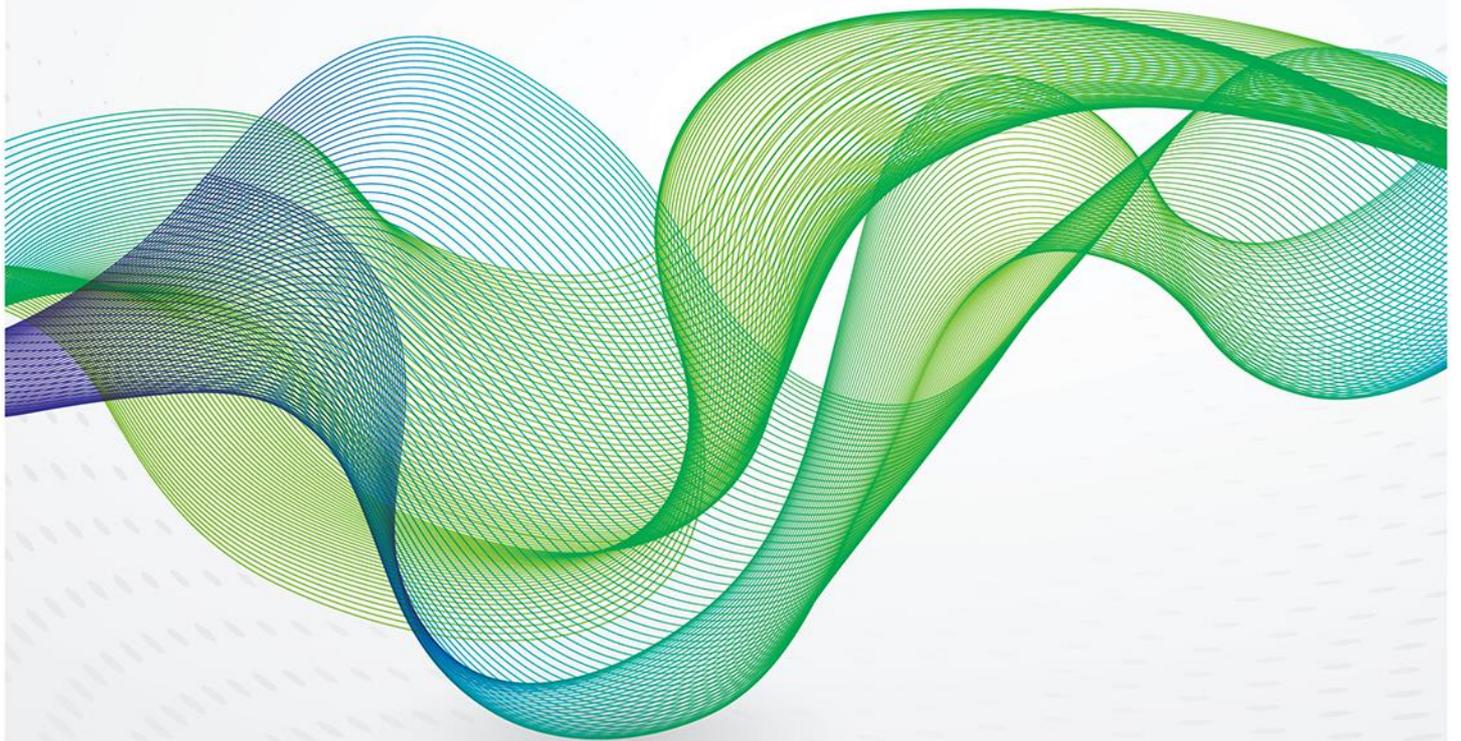




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The structure of China's oil industry: Past trends and future prospects





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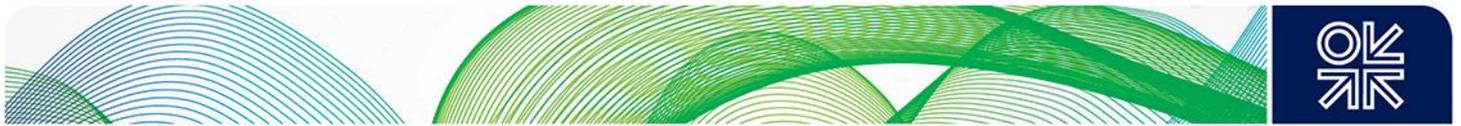
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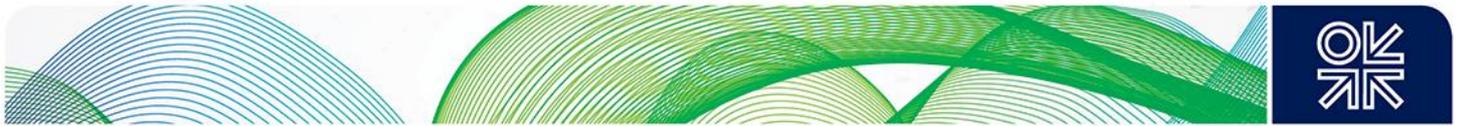
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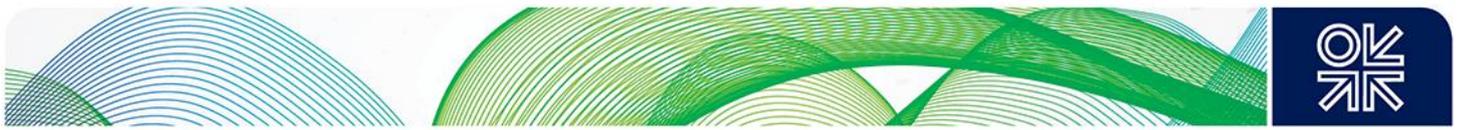


Glossary

boe	barrel of oil equivalent
bpd	barrels per day
CCP	Chinese Communist Party
CDB	China Development Bank
ChinaOil	China National United Oil Corporation
CNODC	China National Oil Development Corporation
CNOOC	China National Offshore Oil Corporation
CNOOC Ltd	China Offshore Oil Corporation Ltd.
CNPC	China National Petroleum Corporation
COCOM	Coordinating Committee for Multilateral Export Controls (an organization of western states aiming to control strategic exports to Communist countries)
E&P	Exploration and Production
EBL	energy-backed loan
ELSG	energy leading small group
EOR	enhanced oil recovery
FDIs	Foreign Direct Investments
FYP	Five Year Plan
GNPOC	Greater Nile Petroleum Operating Company
ICBC	Industrial and Construction Bank of China
IOC	international oil company
IPO	initial public offering
M&A	mergers and acquisitions
MLNR	Ministry of Land and Natural Resources
MOC	Ministry of Coal Industry
MOE	Ministry of Energy
MOEP	Ministry of Environmental Protection
MOFERT	Ministry of Foreign Economy Relations and Trade
MOFCOM	Ministry of Commerce
MPI	Ministry of Petroleum Industry
mt	million tonnes
mtce	million tonnes coal equivalent
NDRC	National Development and Reform Commission
NOC	National Oil Company



NORINCO	China North Industries Corporation
ODI	Overseas Direct Investment
PAB	Petroleum Administrative Bureau
PLA	People's Liberation Army
PRC	People's Republic of China
RMB	Renminbi, the Chinese currency
SAFE	State Administration of Foreign Exchange
SASAC	State-owned Assets Supervision and Administration Commission
SDPC	State Development and Planning Commission
SEC	State Economic Commission
SEO	state energy office
SEPA	State Environmental Protection Administration
SETC	State Economic and Trade Commission
Sinochem	China National Chemical Import and Export Company
Sinopec	China National Petrochemical Corporation
Sinosure	China Export and Credit Insurance Corporation
SIPC	Sinopec International Petroleum Exploration and Production Corporation
SOE	State-Owned Enterprise
SPC	the State Planning Commission
SPR	Strategic Petroleum Reserve
Unipecc	China International United Petroleum and Chemical Corporation
WTO	World Trade Organization
y/y	year on year



1. Introduction

China is now the world's largest oil consumer and importer. While this gives the country significant clout in the global oil market, its weight is compounded by the fact that in 2013 it was also the world's fourth largest oil producer – after Saudi Arabia, the USA, and Russia. China's oil sector has been dominated by three large state-owned oil companies who have been developing the country's domestic reserves, building and operating pipelines, managing China's increasingly sophisticated downstream, and filling its strategic petroleum reserves (SPR). These companies employ millions of workers, enjoy ministerial status—meaning that they outrank a number of other bureaucracies—and close connections to the top leadership. Over the years, as China's demand has outstripped production, they have also become major investors in the global upstream and established a presence in global refining and oil trading. They now rank among the top ten global oil companies.

Yet despite China's growing international reach, its oil sector remains heavily dominated by the Chinese state. From a majority stake in the oil companies, through price setting and diplomatic support for outbound investments, the government maintains significant influence over commercial decisions. At the same time, the technical knowhow and market expertise of the National Oil Companies (NOCs) offer them an important role in policy-making. This relationship is poorly understood, but it is now set to evolve further, alongside government efforts to gradually liberalize the energy sector and reform its state owned giants.

As the Chinese government embarks upon an ambitious economic restructuring and environmental upgrading that will allow more private participation throughout the oil industry, both the regulatory framework and the oil and gas companies are adjusting, leading to changes in the balance of power between the state and the industry. This paper provides a historic overview of the development of the Chinese oil industry, focusing on the relations between the government and the oil companies before assessing how the reform agenda outlined by President Xi Jinping and the liberalization of the oil industry is impacting government–industry relations, as well as China's global energy footprint.

2. The origins of China's oil and gas industry: From self-sufficient to inefficient

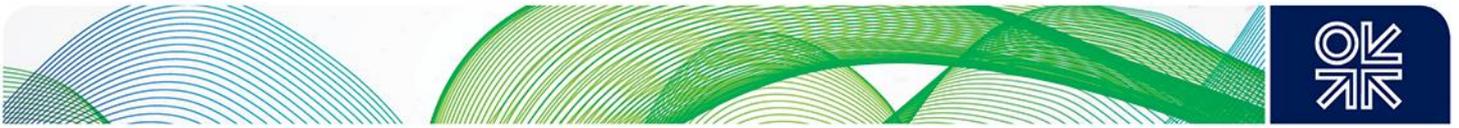
China under Mao Zedong and the Communist Party, beginning in the 1950s, introduced a centrally planned command economy modelled on the Soviet Union. This economic system involved the abolition of household agriculture in favour of collectives as well as a move toward centrally allocated industrial inputs and outputs, in accordance with a plan developed by the State Planning Commission. Market forces were largely eliminated in industry and commerce as the government set wages and allocated skilled workers to jobs.

In the energy sector, the country's meagre industrial base was ill equipped for the exploitation of its vast mineral resources. A predominantly rural population used coal and biomass as key sources of energy throughout the 1950s,¹ with coal accounting for 96 per cent of China's energy production and 94 per cent of consumption.² Yet during the Mao Zedong era (1949–76), as the country embarked on an industrialization process and sought energy independence, its commercial energy industry grew rapidly. Primary energy consumption rose from 24 million tonnes coal equivalent (mtce) in 1949, to 50 mtce in 1952, and over 500 mtce by 1976.³

¹ Vaclav Smil, 'China's Energy Prospects: A Tentative Appraisal', *Pacific Affairs*, volume 51, no. 2, Summer 1978, 230–44; Mark D. Levine, Feng Liu, and Jonathan E. Sinton, 'China's Energy System: Historical Evolution, Current Issues and Prospects', *Annual Review of Energy and the Environment*, no. 17, November 1992, 405–35.

² Wang Zhongan (ed.), *1995 Energy Report of China's Department of Communication and Energy*, Beijing; State Planning Commission, 1996 (Chinese).

³ Vaclav Smil, 'China's Energy Prospects: A Tentative Appraisal', op. cit., 232.



Yet Mao's era is significant beyond the country's industrialization, which laid the foundations for rising energy consumption. It was also during this time that the Chinese oil industry was shaped: the corporate structures, the ambiguous relations between party, state, and industrial actors, as well as the underlying principles guiding the industry, all originated during the Maoist era and remained well after this time.

The industry was, first and foremost, shaped by Mao's decision in the early 1950s to industrialize the country and embrace the Soviet economic model; this also led to close cooperation between Beijing and Moscow in developing the Chinese oil industry.⁴ It was during this time as well that China's views of supply security as a strategic vulnerability emerged: Shortly after the Korean War broke out in 1950, the Coordinating Committee for Multilateral Export Controls, or COCOM (an organization of western states aiming to control strategic exports to Communist countries created after World War II), declared an oil embargo on China, leading the country to rely on eastern European and Soviet exports.

So after getting a cautionary taste of energy insecurity, Mao was determined to promote self-sufficiency by developing the country's oil resources. In 1952, Mao ordered a unit of the People's Liberation Army (PLA) to become the 1st Division of Oil⁵ and develop the country's untapped reserves, while a newly created Ministry of Petroleum Industry (MPI) was in charge of managing and coordinating the production, transportation, and marketing of oil.⁶ In 1958, Mao also assigned Deng Xiaoping to be Vice Premier with special responsibility over oil, developing the Chinese oil industry through 'massive campaigns' under the leadership of the State Council.

So in 1959, with the beginning of the Sino-Soviet discord, Moscow's decision to withdraw its assistance from the Chinese petroleum sector and the subsequent shortage of expertise (and oil supplies) prompted Beijing to accelerate efforts to develop its domestic oil deposits and become self-sufficient. That same year, after the discovery of the country's first oilfield, Daqing, the 'spirit of Daqing' was made a model of political and economic development. The oilfield was given priority in the allocation of machines and equipment and was also set up as a semi-autonomous economic and political unit, in charge of providing facilities and a welfare system to employees in and around the oil production sites. Daqing rapidly expanded, as technological services, engineering and construction units, infrastructure, and equipment facilities were also built up on site. Additional services including agricultural production, housing, schools, and restaurants were also developed to meet the needs of the workers.

Daqing Oilfield gradually grew to include 67 subordinate units in five sectors including:

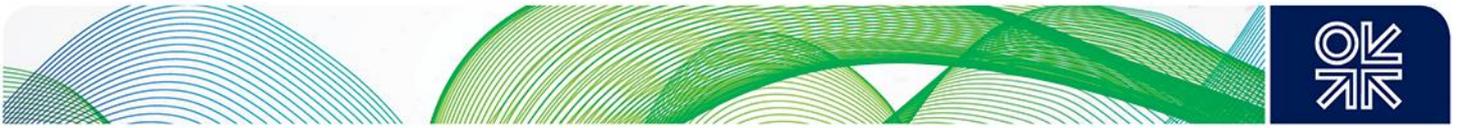
- 1) Core oil business such as extraction, transportation, refining, marketing, and R&D,
- 2) Service companies such as geological prospecting, drilling, well logging, materials, and equipment,
- 3) Infrastructure units for water and electricity supply and communications,
- 4) Diversified business units responsible for transportation, construction, agriculture, property management, catering, and hotels, and finally,
- 5) A social services unit in charge of education, hospitals and health care, police and fire brigades, and government and administrative functions.

Of over 260,000 employees, only 40 per cent worked in the core oil business. This structure was replicated throughout the industry, with each Petroleum Administrative Bureau (PAB) designed to

⁴ Kenneth Lieberthal and Michel Oksenberg, *Policy Making in China: Leaders, Structures and Processes*, New Jersey: Princeton University Press, 1988.

⁵ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, London: Routledge Curzon, 2004, 230; Zhang Kang, (ed.), *The Development Strategy of China's Oil and Gas*, Beijing: Geology Press, 2002 (Chinese).

⁶ Lieberthal, Oksenberg, *Policy Making in China: Leaders, Structures and Processes*, op. cit., 72-8.



cultivate a strong sense of responsibility for the collective and the country.⁷ As a result, the ‘massive campaign’ model led to the discovery of a series of large oilfields (Shengli in 1963, Dagang in 1964, and Liaohe in 1969) and gave hope for further discoveries in China⁸ – going as far as fuelling speculation that China was set to become a major oil exporter.⁹

As a result, the share of oil in the Chinese energy mix grew from 2.5 per cent in 1960 to 13.5 per cent in 1968 and oil became an important pillar of the Chinese energy industry, and of its economy. But beyond its contribution to oil output, the development of China’s oil industry was significant for a number of reasons: first, the experience of the 1950s engrained the notion of self-sufficiency for energy in the central leadership and instilled a fear of dependency on imports; second, the development of the industry gave rise to a new political elite known as ‘the petroleum faction’. Daqing oilfield became a political model of revolutionary spirit, commitment to the Communist Party, and high motivation.¹⁰ Subsequently, when Mao realized that members of the petroleum faction shared his views on economic development, they quickly rose through the party ranks to become his trusted economic advisors. In the aftermath of the Great Leap Forward, when a debate emerged on the way forward for the Chinese economy, Mao decided to curb the power of the State Planning Commission and the State Economic Commission – the two most prominent units under the State Council (the Chinese government) – and replaced the leading officials with others more loyal to him. He then created the Small Planning Commission in 1964 – a body that was directly under the central party leadership – and staffed it with members of the ‘petroleum faction’, led by Minister of Petroleum Yu Qiuli,¹¹ thereby subordinating his challengers to a body composed of trusted political allies.

