three conflicting functions: on the one hand, being public, they were interested in cooperation with foreign companies and making its assets operationally profitable; on another hand – being at the same time state-controlled, they had to take into account “energy security” strategy, lead negotiations (so-called “bargaining”) with government regulators on price levels and the amount of subsidies; thirdly, as full and vice ministerial ranking companies, they also had to play a role of market regulator. Members of NOC’s boards of directors were holding senior positions in the Executive Committee of the Communist Party of China, expert organizations and research institutions, while the companies itself had quite a high level of autonomy and so broad powers, that they were able not only influence the government’s energy policy, but were even able to formulate it. Thus, for example, it was NOC, who initiated the construction of “West-East” pipeline and foreign oil assets acquisition; these projects were approved by the government later. National oil companies can intentionally understate domestic supply in order to force the National Development and Reforms Commission (NDRC) to set higher oil products prices.

For many years Chinese oil sector was controlled by a dozen of horizontal institutions, studying its own, often conflicting, interests. And there were no single institution, with the authority to coordinate them and develop national energy policy.

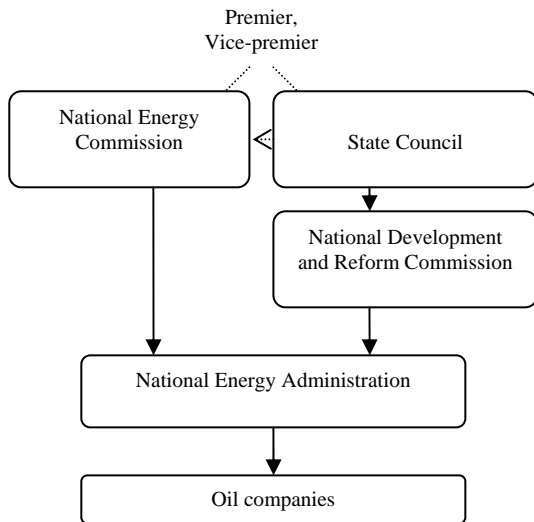
Prior to 2008 the only vertical institution responsible for strategy planning and coordination across industries and ministries was National Development and Reform Commission, accountable directly to the State Council. Its efficiency was quite low, as it had a broad mandate from formulation to implementation

of energy policies, while its resources, both human and financial, were quite limited (its staff numbered just several dozens of people, not to be compared with the US Ministry of Energy staffed with 4000 people). [4, 5]

In 2008 some of separate energy offices and institutions were absorbed by the newly created body - the National Energy Administration (NEA) (see scheme 1). It was responsible for drafting energy plans, negotiating with international energy agencies and approving foreign energy investments. The creation of the NEA was aimed at tightening control over oil corporations and at strengthening energy decision-making process, but due to lack of authority, political clout, manpower and tools to deal with the country’s energy challenges, new Administration failed to improve the sector’s efficiency. [5]

At the same time the government planned to establish more authoritative body - National Energy Commission (NEC), but officially its formation was announced only two years later, in January 2010. The Commission, which first session took part in April 2010, is headed by Premier Wen Jiabao and comprised of 22 senior-level officials (Vice-premier, ministers, top leaders of the NDRC) and is responsible for drafting national energy development plan, reviewing energy security and major coordinating international cooperation. NEC outranks all other government departments and state-owned enterprises that were in charge of the various energy sectors. Although NEC decisions still require approval by the State Council, given the seniority of its members it is well positioned to coordinate energy policy. The existing NEA is subordinate to the NEC, but continues to be responsible for the drafting and implementation of energy plans, industrial policies and standards. [6]

Scheme 1. Vertical management system in China's energy institutions



Creation of the NOC was confronted by such a powerful actors as the national oil companies (afraid of losing its influence and autonomy); different ministries and the NDRC (which didn't want to be deprived of a substantial portion of its portfolio and important tools of macroeconomic control). For many years China's energy policy (including foreign investment policy) was quite inconsistent, as it was undermined by a balance of interests between politically powerful oil corporations and less authoritative regulators, rather than by market signals. Even if foreigners' entrance to the oil sector was economically reasonable, it could have been restrained by the national corporations trying not to let competitors enter the market. However China's shift to a new energy structure and the seniority of the NEC members is the clear indication of the central government's strong political will, its commitment to the problems of oil sector and, probably, perception of the market's call for more drastic reforms, and it can be regarded as positive sign for foreign investors.

For foreign investors pricing policy is the key factor in determining attractiveness of the market. Until the end of 1990s China maintained traditional for command economy administrative pricing rules. In recent years Chinese government undertakes more active actions to reform them. For example domestic crude oil price for the state corporations is set at the international level. Prices for oil products are still under control, but they are set with a reference

to the international crude oil prices. From the beginning of 2000 the government conducted several rounds of price reform. The latest one, implemented at the beginning of 2009, imposes ex-refinery oil prices as the sum of weighted average price of benchmarked international crude oils (Brent, Dubai, and Cinto, equal weighting), refining costs, taxes and refining profit (5 percent of crude oil cost when international oil price is at or below \$80 per barrel; at a decreasing percentage of crude oil cost when the international oil price rises above \$80 per barrel, declining to zero when the international oil price reaches \$105 per barrel; zero refining profit when the international oil price is between \$105 and \$130 per barrel). The retail price ceiling varies for different provincial markets but is set on average at approximately RMB 780 per metric ton above ex-refinery prices.