This form of dominance of industry over politics was replicated throughout the political hierarchy, with local governments also coming *under* the authority of the various petroleum bureaucracies. The director of the Daqing Petroleum Administrative Bureau, for example, was also mayor of the city government.¹² In turn, the prominence of the ‘petroleum faction’ in economic decision-making allowed its leaders to promote the development of the oil sector and incorporate it in the third Five Year Plan (FYP) in 1965, ensuring that fiscal and political resources would be devoted to it. But shortly thereafter, the ‘petroleum faction’ fell from grace during the Cultural Revolution (1966–76) and its members were marginalized in domestic politics.¹³

Throughout the Maoist period (1949–76), however, China made significant advances in energy exploration, extraction, as well as in transportation and conservation techniques. Even though its technological level was lagging behind that of developed countries, for a country that relied for the most part on its own engineers and resources, its advances were deemed impressive.¹⁴ Amongst the most notable success stories was the development of hydroelectric capacity. By 1976, the country had 11 hydro stations with a capacity of over 200 MW, alongside countless small hydro stations. Aggregate installed hydro capacity accounted for 36 per cent of Chinese power production, a share higher than in other major power producing countries,¹⁵ with most of the design developed in China.¹⁶ Between 1968 and 1978, coal production and oil output were expanding regularly and energy

⁷ Jin Zhang, *Catch-up and Competitiveness in China*: op. cit., 74–5.

⁸ Mark D. Levine et al., ‘China’s Energy System’, op. cit.; Jessica Leatrice Wolfe, ‘Political Implications of the Petroleum Industry in China’, *Asian Survey*, Vol. 16, No. 6, June 1976, 525–39.

⁹ Larry Chuen-ho Chow, ‘The rise and fall of Chinese oil production in the 1980s’, *Energy Policy*, Volume 19, Issue 9, November 1991, Pages 869–78.

¹⁰ Vaclav Smil, *China’s Energy: Achievements, Problems, Prospects*, New York: Praeger Publishers, 1976.

¹¹ Lieberthal and Oksenberg, *Policy Making in China*, op. cit., 42–51; 183–96.

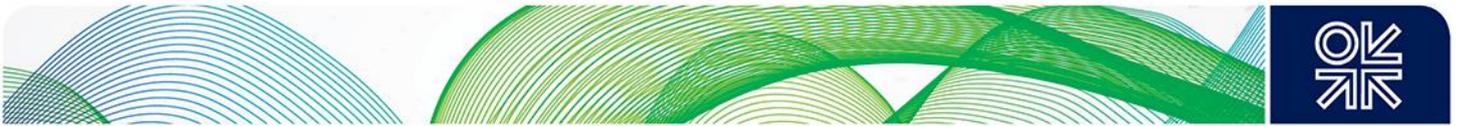
¹² Bo Kong, *China’s International Petroleum Policy*, California: Praeger Security International, 2010.

¹³ Lieberthal and Oksenberg, *Policy Making in China*, op. cit., 189–96.

¹⁴ Vaclav Smil, *China’s Energy Prospects* op. cit., 234.

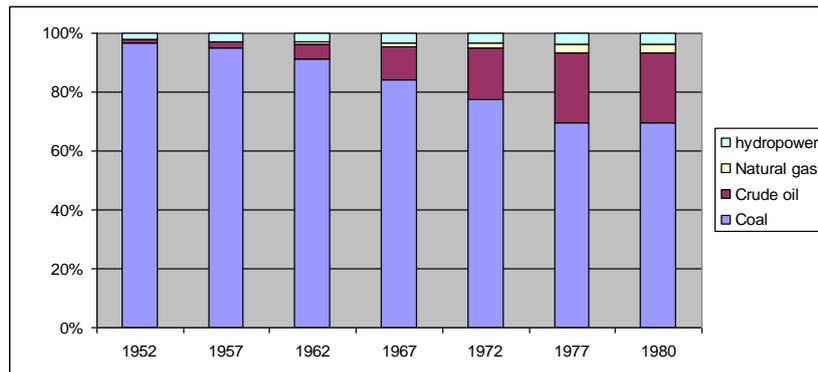
¹⁵ *Ibid*, 236.

¹⁶ Foreign contribution to the Chinese energy sector is still under debate, expertise in developing oilfields may have come from Soviet technicians before their retreat from China, Mark D. Levine et al., ‘China’s Energy System’, op. cit.; Jessica Leatrice Wolfe, ‘Political Implications of the Petroleum Industry in China’, op. cit. Some officials in the energy industry did, however, call for foreign technology but only the most pressing was introduced. Lieberthal and Oksenberg, *Policy Making in China*, op. cit.



production grew at a staggering annual rate of 13 per cent. On the eve of the 1978 reform and opening up, China was the fourth largest energy producer in the world, after the USA, Saudi Arabia, and the Soviet Union. Its energy mix was more diversified than it had been in 1949 (see Figure 1), consisting of 75 per cent coal, 17.5 per cent oil, and natural gas and hydropower representing 2 per cent and 5.5 per cent respectively.¹⁷

Figure 1: China’s energy production by fuel source 1953–80



Source: *Energy in China*, Ministry of Energy, the People’s Republic of China, Beijing: 1989.

Moreover, by the end of the Maoist era, China had become the world’s third largest energy consumer, although per capita consumption remained low. The leadership’s emphasis on developing the country’s industrial capacity meant that industry accounted for 60 per cent of Chinese energy demand. The burgeoning transport system consumed an additional 7 per cent, while energy for residential and commercial use – mainly represented by inefficient coal combustion in small stoves and boilers – contributed an additional 28 per cent. Agriculture required a meagre 5 per cent, consisting essentially of biomass.¹⁸

Yet geographic constraints complicated the Chinese energy picture, since production was concentrated away from the main consumer hubs and the limited transportation for energy quickly produced bottlenecks: the two northern economic areas (the North and the North east) produced around two-thirds of China’s fossil fuels, which then needed to be delivered to the East and Central–South regions, where over half of the nation’s growing population and two-fifths of industrial output were concentrated. Despite inefficiencies resulting from energy transportation, as of the early 1970s, China was self-sufficient for its primary energy supplies and was a net exporter of both oil and coal, which brought much needed currency into the country.

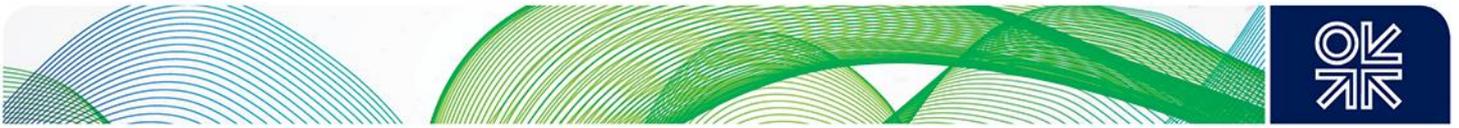
3. The 1970s and 1980s: A more complex and diversified oil industry

In 1978, Deng Xiaoping—China’s paramount leader after the death of Mao Zedong—initiated economic reforms that gave rise to decades of high economic growth rates and to a substantial change in energy production and consumption patterns throughout the country. The Chinese leadership embarked on a series of reforms which emphasized relaxing central planning, introducing gradual market mechanisms, and encouraging limited foreign participation in the economy.¹⁹ As a result, the economy expanded while energy demand also surged, but production often lagged behind.

¹⁷ Wang Zhongan, *1995 Energy Report of China’s Department of Communication and Energy*, op. cit., 48.

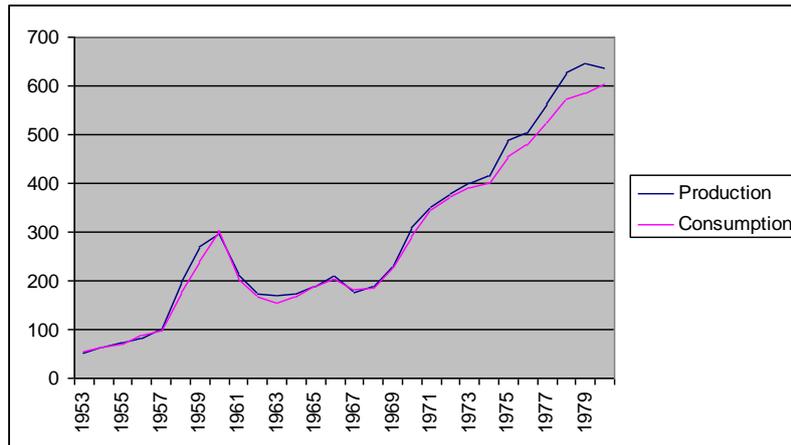
¹⁸ Vaclav Smil, ‘China’s Energy Prospects: A Tentative Appraisal’, op. cit., 234–5; Vaclav Smil, *China’s Energy: Achievements, Problems, Prospects*, op. cit.

¹⁹ Susan L. Shirk, *How China Opened Its Door*, Washington: The Brookings Institution, 1994; Fuqiang Yang, Ning Duan, Zhijie Huan, Mark D. Levine, Nathan C. Martin, Jonathan E. Sinton, Dadi Zhou, Fengqi Zhou, and Chengzhang Zhu, *A Review of China’s Energy Policy*, Report no. LBNL-35336 California: Lawrence Berkeley National Laboratory, 1995, 5; Nicholas R. Lardy,



Thus in 1979, China produced 645 mtce of energy and was consuming 585 mtce²⁰ (see Figure 2); however, with its unprecedented economic growth, a decade later it was already consuming 920 mtce²¹ and witnessing its first shortages.²² From an agricultural society to an increasingly urban population relying on industry and services for GDP growth, China's economy became more energy intensive – a path other developing nations had also taken before it.²³

Figure 2: Primary energy production and consumption (mtce) 1953–80



Source: *Energy in China*, Ministry of Energy, the People's Republic of China, Beijing: 1989, pages 78–9.

This energy-intensive growth model confronted the leadership with numerous problems related to the development of the country's energy sources and also to the management of an increasingly complex sector. From an energy mix dominated by coal, and an industry managed by the Plan, China's energy sector began to include more oil, gas, and renewable sources of energy, and it was regulated by increasingly mixed mechanisms. The policy priorities remained in line with those of the Maoist era, but policy tools were slowly changing.

3.1 Policy priorities for reforming the energy sector

At the onset of the 1978 reforms and opening up, the Chinese leadership was once again focusing on the need to modernize the Chinese economy. For the energy industry, the aim was to increase production at a time when oil output was beginning to stagnate. By the middle of the 1980s, electric power had become the government's main priority, accounting for the largest share of investment in the energy sector. With little exploration activity, investments in oil and natural gas rose marginally, as did output, and growth in primary energy production was achieved through expanding coal supply.

While leaders from the oil sector had recovered from their earlier marginalization during the Cultural Revolution and once again exercised significant political clout, output from China's oilfields was becoming increasingly unpredictable.

China's oil production underwent three main stages: the first was the discovery of Chinese oilfields in the late 1950s and early 1960s which allowed significant increases in production. The second was in

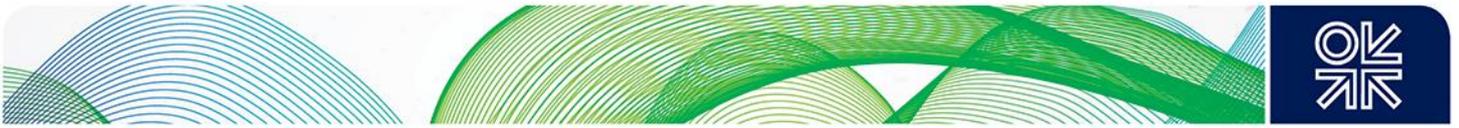
China's Unfinished Economic Revolution, Washington: Brookings Institution Press, 1998; Barry Naughton, *The Chinese Economy: Transitions and Growth*, MIT Press: 2007.

²⁰ Ministry of Energy of the People's Republic of China, *Energy in China*, Beijing: 1989, 78–9.

²¹ Ibid.

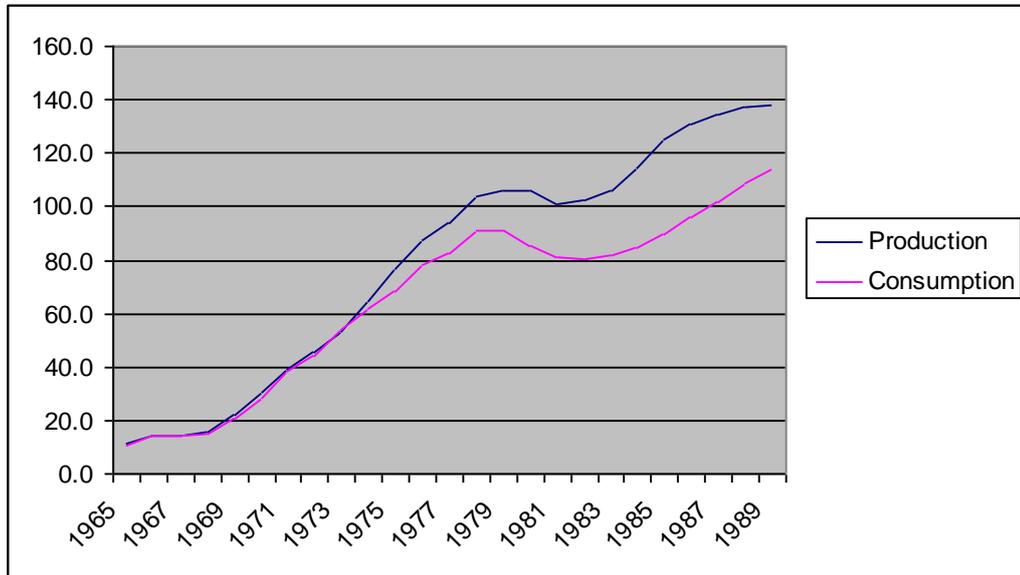
²² Philip Andrews-Speed, *Energy Policy and Regulation in the People's Republic of China*, London: Kluwer Law, 2004.

²³ Kenneth B. Medlock and Ronald Soligo, 'The Composition and Demand of Energy Growth in China', *China and Long-Range Asia Energy Security: An Analysis of the Political Economic and Technological Factors*, James Baker III Institute for Public Policy, Rice University, 1999.



1979, when production slowed down unexpectedly, and the third took place when production, almost as unexpectedly, showed signs of renewed strength in 1983–4 (see Figure 3).

Figure 3: Oil production and consumption (mt)



Source: *BP Statistical Review 2011*.

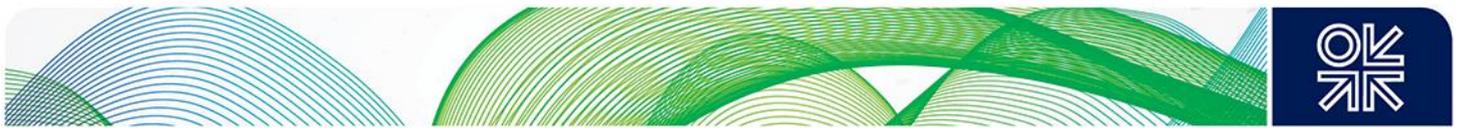
After the first discoveries and with the support of the ‘petroleum faction’, as discussed above, oil production increased rapidly. China’s future as a potential oil giant dominated discourse – going as far as talking of possible OPEC membership. Government and industry estimated that by 1990 China would produce 539 Mt (10.78 mb/d).²⁴ But in 1979, production from the developed fields was stagnating. Total oil output dropped from 106 Mt (2.12 mb/d) in 1979 to 101 Mt (2.02 mb/d) in 1981, with government investment also falling by half that same year.²⁵ Tight government control over the oil sector, while effective in spurring production in the first years, was now taking a toll on output and on revenues. Supply and demand were determined by quotas, product prices were kept low, and the oilfields were not allowed to retain revenues; this gave them little incentive to produce more, and made them totally dependent on the government for investment. With government funding for exploration and production dwindling due to other, more pressing, financing needs, the industry’s output capacity declined. What is more, each oilfield was also responsible for education and health care, meaning that its operating costs were rising. Production rates declined rapidly in 1980 and 1981 and the industry needed to raise funds in order to stabilize output in the developed oilfields and to explore new sources.

3.2 Decentralizing control

In response, the government implemented the ‘big contract system’ whereby it signed contracts with the oil and gas production units, requiring them to produce 100 Mt (2 mb/d) of crude oil annually. Any above-quota oil could either be exported by the Ministry of Petroleum Industry (with the revenue in foreign exchange earmarked for foreign technology and equipment) or sold on the domestic market. Above quota oil output could therefore be used for importing pipelines and steel products for the oil industry, or sold at a higher price on the domestic market, which in turn generated additional capital for oil exploration and development.

²⁴ Larry Chuen-ho Chow, ‘The rise and fall of Chinese oil production in the 1980s’, *Energy Policy*, Volume 19, Issue 9, November 1991, 869–78.

²⁵ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 77.



The contract system was the first step in moving away from central planning in the energy sector and an initial contact with the international energy markets, prices, and practices – albeit in a controlled and limited manner.²⁶ It also provided a strong incentive to increase oil output: the contracted oil output for Shengli was 15.9 Mt (0.31 mb/d) in 1981 and actual output reached 16.11 Mt (0.32 mb/d).²⁷ The two-tier pricing system, introduced in the same year as the contract system, was another important component of reform. The government set the price for the contracted oil, but all excess output destined for export was sold at international market prices. Previously, fixed prices varied between Renminbi (RMB)100 and 200 per tonne, according to the field,²⁸ but exported oil was sold at around RMB600 per tonne.²⁹

The adoption of the contract system and of pricing reforms therefore played a significant role in the second turnaround that occurred in 1984. New capacity was brought on line through increased drilling with better quality work, equipment, and greater efficiency. The government had emphasized exploration and development rather than production, and this only resulted in short-term increases in output. However, between 1981 and 1990, the industry managed to generate RMB43.4 billion that it could allocate toward oil exploration, while state investment was RMB23.2 billion.³⁰

Yet the contract system quickly reached its limit. Despite an initial surge in production and revenues, it was unable to offset the stagnation of the older oilfields. During the seventh FYP (1986–90) output growth began to slow and reached an annual average of 2.12 per cent, falling short of the 6.97 per cent recorded in previous years. This was due to several reasons:

- Starting in 1986, the government raised its production targets but kept prices (both for oil contracted within the state plans and for oil sold above-quota) lower than international prices, thereby dampening producers' enthusiasm.
- Differences in the pricing of upstream output and downstream products allowed refineries to profit at the expense of oilfields. This contributed to the overdevelopment of refining facilities, many of which were small plants built by local governments that hoped to capture the rents created by the pricing system.
- Labour and production costs in China were rising as inflation skyrocketed in 1987/8. In 1988, for example, the government raised plan prices again, but prices varied between RMB137/tonne and RMB485/tonne³¹ according to fields and crudes. On average though, the cost of production (RMB177/tonne) had surpassed the average in-plan wellhead price (RMB167/tonne). With an increased tax burden on the oil companies aimed at replenishing central government coffers, together with declining oil prices on the international markets in the 1980s, revenues were decreasing and as a result, the growth in output slowed.

While crude oil output rose to 137 Mt (2.74 mb/d) in 1988, the increase was much less than Chinese planners had previously estimated. By the end of the decade the declining profitability of the oil industry was all too evident and it became incapable of generating sufficient funds for increasing production, while the central government was also hard pressed to finance it.

The policy response, as reflected in the priorities of the sixth FYP (1981–1986) was to continue stressing supply while also trying to improve efficiency in consumption. And with a relatively coordinated institutional framework, the efficiency efforts bore fruit for several years. The central government's energy conservation programmes targeted the most energy-intensive industrial sub sectors – steel and iron, chemicals, building materials, and power generation – encouraging

²⁶ Zhang Kang, (ed.) *The Development Strategy of China's Oil and Gas*, op. cit., 499–501.

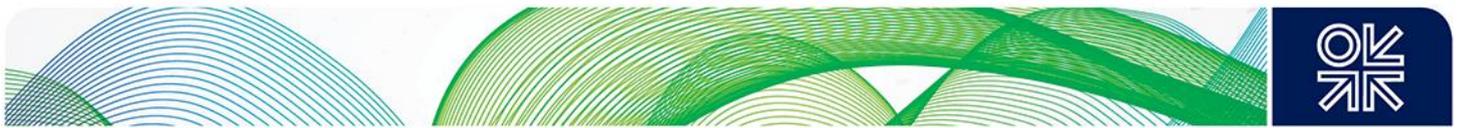
²⁷ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 77–9.

²⁸ In 1971 production from Liaoning province was sold at 100 yuan/tonne, output from Xinjiang and Qinghai was sold at 115 yuan/tonne. Ibid.

²⁹ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 78.

³⁰ Yang Fuqiang et. al, *A Review of China's Energy Policy*, op. cit., 26–8.

³¹ Zhang Kang et al., *The Development Strategy of China's Oil and Gas*, op. cit., 502–3.



investments in technological upgrades to improve manufacturing processes and equipment. Moreover, the government provided low-interest loans and tax credits for investment in energy conservation, which subsequently rose rapidly between 1981 and 1995.³² By 1995, Chinese energy efficiency efforts were making evident changes in the country's consumption pattern, with Beijing managing to use half as much energy as it would have if energy consumption had pursued its previous patterns.³³ Government policy played an important role in promoting energy efficiency. What is more, the existence of a bureaucratic structure with sufficient authority and policy tools to command the sector (with a mix of market but mainly administrative means) was an important factor in the success of the conservation policy.³⁴

3.3 Adapting the energy bureaucracy

The evolving energy picture led to several waves of institutional reshuffling and experimentation with different forms of governance. Each step of these bureaucratic reforms was determined by internal bargaining by the different ministerial-level entities involved.³⁵ Indeed, reforms did not follow a comprehensive strategy but were piecemeal adaptations to the rapidly changing needs of the sector, under the overarching macroeconomic framework set out by the government.

With the creation of the PRC in 1949, the energy industry was designed along the Soviet model. The Ministry of Fuel Industry, created in 1949, managed the entire energy sector. Three bureaus were set up under it: the Bureau of Coal Administration, the Bureau of Petroleum Administration, and the Bureau of Electric Power Administration. And just as in the rest of China's centrally planned economy, the State Planning Commission (SPC), created in 1952 – the predecessor to today's National Development and Reform Commission (NDRC) – assumed a central managerial role in the energy sector. Focusing on macroeconomic management, it determined the speed and contours³⁶ of China's national economic development. The SPC was pivotal in guiding and organizing the allocation of major commodities and the construction of major projects.

In the energy sector, it formulated mid- and long-term plans drawing on the advice of experts from the Ministry of Fuel Industry. It then had decision-making power over investments and production, construction, and conservation efforts; it carried out the feasibility studies required for the projects under consideration and determined the pace of their development as well as the year of launch, once approved.³⁷ Alongside the SPC, under the State Council, the State Economic Commission (SEC) was in charge of short- and medium-term implementation of the production plans made by the SPC.

As a supra-ministerial organization, the SEC was able to solve the coordination problems that arose between the different ministries and was thus critical in enabling projects to function effectively, but it had relatively little power in formulating policies.³⁸

During the 1950s, the centrally controlled system functioned well in the country's transition from the previous years of civil war and political turmoil. It effectively pooled the limited resources available and allowed the country to meet the immediate demands of economic development. But as the economy developed and policies to diversify supplies were adopted, the Ministry of Fuel Industry could no

³² *China Energy Yearbook 2004*, Beijing: China Petrochemical Press, 2005 (in Chinese), 199–203.

³³ Jonathan E. Sinton, Mark D. Levine, Wang Qingyi, 'Energy efficiency in China: accomplishments and challenges', *Energy Policy*, 26(11), February 1998, 813–29.

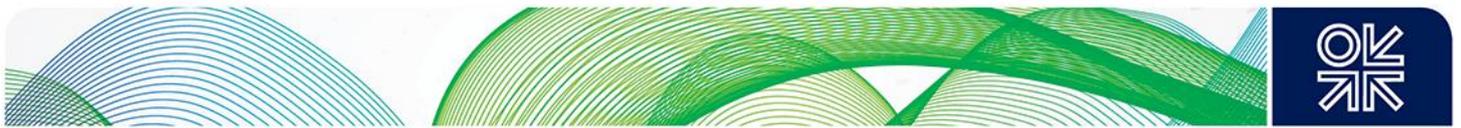
³⁴ Development Research Center of the State Council and the Energy Research Institute, *China National Energy Strategy and Policy 2020*, Beijing, June 2004 (Chinese).

³⁵ Erica S. Downs, Energy Security Series: 'China', The Brookings Foreign Policy Studies, December 2006, 16–24; Special investigative team from the China Academy of Science department of quantitative technological economics, 'An Analysis of government decision-making in energy policy', *Review of Economic Research*, no 36, 2006 (Special Issue, Chinese), no. 36 B-5, 2006, 41–4.

³⁶ Lieberthal and Oksenberg, *Policy Making in China*, op. cit., 65.

³⁷ For more details see Yang Fuqiang et. al., *A Review of China's Energy Policy*, op. cit.; Zhao Jimin, *Reform of China's Energy Institutions and Policies: Historical Evolution and Current Challenges*, BCSIA Discussion Paper 2001-20, Energy Technology Innovation Project, Kennedy School of Government, Harvard University.

³⁸ See also Lieberthal and Oksenberg, *Policy Making in China*, op. cit., 72–8.



longer deal with the increasing demand for energy services and in 1954, five years after its creation, the State Council disbanded it. In 1955 it created the Ministry of Coal Industry (MOC), the Ministry of Petroleum Industry (MPI), and the Ministry of Electric Power (MEP).³⁹

During the Cultural Revolution, China's administrative structures were reshaped along ideological lines that favoured institutional simplification. As a result, in 1970 the MOC and MPI were merged with the Ministry of Chemical Industry to form the Ministry of Fuels and Chemical Industries, which then took over the management of all state-run enterprises from local governments.

But in light of the energy sector's poor performance during those years – due to both the turmoil of the Cultural Revolution and to the restructuring and decentralization – the government scaled back its previous reforms and recreated, in 1975, the MOC and a Ministry of Petroleum and Chemical Industries. Shortly thereafter, in 1978, the Ministry of Petroleum and Chemical Industries was broken down into its two initial components: the MPI and the Ministry of Chemical Industries. The MPI pioneered the policies of importing foreign technologies and equipment, exporting natural resources, and forming joint ventures.⁴⁰

After Deng Xiaoping launched his reform and opening up, two major reorganizations took place in the energy sector: the first wave of reforms (1981 to 1983) focused on the oil sector. The expectations of expanding output (which nonetheless failed to materialize) led the MPI to lobby the government for greater foreign participation in the Chinese energy sector, especially in offshore development.⁴¹ This then paved the way for changes in the institutional landscape and the subsequent moves towards corporatization.

In February 1982, the government created its first state corporation, the China National Offshore Oil Corporation (CNOOC). In the political hierarchy, CNOOC was equivalent to a 'general bureau', lower than a ministry but higher ranking than a regular bureau, and was given exclusive control over the negotiations and bidding, exploration, development, and marketing of offshore oil resources as designated by the government.⁴²

This first restructuring set the stage for the subsequent dismantling of the MPI and its transformation into two corporate entities: China National Petrochemical Corporation (Sinopec) was created in 1983 and in 1988 the MPI was dismantled to become the China National Petroleum Corporation (CNPC), a wholly state-owned oil company with the political ranking of a ministry, designated by the State to manage the assets of the former MPI.

CNOOC: The first oil company

The formal creation of CNOOC in February 1982 came after four years of discussions and interactions between the MPI and foreign firms. It emerged from a combination of several factors: first, Chinese officials sought to draw lessons from other countries on how to organize foreign involvement in oil and gas exploration; second, it was the outcome of efforts by Qin Wencai, vice minister of the MPI, to create a separate organization that he could head, and which would take charge of cooperative efforts with Western companies; and third, it was a response to Western firms that urged China to establish a legal entity with clearly defined jurisdiction and with which foreign firms could sign contracts.⁴³ Prior to CNOOC's creation, foreign firms negotiated with teams from the National Oil and

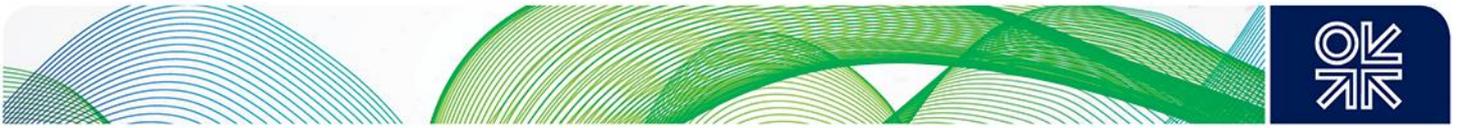
³⁹ Zhao Jimin, *Reform of China's Energy Institutions and Policies* op. cit.; Yang Fuqiang et. al., *A Review of China's Energy Policy*, op. cit.

⁴⁰ Kim Woodward, *The International Energy Relations of China*, California: Stanford University Press, 1980:13–29; Ma Chi, 'First Exploration of the International Energy Crisis of the 1970s as seen in China', *Studies in Science of Science*, 1988, vol. 6, no. 3, 48–57 (Chinese).

⁴¹ Zhao Jimin, *Reform of China's Energy Institutions and Policies* op. cit.; Todd M. Johnson, 'The Structure of China's Petroleum Administration', in Fesharaki and Fridley, (eds.), *China's Petroleum Industry in the International Context*, Westview Press: 1986, 11.

⁴² Lieberthal and Okseneberg, *Policy Making in China*, op. cit., 252–8.

⁴³ Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, Beijing: Economy and Management Publishing House, 2006 (Chinese).



Gas Exploration and Development Company, as well as with representatives from the relevant ministries such as the Ministry of Geology or the Ministry of Finance. And even though foreign firms noted the rapidity with which their Chinese interlocutors learned the international oil business, the number of actors involved and the lack of coordination among them soon became an impediment: the Ministry of Geology would begin exploration in blocks that had been given exclusively to the MPI (and therefore were to be developed jointly with foreign firms);⁴⁴ difficulties arose with provincial governments that had jurisdiction over offshore areas regarding contract implementation or in negotiating the terms of essential support services. In short, Western firms wanted a single interlocutor with the legal authority to sign and execute contracts.⁴⁵

By the time CNOOC's creation was formally announced, foreign firms had already been working with its staff and had grown accustomed to the employees. CNOOC was the legal entity with which foreign firms could sign contracts and through which China could assume equity positions if commercially viable quantities of oil were found. CNOOC could procure foreign exchange loans directly from the Bank of China or from foreign banks and retain the foreign exchange it earned, as well as after-tax profits. But despite its close ties to the leadership, it had little influence on major policy issues such as allocation of offshore oil blocks for foreign participation, or the terms of participation. CNOOC could formulate proposals but had to seek the approval of the MPI or the State Council.⁴⁶ In order to manage contract implementation, which often involved negotiating with foreign firms and local governments, CNOOC created four operating companies and set up joint ventures with local Chinese firms that assumed managerial and logistics tasks.

Sinopec and the corporatization of the Chinese downstream

The China National Petrochemical Corporation (Sinopec) was created in 1983 under the State Council by merging petrochemical assets from the Ministry of Petroleum Industry and the Ministry of Chemical Industry.⁴⁷ Most of Sinopec's personnel also came from these two ministries, with the notable exception of its president Chen Jinhua, who had been vice-mayor of Shanghai between 1977 and 1983. Chen was an industry outsider, a choice likely motivated by the need to unify the various ministerial factions within Sinopec.⁴⁸ Chen was also reportedly a protégé of Zhu Rongji, a reform-minded vice minister of the SEC at the time, who would later become premier.⁴⁹ Moreover, Chen had previously worked at the Ministry of Textile Industry and in petrochemical corporations, where he had been a vocal proponent of economic reform in the petroleum refining sector.