2.3. Cooperation with foreign investors

Proclaimed at the end of 1970 the policy of "reforms and openness" meant a shift to not only a more market-oriented industry, but also to more active cooperation with foreign investors on both domestic and international markets. Foreigners entered the upstream sector at the beginning of 1980, and the restrictions on their participation in the downstream were removed after China's entry to the World Trade Organization in 2001. Due to the reforms of the recent years Chinese oil sector became more open and liberalized. This, together with market capacity and growth potential makes Chinese oil industry highly attractive for foreign companies. Major international oil companies, such as BP, Shell, Total, Exxon Mobil and Saudi Aramco are represented already in the downstream sector of China.

Russia is also interested in the development of joint projects on China's territory. It keeps with the national strategy of encouraging international projects and producing higher value-added products. But there is a range of problems which can raise difficulties on the Russia's way to the Chinese downstream market.

First of all, despite of all market reforms, there is still a huge gap between domestic and inter-

national oil product prices. The current pricing mechanism guarantees margin to the companies engaged in the retail business, while those engaged in refining can expect to have a profit only when the international oil price is below 105 doll./bar. According to the data of IEA, for only one year (2008) Sinopec and CNPC suffered 29 bln. doll. losses. Under such conditions the key role in defining investment attractiveness plays company's ability to receive subsidies, tax deductions and enjoy other advantages provided by the government. Otherwise when international oil prices are staying high the construction of the refinery in China can prove to be economically unreasonable.

Another problem is that price changes are difficult to predict. Despite of the fact, that new pricing formula is in close relationship with international oil prices, it is not obligatory for the regulator to follow it. Thus, according to the last version price reform, when the moving average of benchmarked international oil prices for 22 consecutive business days changes more than 4 percent from the previous price-setting level, the government may decide to adjust domestic gasoline and diesel prices accordingly. However experience has shown that the government makes price review more rarely than it is needed.

Secondly, doing business in China involves such important (especially for East economies) recourse, as "contacts". For a refinery project to be at least break-even, between an investor and both local and central governments should be established long-term, mutually beneficial relations. In other words, it is necessary that the company has already had joint oil projects; has a certain amount of accumulated investments and can offer to Chinese projects which they can not do alone. It can be hydrogen stations of BP and Shell, coal cleaning and liquefaction technology transfer, cooperation in developing alternative energy sources, construction of cleaner refineries, guaranteeing crude oil supply etc. If foreign company fail to pick the Chinese interest, it would be difficult to gain tax reductions and other benefits necessary for loss-free operating.

Moreover, a company that is going to work on the downstream market of China should estab-

lish relationships with all levels of public authorities: from the Ministry of Trade to local and city governments. It should have a certain amount of equity capital, adequate infrastructure and stable supply channel. After its registration, foreign investment company should go through a series of certification tests and contact with authorities every time they want to gain an access to land property, transport and infrastructure elements; obtain import and export licenses etc. After 2006 companies acquired assets in "strategically important" oil industry should go through a series of "national security" checks (the rule was imposed by a new antimonopoly law in august 2007), and should be approved by the Ministry of Trade (earlier only acquisitions for more than 100 mln. doll. required approval).

There is no single energy law concerning foreign investment in Chinese downstream. Foreigners' participation in the sector is controlled by a dozen of separate laws and regulations and by 11 ministries, 4 commissions and the national companies themselves. Prospects, that the new Energy law will systematize the regulation didn't come true: the draft of the law pays attention only to foreign investment in the upstream sector. [7, 8]

Thirdly, foreign companies in China have to make business on a highly monopolized market: two companies, CNPC and Sinopec controls 89% of the refining capacity and 80% of China's retail stations. They also control access to energy infrastructure, production and import of oil. Almost without exception they are holding a control stake of the joint sino-foreign enterprises, and wholly foreign assets (for example retail outlets) often have to operate under less favorable terms (for example their stations have less advantageous location than that of CNPC or Sinopec). National companies are state-aided, while foreign ones often don't enjoy the government's favor. On a highly monopolized market unfavorable business environment complicates foreign companies' life.

3. CONCLUSION

Despite the official openness to foreign investment, Chinese government still maintains significant control over the downstream sector and has enough economic instruments to restrict foreign presence in it. Foreign companies, working on Chinese downstream today, entered the market with a view to the deregulation and price growth. For the last few years prices for oil products in China indeed were liberalized, but the process of limiting government's intervention is going on much slower, than many of the companies have had expected. Generally, these reforms were not the results of a grand strategy, but immediate responses to pressing problems. Crisis of 2008-2009 highlighted defects of the oil sector and forced the government to make decisions (such as changing institutional structure, introducing new pricing reform) that previously have been delayed. A range of a serious problems (such as NOC's attempts to reduce their output to pressure the government to raise state-set prices of refined products, and an excess demand when oil products are undervalued) which can not be solved under the current system, bring to a conclusion, that the Chinese oil sector is on the transition period now and in the longer perspective it will be changed and become more attractive for foreign (including Russian) investments.

High market capacity and growth potential makes Chinese oil industry attractive for Russian companies. Our countries already have joint projects in the investment, credit, oil trade and supply fields. Rosneft's entrance into Chinese downstream can make a substantial contribution into the development of Sino-Russian oil cooperation. However due to some peculiarities of the Chinese downstream market, and a high level of the government's intervention, Russian project in the sector may prove to be quite risky. Russia side should enlist Chinese government's support and ensure certain state guarantees (for example guarantee of margin or market channels). It is also important to conduct a political dialog, as it expands cooperation potential and create new business opportunities.

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