Sinopec was responsible for formulating policies for China's refining and petrochemical industry. In the ninth FYP, the goal was to make the Chinese petrochemical industry competitive with the world's largest companies in terms of technology, management, and efficiency as well as in product quality. The objective was to make it one of China's 'pillar' industries by introducing advanced technology, improved products, and better management practices, and to develop a petrochemical industry on a par with international standards by the year 2000.⁵⁰

Prior to the creation of Sinopec, petroleum processing had been handled by several different ministries according to the final use of the product. For example, oil used as a chemical feedstock fell under the Ministry of Chemical Industry, while for synthetic fibres it was under the purview of the

⁴⁴ Zhang Kang (ed.), *The Development Strategy of China's Oil and Gas*, op. cit., 487–501; 506–8; Yan Xuchao, (ed.), *Major Restructuring of China's Petroleum Industry*, Beijing: Petroleum Industry Press, 1998, (Chinese) 165–7.

⁴⁵ Wang Tao, 'Implement the three Big Strategies, Set up the Three Teams, Introduce the Three Good Procedures' in Wang Tao, *The Development Strategy of China's Oil and Gas*, Beijing: Petroleum Industry Press, 1998 (Chinese); Yan Xuchao (ed.), *Major Restructuring of China's Petroleum Industry*, op. cit., 165–7.

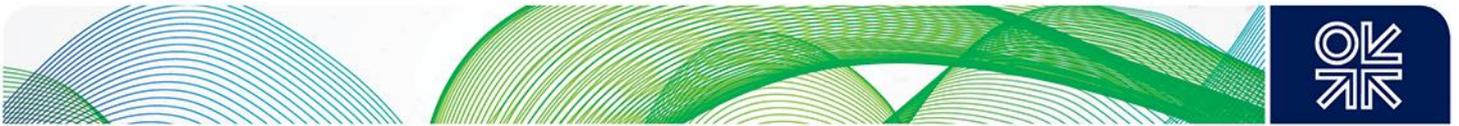
⁴⁶ Lieberthal and Oksenberg, *Policy Making in China*, op. cit., 123–8.

⁴⁷ Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit., 227–8.

⁴⁸ Todd M. Johnson, 'The Structure of China's Petroleum Administration', op. cit., 5–6.

⁴⁹ Willy Wo-Lap Lam, Chris Yeung, 'Deng Aims For Unity in Line-Up', *South China Morning Post*, 26 March 1993, Factiva.

⁵⁰ Mou Shuling, 'Opening up a new world for the petrochemical industry with policy support', in Fu Chengde (ed.), *China's oil development strategy in the 21st century – selected extracts from China's oil forum*, Beijing: Petroleum Industry Press, 2000, (Chinese) 15–18.



Ministry of Textile Industry. This resulted in considerable waste, since each ministry tried to guarantee adequate supplies of oil for its needs, but then much of the output went unused. By creating Sinopec and placing refining and petrochemical operations under one entity, ranked as a ministry, the State Council hoped to reduce some of this inefficiency, especially as oil and petroleum products were becoming increasingly important to the economy.⁵¹

Sinopec's headquarters drafted planning documents and business strategies for its subordinate units, but was also responsible for forecasting China's annual demand of refined products, which it then submitted to the SPC. Based on this, Sinopec, CNPC, and the provincial governments in charge of refineries, worked out their own production plans. They were, however, required to follow the crude oil allocation plan drafted by the SPC, as well as the projections for demand of refined products. Based on the state plan, Sinopec received crude from CNPC and controlled further allocation to its subordinate enterprises.

Investments in key projects and technological upgrades were planned by Sinopec headquarters in line with a government-set list of key projects. Once the project was approved by the government, Sinopec earmarked funds for it and its headquarters were subsequently responsible for monitoring the overall budget. The subordinate units, however, enjoyed a considerable degree of financial autonomy, despite the headquarters nominally being in control of finances. The subordinate units were responsible for their own profits and losses and for producing their own annual financial reports that they then submitted to headquarters; even though they were supposed to hand over a quarter of their after-tax profits to headquarters, they retained substantially more.⁵² Subordinate units were also granted freedom in setting up joint ventures with foreign partners.

Sinopec headquarters tried to centralize procurement across the company but were unsuccessful, since subordinate enterprises made their own procurement plans. R&D was also nominally decided centrally (the headquarters formulated a long-term research and development plan for the company) but in reality, enterprises often financed their own R&D projects. Funding provided by the headquarters amounted to a mere 30 per cent of R&D investments.⁵³

The limits to the powers of the headquarters extended also to its interactions with other ministerial entities. Part of China's refining capacity (roughly 5 per cent) remained under the MPI (later to become CNPC). Moreover, since distribution and marketing had previously been under the control of the Ministry of Commerce, many provincial distribution companies still escaped Sinopec's oversight.⁵⁴ Exports, despite Sinopec's desire to trade directly, also remained under Sinochem (see below). Finally, the State Council and the Chinese Communist Party (CCP) Organization Department retained control over personnel nominations, for president and vice presidents, as well as for the positions of chairmen in the large subordinate enterprises.⁵⁵

CNPC: China's Upstream incorporated

In 1988, the China National Petroleum Corporation (CNPC), the onshore oil company, was created. It was a ministry-level corporation directly under the State Council and was an amalgamation of assets from 87 different units, including the country's main oilfields – Daqing, Shengli, Liaohe, Xinjiang, and Tarim. In the 1990s, CNPC employed more than 1.4 million and by 1997, CNPC accounted for 90 per cent of China's total oil output and 77 per cent of its natural gas output, though its refining capacity remained limited.

CNPC engaged in international business development and operations. Subordinate units became enterprise groups with an oil company as the core. The oil company covered production and business

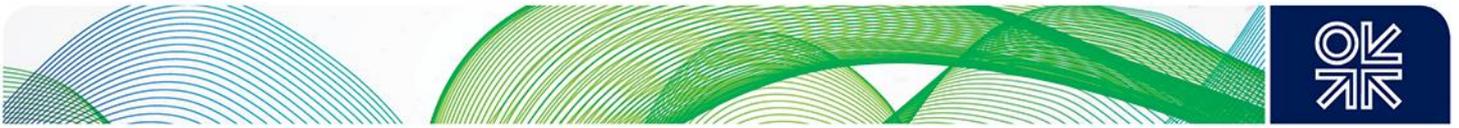
⁵¹ Todd M. Johnson, *The Structure of China's Petroleum Administration*, op. cit., 5–6.

⁵² Peter Nolan, *China and the Global Business Revolution*, Basingstoke: Palgrave, 2001.

⁵³ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 90–100.

⁵⁴ Todd M. Johnson, *The structure of China's Petroleum Administration*, op. cit.

⁵⁵ Erica Downs, 'Business Interest Groups in Chinese Politics: The Case of the Oil Companies', in Cheng Li (ed.), *China's Changing Political Landscape*, Washington DC: Brookings Institution Press, 2008.



units in exploration, development, refining, transportation, marketing, and geological R&D. Other related business units such as machinery manufacturing and maintenance, utilities, and material supplies were to be transformed into specialized service companies. Finally, some social service units were restructured and gradually separated from the core business.⁵⁶

CNPC headquarters, through the Planning Bureau, was responsible for devising medium- and long-term business plans (five and ten years), guided by the overall development strategy set out by the SPC and the State Council. Planning projects included strategies for oil resources, natural gas development, oil and gas pipelines, downstream refining, and development as well as plans to further develop CNPC as an integrated oil and petrochemicals company.⁵⁷

The company's Planning Bureau conducted research plans for oil and gas exploration and development.⁵⁸ CNPC headquarters also made projections for annual oil and gas demand and supply for the whole country, and drafted the annual plan for oil and gas production, transportation, and marketing for the entire industry. The projections and production proposals were then submitted to the SPC and the SEC, which devised the country's annual plans for the overall balance of oil supply and demand, production, allocation and processing, imports, and exports. Based on the state plan, the CNPC Planning Bureau worked out annual, quarterly, and monthly plans to be implemented by the subordinate enterprises within CNPC. Together with Sinopec, it then coordinated the allocation of crude oil to Sinopec's refineries. But before 1998 – when the second big industrial reshuffle took place (see below) – Sinopec relied on CNPC for 60 per cent of its feedstock⁵⁹ even though cooperation was difficult, so when disputes arose, the State Economic and Trade Commission (SEC) acted as mediator between the companies.

The CNPC Planning Bureau approved the company's large-scale projects, allocated funds for them, and applied to the government for additional investment funds. Projects were selected according to the company's development strategy and (nominally) the centre controlled investments in overseas projects. The subordinate enterprises were not permitted to develop international operations, but in reality this was not always the case. The subordinate enterprises were divided into core business and non-core business. For the former, the headquarters held the powers of strategic control, planning, and financial oversight, while for the latter, including service companies, the headquarters exercised financial oversight but granted them rather wide managerial autonomy.

Import and export licences were issued by the Ministry of Foreign Economy Relations and Trade (MOFERT, today's MOFCOM). From the 1950s, the China National Chemical Import and Export Company (Sinochem), under the direct control of MOFERT, monopolized all international trade. In 1993, it went into partnership with CNPC and set up the China National United Oil Corporation (ChinaOil), which became active in the import and export of crude oil. At the same time, it also created a joint venture with Sinopec, called China International United Petroleum and Chemical Corporation (Unipecc), through which it managed part of the international trade of refined products.

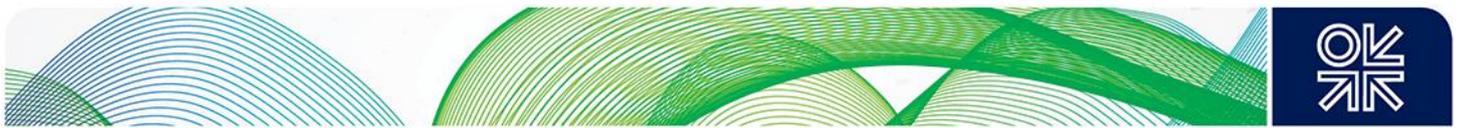
In terms of foreign investment, in 1982 CNOOC was given the exclusive right to cooperate with foreign oil companies, and in 1985 onshore territory was opened up. CNPC's International Exploration and Development Cooperation Bureau was granted exclusive rights to work with foreign multinationals onshore, and was responsible for inspecting and approving letters of intent, or cooperation agreements between subordinate oil companies and foreign oil companies. Decision-

⁵⁶ Yan Xuchao, *Major Restructuring of China's Petroleum Industry*, op. cit., 165–9.

⁵⁷ Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit., 331–5.

⁵⁸ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 81–2.

⁵⁹ Erica Downs, *China's Quest for Energy Security*, RAND MR-1244-AF, Santa Monica: 2000; Philip Andrews-Speed, *Energy Policy and Regulation in the People's Republic of China*, op. cit.



making power over the agreements lay with the leaders at the headquarters, even though provincial units would often sign agreements first and seek approval or notify the headquarters later.⁶⁰

CNPC headquarters were autonomous from the government for most aspects of management. Subordinate enterprises were responsible for their own profits and losses in business operations, while the headquarters and subsidiaries negotiated their revenue-sharing schemes. Subordinate units were initially granted autonomy for procurement decisions, but when the centre felt it was losing control over the cost and quality of machines, and after reports of serious accidents in oilfields (because of the use of low-quality and counterfeit equipment) came to light, the headquarters started to centralize procurement in 1997.⁶¹

CNPC was, however, dependent on the government for two major aspects of its management: personnel appointment and funding. The president and vice president of CNPC were appointed by the State Council and the Party's Organization Department – the human resources department of the Chinese Communist Party (CCP). The party committee at CNPC headquarters selected and appointed managers at enterprise level, except for the head of Daqing who was appointed by the State Council. The party committee was also responsible for evaluating managers.⁶²

CNPC's first president, Wang Tao (1988-1996), was a professional geologist with experience in China's largest and most important oilfields. He had been chief geologist in Dagang oilfield; deputy director of the Petroleum Exploration Bureau and chief geologist at Liaohe oilfield; and general manager of Nanhai East Oil Corporation, a division of CNOOC. He advocated for the development of China's domestic sources and emphasized developing resources in China's Western provinces, but at the same time he did not have a record of building powerful fiefdoms in his previous positions.⁶³ While he still provided some support for the energy sector after his departure from CNPC in 1996, he yielded limited influence in his new position at the National People's Congress – China's rubber stamp legislature. His successor, Zhou Yongkang became a highly influential leader and patron of the oil industry.

Funds for CNPC came from several channels including the state budget, bank loans from the State Development Bank and the State Construction Bank, and domestic bond issues (starting in the early 1990s). Within the Chinese system CNPC, as the successor to the MPI, was in an advantaged position for securing funding, and it enjoyed easier access to financial institutions than its peers. The MPI had been a major source of state tax revenue; its corporate successor therefore had significant clout and prestige within the bureaucracy and was more successful than other energy departments at placing its people on the staff of the Ministry of Finance and the Bank of China. CNPC received loans from Japan Energy, the World Bank, and the Bank of China (in foreign exchange) as well as loans from foreign governments through the Ministry of Finance or the Bank of China.⁶⁴ Finally, pricing decisions were also made by the State, thereby giving it indirect control over the company's finances.

Sinochem: a trader with Chinese characteristics

China National Chemicals Import and Export Corporation, or Sinochem, directly under the control of MOFERT was one of China's largest state-owned foreign trade companies. Set up in the early 1950s, it held the monopoly on foreign trade in oil and petrochemicals. But when the government offered trading licenses to additional companies in 1987, Sinochem began losing its monopoly and as a

⁶⁰ Zhang Kang (ed.), *The Development Strategy of China's Oil and Gas*, op. cit., 487–501; Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit.

⁶¹ Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit.

⁶² Erica Downs, Energy Security Series: 'China', op. cit.

⁶³ 'Exploratory Emphasis Shifts to the West', *World Oil*, 1 January 1990; Interview with Wang Tao, President of CNPC, Factiva; 'Everything to Play for In China's Tarim Basin', *Financial Times*, 31 March 1993; 'China to lay off 500,000 workers in revamp of oil sector', *Agence France Presse*, 24 August 1993; Mark O'Neill, 'Official says China may become net oil importer', *Reuters*, 24 August 1993; Steven Mufson and Steve Coll, 'China Offers Its Oil Riches on Open Market', *Washington Post*, 20 March 1994, Factiva.

⁶⁴ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 82–90.



consequence, the company sought to diversify its activities. In order to capitalize on its strengths (namely its foreign trade skills and overseas connections), Sinochem applied for, and was given, permission in late 1987 to engage in new business ventures, including overseas investment. It was also designated as the first pilot corporation in China to diversify its business with the objective of becoming a top multinational.⁶⁵

Attracted by the profits Sinochem was earning, CNPC entered into a joint venture with Sinochem to form ChinaOil. Similarly, Sinopec formed a joint venture with Sinochem to create Unipec. Both of these offspring companies were then licensed to import and export products and crude. Several additional state-owned companies and local governments were, at times, allowed to trade, but their licences were granted on a case-by-case basis and usually for a specified time period.⁶⁶ In 1994, the central government issued new regulations governing export of crude and products to clarify responsibilities among importing and exporting companies. While crude designated for export by the State Planning Commission continued to be handled by Sinochem, about 35 per cent of that total export volume was to be exported by ChinaOil, with the proceeds going for repayment of foreign loans. Refined products allocated to Sinopec (and its affiliated refineries) for export were to be handled jointly by Unipec and Sinopec.

3.4 Formal arrangements and informal procedures

Behind the formal structure described above, reality was very different. First, government intervened regularly in managerial processes. Moreover, despite having disbanded the MPI and created CNPC,⁶⁷ subordinate units still retained their ministerial denominations and functions.⁶⁸ Management methods were slow to evolve and the old institutional affiliations left their mark on regulation and accounting practices. Quotas and prices were still set by the government and, having to assume social responsibilities, companies were handicapped under more competitive market conditions.⁶⁹

Second, company headquarters still complained about difficulties in controlling their subordinate units and negotiating various aspects with local governments.⁷⁰ Some of China's larger oilfields (Daqing, Shengli) held bureau status within the MPI, making them answerable only to vice-ministers and ministers. They also had access to the top leadership, and refineries actively lobbied central government officials in a bid to secure their desired outcomes. For example, Shanghai Petrochemicals remained autonomous and avoided a forced merger while Shengli, China's second-largest oilfield, was able to guarantee a switch from CNPC to Sinopec ownership, and a new role within a holding company. Furthermore, fields and refineries actively competed with each other for joint-venture contracts, going at times, against the orders of the corporate parents.⁷¹ Finally, subordinate enterprises and the headquarters continuously negotiated hand-over amounts, even though these were set annually. Production enterprises renegotiated their above-target profits in order to invest in diversified businesses. As a result, the abundance of diversified businesses, and the

⁶⁵ Steven W. Lewis, 'Privatizing China's State-Owned Oil Companies', working paper Houston: Baker Institute for Public Policy, Rice University, April 1999, available online at www.bakerinstitute.org; Ping Deng, 'Outward investment by Chinese MNCs: Motivations and implications', *Business Horizons*, vol. 47 no. 3 May–June 2004, 8–16.

⁶⁶ Haijiang Wang, 'China's oil policy and its impact', *Energy Policy*. Vol. 23, No. 7, 1995, 627-635.

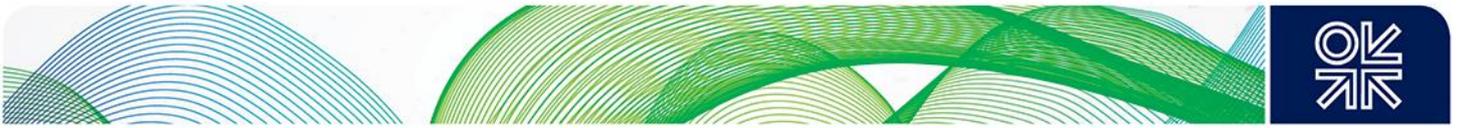
⁶⁷ Gu Guanzi and Li Jiang, 'The New Strategy for Opening Up China's Oil', *Geological Techno-economics and Management*, May 1995, no. 17, 1–7 (Chinese)

⁶⁸ Zhang Yaocang, 'Discussing some relationships in China's oil industry', *Oil and Gas Geology*, no. 19, vol. 4, December 1998, 267–74; Wang Yongfan, Lu Chen, Xue Zhenxiang, 'Reorganization in Foreign Oil Industries and China's Oil Industry Reforms', *World Economics*, 1995, vol. 12, 10–15 (Chinese); Li Weijun, 'The Basic Conditions of China's Oil Industry Transition to a Socialist Market Economy', *International Petroleum Economics* (Chinese), 1993, vol. 4, 27–32.

⁶⁹ Wang Fengchen, 'The Difficulties and Policies for Chinese Oil Companies Entering the Market', *Petroleum University Review*, 1994, Supplementary Issue, 12–16. (Chinese)

⁷⁰ Xi Jingyan and Wang Yunhai, 'Problems and Prospects for the Development of China's Oil Industry', *Daqing Social Science Review*, 1990, vol. 1, 18–21. (Chinese)

⁷¹ Gaye Christoffersen, 'China's Intentions for Russian and Central Asian Oil and Gas', *NBR Analysis*, vol. 9, no. 2, March 1998. Available at <http://nbr.org/publications/analysis/pdf/vol9no2.pdf>.



difficulty of monitoring the actual capital expenditure, soon left headquarters incapable of effectively monitoring their subordinate enterprises.

Third, consolidation of different forms of ownership and fragmented reporting lines also presented difficulties. The economic reform process brought with it a diversification of ownership structures that extended to oilfields and subordinate units: oil was pumped from the ground by a collective production team, under contract with a state-owned enterprise that managed or owned the oilfield under CNPC, and from there it might have been shipped via a provincial government-run shareholding pipeline enterprise, to a municipal government-owned oil depot. It could also have been transported by rail, falling under the jurisdiction of the Ministry of Rail. It may then have then been moved to a Sinopec-owned refinery, or to a joint-venture refinery set up by central and local government authorities as a cooperative technological venture with a foreign company, where it was refined, and it then could have moved to Sinochem for export. Thus, production and distribution networks had become increasingly complex and involved entities owned and operated by various levels of government as well as diverse forms of property.⁷²

Fourth, the subsidiary enterprises struggled to find ways to employ surplus parts of the workforce that had been 'peeled off' during the restructuring process. Companies' productivity tended to be low, due to the burden of social responsibilities and the amount of personnel associated with an oil company – especially in oilfields which were 'big and comprehensive' embarking upon their transformation into 'small and comprehensive' businesses. In 1993 production per employee in CNPC was on average 115.7 tonnes, whereas the international average for companies with a much smaller work force was ten times that ratio, at 1243.5 tonnes.⁷³ Also, the CNPC workforce was unskilled and poorly trained.⁷⁴ Forms of hidden unemployment were recurrent in the big energy companies. In CNPC and Sinopec oilfields, 'diversified operations' enterprises were common in the mid 1990s and represented a large proportion of the workforce.⁷⁵ All in all, when the companies were restructured in 1998, CNPC planned to 'lay off' 250,000 workers, out of its 1.4 million workforce by transferring them to the construction, agriculture, and service sectors. Lay-offs were, however, a thorny issue because they could result in demonstrations and pose a problem for local governments that had to deal with the social unrest and the welfare needs of the newly unemployed. Local governments therefore also became very powerful actors in the restructuring process,⁷⁶ as did local employees of subsidiary fields and refineries.

Relations between CNPC and Sinopec were also tense and coordination efforts were not always fruitful. CNPC followed its own business development strategies and preferred, for example, to allocate oil from the Tarim basin to Sinopec's refineries in Central China, in order to market the oil from the remote Western region, but Sinopec's refineries preferred purchasing oil from nearby fields in the Bohai oil region.⁷⁷

⁷² Steven W. Lewis, 'Privatizing China's State-Owned Oil Companies', op. cit.

⁷³ Gu Guanzi and Li Jiang, 'The new strategy for opening up China's oil industry', op. cit.; According to analysis from the Daqing PAB, China's average productivity was 105.8 tonne per worker. In Xi Jingyan and Wang Yunhai, 'Problems and Prospects for the Development of China's Oil Industry', op. cit., 18–21.

⁷⁴ Zhou Xuqi, 'Solving the Problems for Deeper Reforms in China's Oil Companies', *Petroleum Enterprise Management*, 1995, vol. 3, 26–8. (Chinese)

⁷⁵ For more on asset stripping see Ding X.L. 'The Illicit Asset Stripping of Chinese State Firms', *The China Journal*, No. 43, 2000, 1–28.

⁷⁶ See also Yuelun Liu, 'Public Policy and competition amongst foreign investment projects: a case study of the Daya Bay economic development zone in South China', *Public Administration and Development*, vol. 13, February 1993, 65–80; David M. Lampton, 'A Plum for a Peach: Bargaining, Interest, and Bureaucratic Politics in China', in Kenneth Lieberthal and David Lampton (eds.), 'Bureaucracy, Politics and Decision Making in Post-Mao China', Berkeley: University of California Press, 1992, 43.

⁷⁷ Wang Cailiang, 'Discussing vertical integration in China's oil industry', *Petroleum Enterprise Management*, no. 11, 1997, 16–19; Zhang Kang (ed.), *The Development Strategy of China's Oil and Gas*, op. cit., 487–501.



Figure 4: Map of China's oil infrastructure in the 1990s



Source: *China's Worldwide Quest for Energy Security*, IEA.

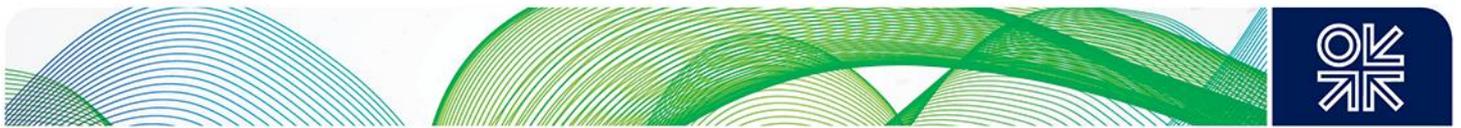
Furthermore, the two-tier pricing system adopted in the 1990s was manipulated by 'oil brokers' who bought oil at government-set prices and sold it at a higher price to small local refineries.⁷⁸ And during the 1990s, CNPC began developing its own refining activities, leading to distortions in the allocation plans as it prioritized supplies to its own refineries over those of Sinopec. Finally, when international oil prices were lower than domestic prices, Sinopec's refineries preferred to purchase oil from the international markets despite import quotas set out by the SPC and the oil allocation plans set out by the headquarters of CNPC and Sinopec. This required frequent negotiations and coordination between CNPC and Sinopec, as well as within each company, between the headquarters and the oilfields or refineries. In the 1990s, as a result of these distortions and due to the state-controlled prices, CNPC's profits rose while Sinopec's stagnated.⁷⁹

The decentralization and market reforms in the economy, combined with constant changes to the bureaucratic setup, diminished the government's monitoring capabilities and incrementally increased the companies' freedom in the marketplace. Classified as 'experimental enterprises', the selected State-Owned Enterprises (SOEs) in the oil industry took advantage of their status and the lax enforcement to pursue initiatives that they thought the government would later recognize anyway.⁸⁰ Thus, approval to set up joint ventures with foreigners was given to CNOOC formally in 1982, but

⁷⁸ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 81–2; Zhang Kang (ed.), *The Development Strategy of China's Oil and Gas*, op. cit., 487–501.

⁷⁹ Philip Andrews-Speed, *Energy Policy and Regulation in the People's Republic of China*, op. cit., 177–9.

⁸⁰ Harry Broadman, 'The Chinese State as Corporate Shareholder', *Finance & Development*, vol. 36, no. 3, September 1999, 52–5.



cooperation began as early as 1981 with CNOOC as a corporation, and as early as 1978 with its ministerial predecessor. CNPC set up its own distribution networks in 1988, even though the formal permission to do so was granted only in the 1990s, and despite formal restrictions on hiring and firing employees, CNPC and Sinopec began doing so, respectively, in 1988 and 1983. So while government was feeling the need to centralize control over its energy companies, the latter were calling for less government intervention in their activities, and for greater autonomy in order to adapt to the new market conditions.⁸¹

In the early 1990s the NOCs were often pushing for greater managerial autonomy and revenues, while competing with each other for market share. They were still, by and large, administrative units, their leaders promoted by the Party's organization department, and they were dependent on the state for financing. They formulated their strategies in line with the broader macroeconomic goals set out by the top economic decision makers, but they devised discrete strategies to promote their corporate interests. Their political clout and access to decision makers allowed them to lobby government units directly and gain support for their priorities and initiatives.

4. Going out for oil and gas

China's first steps in international oil and gas ventures, between 1991 and 1997, provides some interesting insights on the relations between the industry and government regulators. The first overseas investments were introductory and exploratory, as Chinese leaders regarded outbound investments with caution. But a number of converging interests allowed the NOCs to make their first steps on the international markets: first, Chinese state oil enterprises had accumulated technical know-how from their joint ventures with Western partners since the 1970s, and by the 1990s they felt sufficiently confident of their expertise to begin offering it to the international oil industry;⁸² second, successful Overseas Direct Investment (ODI) experiences in other sectors throughout the 1980s, combined with Zhu Rongji's⁸³ bid to reform China's SOEs and make them more competitive internationally, helped the NOCs secure approval from the highest party ranks for its initial global forays. Finally, after several successful deals overseas, starting in the mid 1990s, China's growing need for oil and gas, together with the growing perception that oil shortages were a strategic vulnerability, created greater government support for overseas acquisitions.⁸⁴

CNPC began developing its overseas investment strategy as early as 1991. The company's initial overseas activities were limited since CNPC lacked funding and experience in overseas exploration and production. Furthermore, because CNPC's Exploration and Production (E&P) funds were insufficient even for domestic oil development, when it decided to expand overseas, the company originally planned to allocate no more than 3 to 4 per cent of its E&P funds for this endeavour. These initial activities overseas, in smaller projects and in enhanced oil recovery (EOR), were referred to by a CNPC official as 'tiny eggs laid by a giant hen'.⁸⁵

In its first overseas project, in 1991, CNPC participated in an UN-sponsored oil sand development project in Canada and subsequently purchased 22 million cubic metres of asphalt in North Twining oilfield in Alberta in 1993. The following year, this field produced the first barrel of overseas crude in

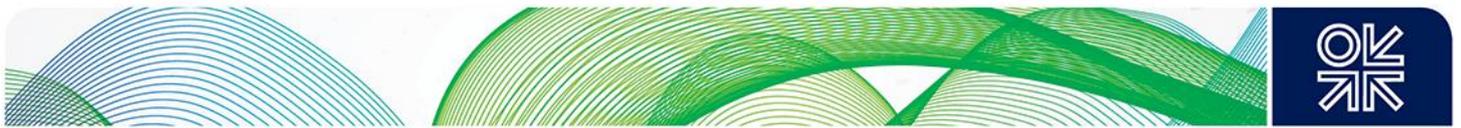
⁸¹ Gu Guanzi and Li Jiang, 'The new strategy for opening up China's oil industry', op. cit.; Wang Fengchen, 'The difficulties and policies for Chinese oil companies entering the market', op. cit.; Zhou Xuqi, 'Solving the problems for deeper reforms in China's oil companies', op cit.

⁸² Peng Qing, 'Chinese Oil Industry's Foreign Investments', *Chinese Investment and Construction*, 1997, vol. 12, 45–6. (Chinese)

⁸³ In successive official positions: director of the SETC in 1991–3, vice premier of the State Council 1993–8, and then premier.

⁸⁴ Qiang Ding, Michèle E.M. Akoorie, Kathryn Pavlovich, 'Going International: The Experience of Chinese Companies' *International Business Research*, Vol. 2, no. 2, April 2009, pp. 148-152.; Deng Ping, 'Outward Investment by Chinese MNCs: Motivations and Implications', *Business Horizons*, Vol. 47, Issue 3, May-June 2004, 8-16..

⁸⁵ Gaye Christoffersen, 'China's Intentions for Russian and Central Asian Oil and Gas', op. cit.; Xu Xiaojie, *Chinese NOCs' Overseas Strategies: Background, comparison and remarks*, Houston: James A. Baker III Institute for Public Policy of Rice University, 2007.



China's history. The company then signed a production-sharing contract for the Banya block in Thailand, successfully bid to improve oil recovery at the Talara block in Peru, and signed an agreement to explore for oil in central Papua New Guinea in 1994.

Although the initial burst of activity resulted in asset acquisition and subsequently in the production of equity oil, the Chinese government was still reluctant to yield greater autonomy to CNPC in financing and regulatory approval, as some officials in the industry had hoped. In corporate quarters, advocates of increased foreign E&P lobbied for a simplification of approval procedures, arguing that the lengthy approval processes led them to miss opportunities.⁸⁶ They also urged the government to give favourable tax treatment to foreign projects, in order to offset any potential financial losses incurred on overseas exploration projects. But others within CNPC, most notably its chairman Wang Tao, preferred to focus funds on domestic exploration.⁸⁷

However, once the ball of overseas investments was rolling it was hard to stop it, especially since CNPC's foreign E&P campaign escaped, at times, the company's own central management. The subsidiaries and affiliate companies initiated deals independently of Beijing. High-ranking officials in some of the overseas subsidiaries maintained close relationships with domestic oilfields, which prompted them to take initiatives without consulting the company's headquarters.⁸⁸ In 1993, Daqing Oil Corporation signed an agreement with the administration of the West Siberian Tyumen region to participate in development of the Tyumen oil basin, for which it would receive 2 Mt/y (40 thousand b/d) of Tyumen crude oil to be processed at the Daqing Refinery – but the deal was signed without approval from Beijing.

CNPC's initial forays laid, however, the groundwork for other Chinese firms to gain approval for overseas investments. In 1993, CNOOC acquired a 32.58 per cent interest in an Indonesian block in the Straits of Malacca, followed by an additional 6.93 per cent interest in 1995, thereby making it the majority shareholder.⁸⁹

That same year, CNPC became involved in the Sudanese oil industry. In September 1995, Sudan's President Omar al-Bashir visited China to discuss potential cooperation in trade and energy, while CNPC conducted its preliminary study of Sudan and concluded that the fields in question were similar in their geology to China's Bohai Bay region. To support CNPC's business in Sudan, the Chinese government signed a framework agreement in September 1995, under which China would provide preferential credit of RMB1.15 billion for oil exploration projects in Sudan, to be used by Chinese companies, under the supervision of the Sudanese Central Bank. The Sudanese government agreed to give China generous concession terms, such as allowing profit repatriations with no restrictions, and exemptions from all domestic taxes on exported oil.⁹⁰

These overtures in Foreign Direct Investments (FDIs) provided some important lessons for the NOCs in managerial autonomy, both vis-à-vis the government and each other. While party leaders had reservations about both the contribution and necessity of ODI, once the first projects had been approved and implemented and showed no signs of negatively impacting China's economic growth or international image, they were allowed to continue.

Yet these investments were not carried out under the banner of energy security, or with explicit promises to deliver oil to China. Moreover, even though China became a net oil importer in 1993, this

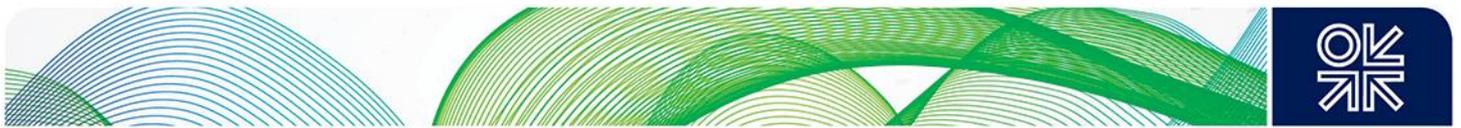
⁸⁶ Gaye Christoffersen, 'China's Intentions for Russian and Central Asian Oil and Gas', op. cit.

⁸⁷ Zhang Sunying and Lan Guangzhi. 'A few problems worth discussing in the development of China's Oil Industry', *Petroleum University Journal*, 1994, vol. 1 (Chinese)

⁸⁸ 'China Stepping Up Foreign E&P Investment as Oil Imports Soar', *The Oil and Gas Journal*, 9 May 1994, Factiva.

⁸⁹ Zhang Yirong, 'China Quickens Its Pace of Overseas Oil Operation', *China Oil & Gas*, Vol. 4, No. 3, September 1997, 174; Chen Shaofeng, 'Motivations behind China's Foreign Oil Quest: A Perspective from the Chinese Government and the Oil Companies', *Journal of Chinese Political Science*, vol. 13, no. 1, 2008, 79–104; Hong, Eunsuk and Sun, Laixiang, Dynamics of Internationalization and Outward Investment: Chinese Corporations' Strategies. *The China Quarterly*. Vol. 187, Sep 2006, 610–634

⁹⁰ Hong Zhao, 'China's Oil Venture in Africa', *East Asia*, no. 24, 2007, 399–415.



had not been foreseen by the government or the companies. Most (published) estimates of China's future oil demand and supplies carried out by different ministries, or by the companies themselves, had not foreseen the amount of imports the country would need only a few years later. While most of them estimated that China would become a crude oil importer in 1995 or 1996 and that the country's production would begin to peak in 2000, they also estimated that the amount of imports required would be around 10 Mt (0.2 mb/d) at that time, climbing to 30–40 Mt (0.60-0.80 mb/d) in 2010.⁹¹ They were widely off the mark, as China imported 240 Mt (4.8 mb/d) of oil in 2010.

4.1 Inklings of dependence on imported oil

Most analyses and assessments were carried out by CNPC and CNOOC at the request of the Ministry of Geology and Mineral Resources.⁹² These analyses concluded that China's production was set to peak within the next decade and highlighted the inadequacy of investments and pricing mechanisms in the energy sector, as well as the need for improvements to refining facilities, so that Chinese refiners would be able to process crudes from different sources.⁹³ Most analysts and stakeholders recommended increasing domestic production ('Stabilizing the East and developing the West'),⁹⁴ focusing on offshore exploration, introducing foreign funding and technology for this endeavour, and developing China's gas market. They also stressed the need for energy conservation and greater efficiency.⁹⁵

Chinese planners therefore moved to introduce more foreign participation, beyond the initial projects offered in 1985.⁹⁶ The government set up rounds of international bidding for those wishing to participate in exploration in Western China and in order to make the deals more economically viable, planners in Beijing announced a gradual rise in crude oil prices.⁹⁷

But other voices began focusing on China's rapidly rising import requirements. By the mid-1990s, academic analyses as well as conferences held by CNPC, Sinopec, and the Ministry of Geology and Mineral Resources suggested that China should diversify its import sources and transit routes, and adapt its domestic markets to the reality of increased reliance on imports in years to come – this would include readjusting the existing import facilities and setting up new infrastructure such as tankers, ports, pipelines, and refineries.

In 1993, Wang Tao, president of CNPC, explained the rationale behind going overseas, in terms of a window of opportunity that had opened up for China: the initial experience of cooperation with foreign companies had been fruitful, and concerted diplomatic efforts were all creating a 'good environment for developing overseas oil cooperation'.⁹⁸ With the disintegration of the USSR and China's improving ties with Central Asian states, Chinese oil companies could and should, argued Wang Tao, pursue energy deals and take advantage of the Central Asian states' desire to diversify their oil trade to new partners. Moreover, declining production in south-east Asia was providing new opportunities for

⁹¹ Ni Jianmin, *National Energy Security Report*, Beijing: People's Publisher, 2005 (Chinese), 315–21; 'China Stepping Up Foreign E&P Investment as Imports Soar', *Oil & Gas Journal*, 9 May 1994, 58; Zhang Yirong, 'China Quickens Its Pace of Overseas Oil Operation', op. cit.

⁹² Zhang Kang et al., *The Development Strategy of China's Oil and Gas*, op. cit., 11–14; Survey of China – Big Shake Up Under Way, *Financial Times*, 18 November 1993; Ni Jianmin, *National Energy Security Report*, op. cit.; Men Kepei and Zhou Daqiang, 'Research Concerning China's Oil and Gas Forecasting', *International Petroleum Economics*, no. 1, 1995, 12–15 (Chinese); Ma Hong 'Liberalizing and widening the reform and development of China's oil industry', *Oil company management*, no. 5, 1995, 3–7; Wu Jingyan, 'Discussion on a few questions related to the development of China's gas industry', *University of Petroleum journal*, no. 1, 1993, 6–8 (Chinese).

⁹³ Xi Jingyan and Wang Yunhai, 'Problems and prospects for the development of China's oil industry', op. cit.

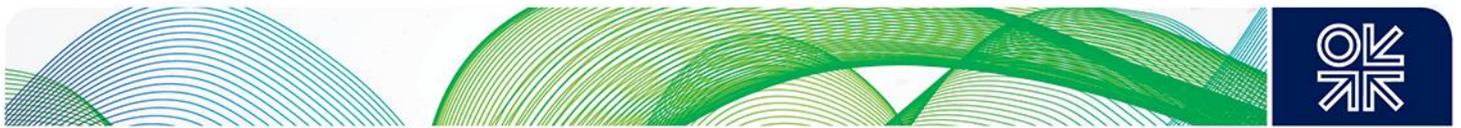
⁹⁴ Li Yongzeng, 'Broad prospects for China's oil industry', *Outlook*, 1991, no. 1;.

⁹⁵ 'Survey of China – Big Shake Up Under Way', *Financial Times*, 18 November 1993; Hu Zepeng, Shi Zhaofu, and Cai Fu'an, 'New thoughts on China's future oil demand and its socio-economic development', *University of Petroleum Journal*, no.1, 1990, 11–17 (Chinese)

⁹⁶ Steven Mufson and Steve Coll, 'China Offers Its Oil Riches on Open Market', op. cit.

⁹⁷ 'China to Lift Oil Price Controls', *Xinhua*, 25 August 1993; Carl Goldstein, 'Not So Slick: Beijing faces tough choices on oil policy', *Far Eastern Economic Review*, 7 April 1994, Factiva.

⁹⁸ Wang Tao, *The Development Strategy of China's Oil and Gas*, op. cit., 149.



cooperation in developing new sources. Finally, tight supply in China meant that overseas oil could alleviate the shortage. The objectives of foreign cooperation, according to Wang Tao, were to enhance the skills of Chinese oil company employees, help China implement a global strategy by familiarizing itself gradually with global trends and new technologies, acquire resources, capture a share of the international market, and build up CNPC's image and reputation abroad. At the same time, Wang Tao was clearly cognizant of the need to appeal to a political audience and suggested that closer commercial ties with these energy producers would also contribute to fostering closer political ties. Indeed, Wang Tao asserted that 'in the face of foreign counterparts, we have not only a commercial hat, but also a political hat'.⁹⁹

On the commercial front, the entry of foreign capital and know-how into the Chinese market was having a beneficial impact on the companies' overall technological level. Going overseas also allowed the NOCs to develop their labour services and gain more engineering contracts, expand their market shares, and develop international commerce – thereby offsetting the pressure of domestic excess labour.¹⁰⁰ Moreover, further overseas acquisitions were important for distancing corporate activities from government scrutiny. The NOCs complained that government cadres, whose thinking and mentality was accustomed to the planned economy, remained an impediment to transnational operations and globalization.¹⁰¹ The president of the China National Petrochemical Corporation (Sinopec), Sheng Huaren, also said in 1993 that China's petrochemical industry should be formed into enterprise groups that would carry out transnational operations, a joint-stock system, and diversification. These transnational corporations needed to be freed from the restrictions of the planned economy, with decision-making fully delegated to them in order to operate in world markets. Such ideas resonated clearly with the priorities of Vice-Premier Zhu Rongji – who was quickly becoming highly influential in economic decision-making. Sinopec also wanted to increase its autonomy in overseas activities and acquisitions, in order to free itself from CNPC's monopoly on crude oil pricing and to squeeze its rival Sinochem out of the trading and refining business.¹⁰²

In 1993, CNPC had already purchased oilfields in Canada and Peru, and had bid on projects in India, Russia, Papua New Guinea, Indonesia, and Venezuela (not all successfully). In 1995 the corporation also considered projects in Thailand, Mongolia, the USA, and Pakistan.¹⁰³ CNPC signed an agreement with the Japanese corporation Marubeni for downstream joint ventures in third countries such as Uzbekistan. During the next big wave of outbound investments (1997–2002), CNPC had already gained more global experience and had become more powerful domestically. The company, alongside its domestic peers, were starting to formulate a clearer industrial and commercial agenda – tantamount to their views of the future of the Chinese oil industry.

4.2 The outbound push gains momentum ...

The mainstream assessment in China was that new oil production should focus on China's western provinces and offshore oil, but the 'going out' strategy had also been clearly integrated into the discourse. And following a sudden spike of Chinese crude oil imports in 1996, CNPC was able to argue more convincingly that overseas equity could contribute to China's energy security. Moreover, the new CNPC president, Zhou Yongkang who took over from Wang Tao in January 1997, believed that the country (and the company) should not pin its hopes on the Tarim basin and should seek overseas oil and gas more aggressively.¹⁰⁴

⁹⁹ Wang Tao, *The Development Strategy of China's Oil and Gas*, op. cit., 151.

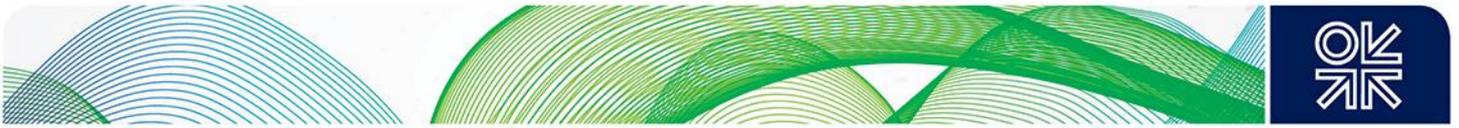
¹⁰⁰ Zhang Yirong, 'China Quickens Its Pace of Overseas Oil Operation', op. cit.; Robert Tansey, 'Who's Who in China's Oil Industry', *China Business Review*, 1 July 1994.

¹⁰¹ Gaye Christoffersen, 'China's Intentions for Russian and Central Asian Oil and Gas', op. cit.

¹⁰² 'Unipecc is only a transition, Sinopec official says', *Reuters News*, 14 September 1993; Wang Cailiang, 'Discussing vertical integration in China's oil industry', op. cit., 16–19.

¹⁰³ 'CNPC: innocent abroad?', *China Oil, Gas & Petrochemicals*, 15 September, 1995, 8–9.

¹⁰⁴ Giles Hewitt, 'Chinese oil industry shifts overseas strategy', *Agence France Presse*, 25 September 1997. Zhou had also been commander of the Tarim oil exploration campaign headquarters between 1988 and 1996.



CNPC began to expand its global outreach, but first the company leadership sought to consolidate internally. Frustrated by the lack of internal discipline within the company and the fact that subsidiaries 'bid for overseas projects separately, sometimes against each other, resulting in a waste of our financial resources',¹⁰⁵ CNPC decided to impose a centralized authority for overseas project evaluation, negotiations, and contracts. CNPC stripped oilfields and other subsidiaries of their ability to engage in independent overseas acquisitions and empowered the China National Oil Development Corporation (CNODC) – the entity designated to oversee onshore oil cooperation with foreigners in China – to organize, coordinate, and lead the company's overseas expansion. When CNODC secured acreage abroad, it organized an internal bidding among CNPC subsidiaries for the project. CNODC created representations all over the world including CNPC Canada, CNPC Central Asia Co., CNPC Asia–Pacific Ltd., MC-CNPC Oil (Hong Kong) Ltd., CNPC Latin America Ltd., etc. In 1997 CNODC was officially designated as the 'only window through which CNPC subsidiaries can participate in overseas upstream projects.'¹⁰⁶ This reorganization also benefitted Zhou Yongkang's family and allies, and spawned a web of corrupt activities that would be uncovered only decades later (see below).

While CNPC recentralized authority over subsidiaries, it also demanded and received more financial autonomy from the government, as well as increased decision-making authority for its overseas investments. CNPC wanted to be able to move more quickly to take advantage of market opportunities as they occurred.¹⁰⁷ CNPC therefore simultaneously sought to strengthen corporate discipline internally, and its corporate autonomy internationally.

In terms of financial autonomy, the State Council gradually came to realize that decades of underpricing had impoverished CNPC and hampered its domestic E&P. Domestic prices would need to be increased in order to allow firms to make more profits that they would then be able to reinvest in E&P. The State Council therefore ordered a gradual increase in the state-allocated price for crude. In 1996 prices were raised, leading CNPC to report RMB6.5 billion in profits. CNPC knew that they would have to invest the profits quickly, or they would be absorbed by government taxation.¹⁰⁸ To invest these windfall profits domestically would take time and yield uncertain results. The Energy Research Institute of the SPC advocated investing overseas, even if this meant delaying the development of domestic reserves, since they were already limited. What is more, the international oil industry offered better prospects for an immediate increase in petroleum supply.

At the same time, the increase in crude prices was detrimental for Sinopec's profit margin, since the company bought crude oil from CNPC but could not pass along the increased costs to consumers. While Sinopec's strategic focus was on downstream and upgrading its refining business, it too saw an opening in tapping into overseas markets. Wang Jiming, vice president of Sinopec, stated that the company's aim was to build:

... larger crude oil transportation and storage facilities as soon as possible for the preparation of building several sour crude processing bases with the capacity of 10 million tonnes a year by the end of this century and the beginning of the next.

He said the company hoped

... to establish close co-operative relationships with large crude oil producers as well as to co-operate with companies with the advanced sour crude processing technology'.¹⁰⁹

It took Sinopec a number of years, however, before it could conclude its first overseas investment deal.

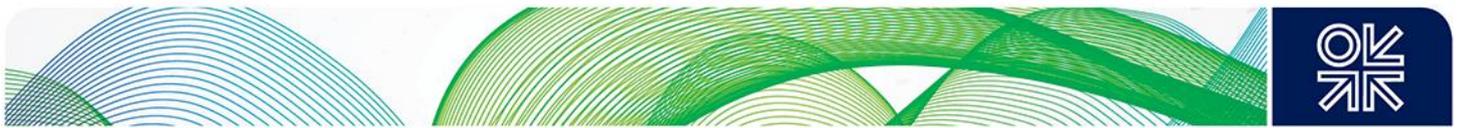
¹⁰⁵ 'CNPC Moves a Step Closer to Globalization', *China Oil, Gas & Petrochemicals*, vol. 5, no. 13 (1 July 1997), 1–3.

¹⁰⁶ Gaye Christoffersen, 'China's Intentions for Russian and Central Asian Oil and Gas', op. cit.

¹⁰⁷ Bo Kong, *China's International Petroleum Policy*, op. cit.

¹⁰⁸ Author's interview in Beijing with energy and foreign policy analyst, January 2006.

¹⁰⁹ 'China expanding refining and petchem industry increases imports', *Alexander Oil and Gas Connection*, Volume 2, issue 28, 22 December 1997.



In 1997, CNPC remained best placed among the NOCs to shore up support for overseas investments and raise its strategic priorities onto the national agenda, since it was routinely consulted by the government on policy matters. In 1997, for example, CNPC was asked to undertake a study on national oil security.¹¹⁰ The report included the need to secure overseas sources of oil, thereby paving the way for the idea of 'going out' gradually becoming a mainstream notion that would also be encouraged by senior leaders.

The nature of the deals evolved during this second bout of outbound acquisitions: projects were no longer restricted to enhanced oil recovery or small exploration, just as returns on investments had become a more important factor in the equation. In the space of a few months in 1997, CNPC pledged over \$8 billion for oil concessions in Kazakhstan, Venezuela, Iraq, and Sudan – four countries that had existing exploration rights tender rounds and where CNPC stood a good chance of winning acreage quickly.¹¹¹

In June 1997, CNPC acquired a 60 per cent share in Kazakhstan's Aktyubinsk munaigaz Production Association, which had combined recoverable reserves of 1 billion barrels. CNPC pledged to invest \$4.3 billion over a 20-year period, including \$585 million between 1998 and 2003.¹¹² The company also agreed to guarantee the pensions and housing of some 5000 employees, service Aktyubinsk munaigaz's debts of \$71 million, invest \$10 million in environmental protection measures, and pay royalties to the government of Kazakhstan. The key to CNPC's success in outbidding its international oil company (IOC) peers – Texaco, Amoco, and Russia's Yujnimos – for the tender were two offers the other companies could not match: CNPC agreed to pay up-front a \$320 million bonus to the cash-strapped Kazakh government and to conduct a feasibility study on the construction of an 1800 mile pipeline from the Aktyubinsk fields to western China, estimated to cost \$3.5 billion, which would provide Kazakhstan with a non-Russian export line.

In September 1997, CNPC outbid Petronas, Unocal, and Amoco to win a controlling interest in Uzen, Kazakhstan's second largest oilfield, with reserves of 1.5 billion barrels. In this deal, CNPC paid an up-front bonus of \$52 million in addition to an immediate investment of \$400 million. CNPC also agreed to pay eight per cent of its net profits in royalties to the Kazakh government, assume Uzen's \$6 million debt, invest \$10 million in training programmes for oil technicians, and provide \$27 million in social services as well as invest in a pipeline from Uzen to the Aktyubinsk fields.¹¹³ CNPC similarly outbid larger oil companies for two marginal fields in Venezuela in June 1997. The company acquired the Caracoles field for \$241 million and the Intercampo unit for \$118 million.¹¹⁴

In March 1997, the 1995 negotiations in Sudan finally materialized and CNPC formally acquired the 40 per cent stake in the Greater Nile Petroleum Operating Company (GNPOC) consortium to explore for oil in Sudan's Heglig and Unity fields and construct a 940 mile pipeline from the fields to Marsa al-Bashair, a terminal located near Port Sudan on the Red Sea. CNPC's partners in this venture were Malaysia's state-owned company, Petronas (30 per cent); the National Oil Company of Sudan (5 per cent); and the Canadian firm Talisman Energy Company (25 per cent).¹¹⁵ The pipeline was

¹¹⁰ Erica Downs, 'The Chinese Energy Security Debate', *The China Quarterly*, no. 177, 2004, 21–42.

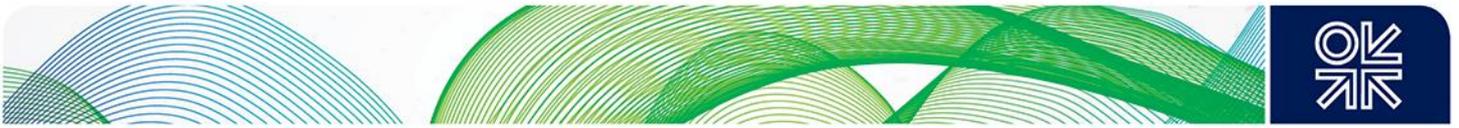
¹¹¹ Xu Xiaojie, *Chinese NOCs' Overseas Strategies: Background, comparison and remarks* op. cit.; Erica Downs, *China's Quest for Energy Security*, op. cit.

¹¹² Philip Andrews-Speed, Xuanli Liao, and Roland Dannreuther, *The Strategic Implications of China's Energy Needs*, London: International Institute for Strategic Studies, 2002. (Adelphi Papers; 346); 'Motivations behind China's Foreign Oil Quest: A Perspective from the Chinese Government and the Oil Companies', *Journal of Chinese Political Science*, 2008, vol. 13, no. 1, 79–104.

¹¹³ Ahmed Rashid and Trish Saywell, 'Beijing Gusher, China Pays Hugely to Bag Energy Supplies Abroad', *Far Eastern Economic Review*, 26 February 1998, 48; Sharon Behn, 'CNPC Deal Tops \$4 Billion', *Platt's Oilgram News*, Vol. 75, No. 108, 5 June 1997, 1; Philip Andrews-Speed and Sergei Vinogradov, 'China's involvement in Central Asian petroleum: convergent or divergent interests?', *Asian Survey* XL no. 2, 2000, 377–97.

¹¹⁴ Jane Knight, 'The Bids Aren't Marginal on Day 2 in Venezuela', *Platt's Oilgram News*, Vol. 75, No. 107, 1; David Holley, 'China's Thirst for Oil Fuels Competition', *Los Angeles Times*, 28 July 1997, 1.

¹¹⁵ 'Sudan Deal Signed by Arakis, Government, and Partners', *Platt's Oilgram News*, Vol. 75, No. 43, 4 March 1997, 1. The Talisman Energy Company of Canada acquired Arakis in March 1998.



constructed between May 1998 and May 1999, with 70 per cent of the work done by the CNPC-owned China Petroleum Engineering and Construction Corporation. In August 1999, the first tanker from China's concession left Sudan with 80,000 tonnes of crude oil bound for Singapore. CNPC also assisted in the construction of a 50,000 b/d refinery near Khartoum, which became operational in mid-2000, using crude from the GNPOC pipeline.¹¹⁶

Finally, in June 1997, a consortium of Chinese oil companies represented by CNPC and China North Industries Corporation (NORINCO), signed a 22 year production-sharing contract with Iraq to develop half of the al-Ahdab field, after UN sanctions on Baghdad were lifted. CNPC also negotiated rights to develop three other Iraqi oilfields – Halfaya, Luhais, and Suba – and to explore the remote Western Desert.¹¹⁷

Thus, in the space of three weeks in June 1997, CNPC cut deals with Kazakhstan, Venezuela, and Iraq that totalled \$5.6 billion. Investment in Kazakhstan reached \$9 billion by September. The company's overseas acquisitions became bolder, more ambitious, and more costly. A departure from its timid beginnings, China's willingness to venture out was brought on by a number of factors related to national priorities, corporate strategies, and the international environment.

Yet shortly after this second round of acquisitions, substantial changes took place in the domestic energy sector leading to a four year lull in overseas investments. The fall in global oil prices following the Asian financial crisis also dampened the NOC's enthusiasm for overseas acquisitions and changed the government's attitude toward outbound investments. At \$9–10 per barrel, government officials argued that buying oil directly from the market was cheaper than producing abroad and then shipping it back to China.¹¹⁸ This informed caution within the companies, and CNPC pulled out of the \$400 million deal for developing the Uzen oilfield in Kazakhstan in 1999. (The government of Kazakhstan had been reluctant to give CNPC permission to develop Uzen until they had committed to building the 3,277 km trans-Kazakhstan oil pipeline¹¹⁹ but CNPC feared that there would not be enough crude available to make the pipeline investment worthwhile,¹²⁰ leading CNPC to shelve the project.) At the same time, CNPC's overpayment on the Kazakhstan and Venezuelan deals¹²¹ prompted a reassessment within CNPC, since the amount invested was significantly higher than the value of actual production, especially as global oil prices collapsed. CNPC's vice president for international business consequently decided to prioritize production from a number of targeted assets¹²² rather than additional acquisitions. But it was mainly the upcoming changes to its domestic energy industry, ahead of China entering the World Trade Organization (WTO) in 2001 that diverted the NOCs' attention from their overseas forays.

5. 1998: Ministerial reshuffles benefit the NOCs

In March 1998, the government announced a radical reorganization and streamlining of government agencies, as well as a restructuring of certain state companies. The number of ministries and

¹¹⁶ 'Sudan Pipeline Operational', *Petroleum Economist*, 26 August 1999, 15; 'China Exports Oil from Sudan Project', www.chinaonline.com, 3 September 1999; Hong Zhao, 'China's Oil Venture in Africa', op. cit.; Sudan, Energy Information Administration; Linda Jakobson, Zha Daojiong, 'China and the Worldwide Search for Oil Security', *Asia Pacific Review*, vol. 13 no. 2, 2006, 60–73.

¹¹⁷ Hassan Hafidh, 'Iraq and China Sign \$1.2 Billion Oil Contract', Reuters World Service, 4 June 1997; Winnie Lee, 'CNPC's Spree Looks to Fill Supply Gap', *Platt's Oilgram News*, Vol. 75, No. 165, 26 August 1997, 1.

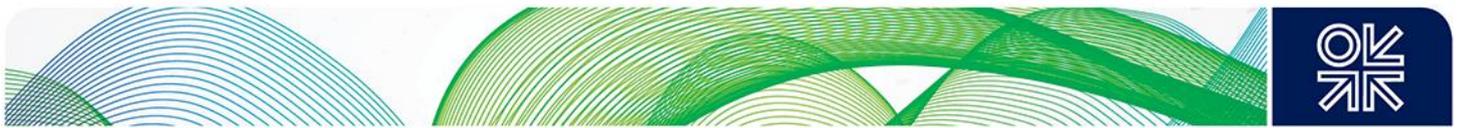
¹¹⁸ Keun-Wook Paik, Valerie Marcel, Glada Lahn, John V. Mitchell, and Erkin Adylov, *Trends in Asian NOC Investments Abroad*, Chatham House Working Background Paper, March 2007.

¹¹⁹ 'Global strategies – Eurasia – Russia and China's interests in the Middle East and Caspian', *Petroleum Review*, 12 June 1998.

¹²⁰ Xu Yihe, 'China–Kazakhstan Pipeline Plan Stalled On Lack Of Crude', *Dow Jones Newswires*, 23 August 1999.

¹²¹ China offered 30 percent more than its nearest rival for Uzen, and double for its investment in Venezuela according to Ahmed Rashid, Trish Saywell, 'Beijing Gusher: China pays hugely to bag energy supplies abroad', op. cit.

¹²² Keun-Wook Paik, et al., *Trends in Asian NOC Investments Abroad*, op. cit.



commissions under the State Council was reduced from 40 to 29¹²³ in a bid to reduce government expenditure; to streamline, simplify, and further centralize control. An additional goal was to separate the commercial operators from policy makers and regulators.¹²⁴

In the energy sector, the Ministries of Power and of Coal were abolished, and the revamped State Economic and Trade Commission (SETC) retained the operational oversight of the energy industry. One bureau within the SETC was appointed to manage the oil and petrochemical industry and take over the government functions of CNPC and Sinopec. Its main responsibilities included industrial planning, devising overall strategies for the oil and petrochemical industries, and promoting the ongoing restructuring of the 7,500 state-owned enterprises under CNPC and Sinopec.¹²⁵ But the bureau had neither the political clout nor the manpower to effectively regulate the petroleum industry, as it was outranked by the NOCs and often deferred to their expertise on technical policy issues. At the same time, the SPC – renamed State Development and Planning Commission (SDPC) in 1998 – retained authority for planning, for investment approval, and for pricing. It formulated medium- and long-term plans and allocated resources for sectoral development including electric power, coal, and energy conservation.

But the ambition to separate government and corporate functions was thwarted by the fact that the SETC staff was largely drawn from the state energy industries. Both the SETC and the newly created Ministry of Land and Natural Resources (MLNR, discussed below) were headed by former industry executives. As a result, they retained close links to the industries from which they had come. Furthermore, the restructuring involved reducing the number of government officials in the ministries, so policy makers relied increasingly on the energy corporations for professional staff. In later years, for example, employees from Sinopec were involved in drafting China's strategic oil reserves law because they had the most technical knowledge in this area. Thus, though government was slightly less involved in enterprise management, it was now beholden to its corporate entities on professional matters and the companies were far from removed from policy making and regulation. The SETC was also undermined by the SDPC, which secured the role of long-term policy formulation, and by the industrial associations that acted as the *de facto* link between government and industry.

Several other ministries were influential in the energy sector. The Ministry of Land and Natural Resources (MLNR), established in 1998, combined four former ministries: the Ministry of Geology and Mineral Resources, the State Land Administration, the State Oceanic Administration, and the State Bureau of Surveying and Mapping. The MLNR oversaw planning, management, protection, and sustainable use of all natural resources including land, mineral (coal, oil, and gas), and oceanic resources and was headed by Zhou Yongkang, former president of CNPC (1996–8).¹²⁶

In this administrative fragmentation, the NOCs – holding ministerial rank – enjoyed considerable power as agenda setters and as information providers for the government. More importantly, however, in the power vacuum that emerged from the bureaucratic infighting between the SETC and the SDPC, the NOCs promoted their interests without having to answer to a single formal administrative authority. They wielded political influence, however, not just because of their rank but also because they were large employers, and the central government's 'cash cows'¹²⁷ through a combination of favourable price subsidies and tax policies. While they were still bound to the government and the Party, they were far from pawns of the government. At the same time, there were still significant ties binding state-owned firms to the Party–State: the NOCs' ministerial-level ranking also entailed political responsibilities. At the end of a successful career in industry, SOE managers

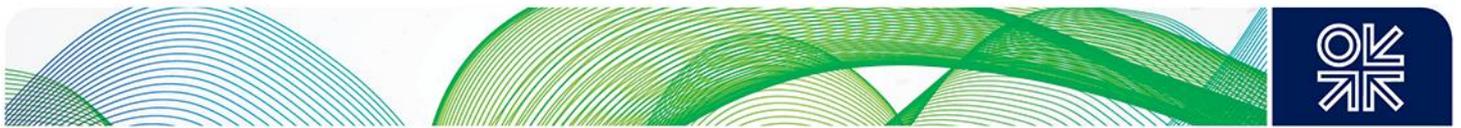
¹²³ Kjeld Erik Brødsgaard, 'Institutional Reform and the *Bianzhi* System in China', *The China Quarterly*, no. 170, June 2002, 361–86.

¹²⁴ Philip Andrews-Speed, *Energy Policy and Regulation in the People's Republic of China*, op. cit., 169–83; Zhao Jimin, *Reform of China's Energy Institutions and Policies: Historical Evolution and Current Challenges*, op. cit.

¹²⁵ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 102–4.

¹²⁶ Philip Andrews-Speed, *Energy Policy and Regulation in the People's Republic of China*, op. cit. 176–7.

¹²⁷ Barry Naughton, *Growing Out of the Plan, Chinese Economic Reform, 1978-1993*, New York: Cambridge University Press, 1995.



could look forward to a career in politics and knew that the assessment of their tenure at the companies would include both political and commercial objectives.¹²⁸ Moreover, the leaders of the large SOEs (managers, deputy managers, and of course secretaries and deputy secretaries of the party core groups in the SOEs) were designated and approved by the Party's Organization Department.

The existing state of play created a number of structural deficiencies: the subsidies and tax policies shielded China's NOCs from competitive pressure and their low rates of return on capital investment led to losses in most of them. This, in turn, increased debts to banks and resulted in a decline in revenues and tax handed over to the government. Chinese analysts at the time pointed out that the state-directed pricing system was impeding further market reforms, as were the recurrent 'bail-outs' of companies and the 'consistently biased support from the government';¹²⁹ NOCs were also performing many non-core duties and were therefore staffed with unskilled personnel, and were being weighed down by the social responsibilities they still had to undertake.¹³⁰

Despite the government's declared ambition to make companies more autonomous, it was still manipulating prices and costs in the sector. Moreover, price distortions and the lack of financing avenues meant that most companies were in the red.¹³¹ Upstream and downstream companies were therefore competing for funding from the government, as well as for a greater say in setting prices. One company's gain in investment capital would be at the cost of another company's resources, even though ultimately, the government was still responsible for all losses incurred.

Zhu Rongji recognized that he would need to strike a balance between centralized government control (in line with his plans to streamline the bureaucracy) and greater managerial autonomy, in a bid to make Chinese industry more competitive ahead of the country's entry into the WTO. China's corporate actors were also advocating a change in the system: by 1997, China's oil and petrochemicals industry was divided into four sub-sectors, with a major company in charge of the core business in each. CNPC and CNOOC were dominant, respectively, in onshore and offshore exploration and production. Sinopec was the main refiner and petrochemical producer, owning more than 90 per cent of China's refining capacity. Sinochem, under the supervision of MOFTEC, had the monopoly over foreign trade, while petroleum sales companies at the provincial level were in charge of retail and distribution in the domestic market. Yet CNPC and Sinopec both had strong ambitions to expand and become competitive throughout the value chain, and each one was lobbying the government to allow it to absorb its rival.¹³²

In 1997, there was a vibrant debate in Beijing regarding the optimal structure for China's oil and gas industry.¹³³ Some advocated the creation of many regional companies that would also compete against each other, while others called for centralized control, preferably under the auspices of one big company.¹³⁴ The NOCs advocated for the latter. Party and government leaders were taking steps to create regional companies, forming China United Eastern Petrochemical Group around four large refineries in Jiangsu province, as well as another group around the Qilu refinery in Shandong

¹²⁸ Erica Downs and Michal Meidan, 'Business and Politics in China: The Oil Executive Reshuffle of 2011', *China Security*, no. 19, September 2012.

¹²⁹ Gu Guanzi and Li Jiang, 'The new strategy for opening up China's oil industry', op. cit., 2.

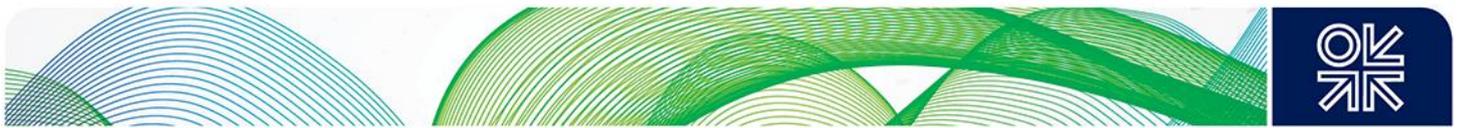
¹³⁰ Wang Cailiang, 'Discussing vertical integration in China's oil industry', op. cit.

¹³¹ Wang Fengchen, 'The difficulties and policies for Chinese oil companies entering the market', op. cit.; Wang Yongfan et al., 'Reorganization in foreign oil industries and China's oil industry reforms', op. cit.; Zhang Yaocang, 'Discussing some relationships in China's oil industry', op. cit. It is interesting to note that the Chinese analyses cited here do not make the case for CNPC's rising profits but merely state distortions due to price controls.

¹³² Wang Cailiang, 'Discussing vertical integration in China's oil industry', op. cit.

¹³³ Zhou Xuqi, 'Solving the problems for deeper reforms in China's oil companies', op. cit.; Steven W. Lewis, 'Privatizing China's State-Owned Oil Companies', op. cit.

¹³⁴ Wang Cailiang, 'Discussing vertical integration in China's oil industry', op. cit.; Wang Cailiang, Looking at China's oil industry reforms from international oil industries structure and organization, *International Petroleum Economics*, vol. 5, no. 4, 1997, pp. 42-47.; Zhou Xuqi, 'Solving the problems for deeper reforms in China's oil companies', op. cit.



province, but both of these were dissolved a year later with the reshuffle of CNPC and Sinopec.¹³⁵ The final structure was a compromise and the State Council decided to create two rivals, hoping this would afford the government greater oversight.

5.1 Restructuring and vertical integration in 1998: the birth of the giants

Ultimately, the objectives of the major restructuring in 1998 were threefold: to separate the functions of government from those of the commercial management of the industrial enterprises, to improve efficiency and enhance the companies' competitiveness, and to regulate the relations between company headquarters and the subordinate units.

Government functions were nominally removed from the state companies and placed with the SETC, while the assets of CNPC and Sinopec were reshuffled to create two regional, vertically integrated companies with responsibilities for the full range of activities from exploration to refining and marketing. CNPC now had a monopoly in 12 provinces in the north and west of the country and therefore received 19 of Sinopec's petrochemical enterprises, 14 of which were engaged in production and five in marketing. The new CNPC was led by Ma Fucai, former CNPC vice president and head of Daqing oilfield. The company had a crude production capacity of 106 Mt per year and a refining capacity of 100.3 Mtpy, with assets of \$58.2 billion.¹³⁶ It was strong in upstream oil and gas and accounted for 74 per cent of the total recoverable oil reserves in China, 67 per cent of onshore crude production capacity, and 40 per cent of refining capacity.¹³⁷

Sinopec gained responsibility for petroleum processing and product distribution in 19 provinces in eastern and southern China. CNPC transferred 12 enterprises to Sinopec since they came under its geographic jurisdiction; these included 11 E&P units and one petrochemical plant. Sinopec had a crude production capacity of 36 Mt per year and refining capacity of 117.9 per year with assets of \$45.9 billion.¹³⁸ Headed by Li Yizhong, former executive vice president of Sinopec, the company now accounted for around 60 per cent of China's total refining capacity and about 30 per cent of the onshore crude production capacity.¹³⁹

Both corporations were granted the right to trade freely and independently in both the domestic and international markets, and were allowed to expand their marketing activities, especially the retail business, into each other's territory. Moreover, they were empowered by the State Council to make their own investment decisions, including forming joint ventures with foreign companies and raising funds to finance growth. They also ran scientific research institutions, information centres, and construction companies, as well as colleges and universities.

The 1998 restructuring was, however, just the first step towards creating more market-oriented companies. The reorganization was intended to prepare the firms for greater competition when China entered the World Trade Organization (WTO), and to promote more effective development of China's oil and petrochemical industries. As Sinopec and CNPC aimed to become globally competitive oil companies, they needed more experience in oil and gas exploration overseas in order to gain expertise, and profits.¹⁴⁰ While 'going out' was a policy option, there were different opinions regarding

¹³⁵ Steven W. Lewis, 'Privatizing China's State-Owned Oil Companies', op. cit.

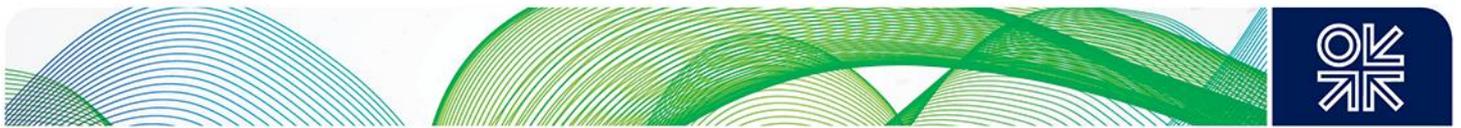
¹³⁶ Sy Yuan and Chen Yi-kun 'An Update on China's Oil Sector Overhaul', *The China Business Review*, Vol. 27, No. 2, March/Apr 2000, 36–43; 39–40; According to Fesharaki and Wu CNPC had crude oil capacity of 83.30 mt/y and refining capacity of 87.8 mt/y In Fereidun Fesharaki and Wu Kang, 'Revitalizing China's Petroleum Industry Through Reorganisation Will It Work?', *The Oil and Gas Journal*, vol 96, no. 32, August 10, 1998, 33–44.

¹³⁷ Jin Zhang *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 102–5.

¹³⁸ According to Sy Yuan and Chen Yi-kun 'An Update on China's Oil Sector Overhaul', op. cit.; 39–40. According to Fesharaki and Wu Sinopec had respectively 59.95 mt/y and 125.24 mt/y.

¹³⁹ Fereidun Fesharaki and Wu Kang, 'Revitalising China's Petroleum Industry Through Reorganisation Will It Work?', op. cit.

¹⁴⁰ The issue of profit making as an incentive for overseas activities was raised by a Chinese analyst of foreign affairs in an interview in Beijing, January 2006.



how best to achieve their goals: investing overseas or partnering with foreign firms and developing domestic resources.¹⁴¹

From 1999 onwards, CNPC and Sinopec implemented an internal restructuring programme in a bid to modernize their corporate structures. The core productive assets for each of the companies (oil and gas exploration and development; storage and transportation; refining and chemicals, marketing; research in exploration and development; engineering, planning, and production maintenance) were separated from the non-core business (which included technical services, diversified business, and social functions). The core business was then grouped together into joint-stock companies intended for international listing. The goal of the initial public offerings (IPOs) was to raise funds for future business development and also to improve management skills within the corporations by forcing them to adhere to strict international guidelines and regulations in accounting and reporting of financial and performance data. The government realized that this would be a necessary step to take in order to compete with multinational companies.¹⁴²

CNOOC, which from its creation in 1982 was smaller and more internationally oriented, was also preparing for the 1998 reforms. Shortly after its creation, CNOOC created four upstream oilfield companies, a sales company, and 10 service companies in order to separate oil production and service companies. In 1998, CNOOC merged its four oilfield companies to create CNOOC Ltd.¹⁴³

In November 1999, CNPC created PetroChina, a joint stock company with limited liability. A few months later, in February 2000, Sinopec Corp. was established on the basis of the core business from Sinopec, which was renamed Sinopec Group. In April 2000, PetroChina was listed on the New York and Hong Kong stock exchanges. The initial public offering (IPO) accounted for 10 per cent of the company's shares and raised a little under \$3 billion from investors which included BP, Amoco, and Hutchinson Whampoa. The remaining 90 per cent were retained by CNPC. In October 2000, Sinopec Corp. was listed in New York, Hong Kong, and London. The IPO accounted for 21 per cent of the company's shares, raising \$3.7 billion. Its main shareholders were ExxonMobil, Shell, BP, and Hutchinson Whampoa. Sinopec Group owned 56 per cent of Sinopec's equity, while a handful of state-owned banks owned an additional 23 per cent. Finally, China Offshore Oil Corporation (CNOOC Ltd.), created in October 1999, was also listed on the Hong Kong and New York stock exchanges, in February 2001. It had considerable advantages over Sinopec and CNPC as it was a smaller company, its personnel was more familiar with Western practices, and the company had fewer liabilities. The value of its assets rose by 62 per cent between 1998 and 2003, twice as fast as the rise in value of CNPC's assets.¹⁴⁴

5.2 Who's in charge? Delineating responsibilities between the government, NOCs and their subsidiaries

At the time of the industrial restructuring, the cost of China's oil production was rising above international levels, due to the lack of investment in research and long-term planning in the industry, and many of the regional oil enterprises continued to make losses despite high domestic and international oil prices. Yet CNPC had very limited ability to spur production, in light of its tenuous relations with its subsidiaries. The government therefore sought to remedy the situation by improving productivity and supporting the NOCs' efforts to recentralize control over their subsidiaries,¹⁴⁵ while introducing more competition into the system. As a result, the 'legal person' status of the regional enterprises was revoked. Subordinate firms were no longer allowed to make investment decisions,

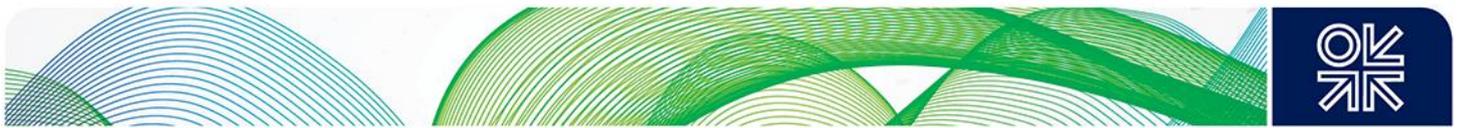
¹⁴¹ An official claiming that China should remain independent for oil and gas until 2010, cited in 'China holds talks with Iraq on oil exploration contracts', *Asia Pulse*, 11 November 1996.

¹⁴² Jiang Binbin, *China National Petroleum Company (CNPC): A Balancing Act Between Enterprise and Government*, Unpublished working paper, January 2008.

¹⁴³ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 102–15.

¹⁴⁴ Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit., 342.

¹⁴⁵ Jiang Binbin, *China National Petroleum Company (CNPC): A Balancing Act Between Enterprise and Government*, op. cit.



sell shares, or operate overseas without seeking approval from headquarters. CNPC also asserted control in product pricing, marketing, and procurement.

At the same time, the asset swaps turned CNPC and Sinopec into competitors. The economies of scale that resulted from the integration of assets strengthened the companies' market position at home and abroad; it improved Sinopec's supply security while allowing CNPC to have direct access to the domestic retail market and to build a brand around refined oil products.¹⁴⁶ Integration also led CNPC and Sinopec to share the benefits from government R&D investments in upstream and downstream technologies. This separation and reintegration into two competitive enterprises also gave each the freedom to determine supply and transportation systems.

But despite the asset reshuffle, each company still maintained a clear advantage in its previous areas of control (upstream for CNPC and downstream for Sinopec). Moreover, the transition was difficult for some of the regional enterprises that had lost their autonomy, and with it their control over management, investment, or production targets. The non-core assets had an even more difficult time after the separation because many were already on the brink of bankruptcy before the separation and were sustained only by cross-subsidy from the profitable oil production enterprises. Subsidies were provided for these companies for three years, until 2002, after which some of them were exposed to market competition.

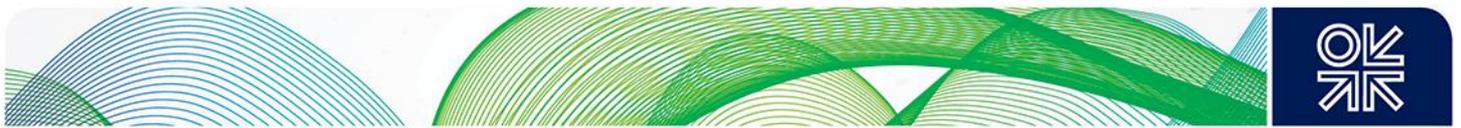
The oil companies and their flagship subsidiaries also had to redefine their respective functions and modes of interaction. Prior to their public offerings, each company had determined a number of functional guidelines: First: CNPC and PetroChina had a non-competition agreement; this stated that as long as CNPC held at least 30 per cent of PetroChina's shares, it would not engage in any business within or outside China that competed with PetroChina's business. Second: when CNPC encountered business opportunities that were in competition with PetroChina, it was obliged to notify PetroChina of them. Third: it agreed to offer any such opportunities to PetroChina on terms and conditions acceptable to PetroChina when possible. Fourth: CNPC granted PetroChina the option to purchase CNPC assets outside China. Fifth: as CNPC retained the non-core business, it committed to continue providing PetroChina with the services it required – such as oilfield construction and technical services, production services, supply materials, and social and financial services. Most of these agreements were designed to provide support to the subordinate company (the companies are referred to as 'mother and child companies'), but as the major controlling shareholder, CNPC also drew its principal income from its 'child' company. In 2000, CNPC received an approximate \$3 billion dollars from PetroChina, accounting for 53 per cent of its net profit. For CNPC, promoting PetroChina made sense as a means of offsetting CNPC's own losses, as it still retained the non-core business and the loss-making social functions.¹⁴⁷

The relationship between Sinopec and Sinopec Group was similar. Two out of ten directors on Sinopec's board were directly affiliated to Sinopec Group, and its chairman was also the President of Sinopec Group. The two companies established a non-competition agreement (like CNPC and PetroChina) and the non-core business in Sinopec Group provided services for Sinopec. Sinopec Group also provided Sinopec's employees with community services including schooling, medical care, and public transport facilities. As with CNPC, Sinopec Group was able to determine Sinopec's dividend payments, in order to help balance out its loss making non-core business, and as the dominant shareholder it now had the authority to intervene in important and strategic managerial issues.¹⁴⁸

¹⁴⁶ Jin Zhang, *Catch-up and Competitiveness in China: The Case of Large Oil Firms in the Oil Industry*, op. cit.; Jiang Binbin, *China National Petroleum Company (CNPC): A Balancing Act Between Enterprise and Government* op. cit.

¹⁴⁷ Jiang Binbin, *China National Petroleum Company (CNPC): A Balancing Act Between Enterprise and Government* op. cit.

¹⁴⁸ Jin Zhang, *Catch-up and Competitiveness in China: The Case of large oil firms in the oil industry*, op. cit., 110–30; Shi Dan (ed.), *Report and Analysis of China's Energy Industry Market Reforms*, op. cit., 337–9; Steven Lewis, *Chinese NOCs and World Energy Markets: CNPC, Sinopec and CNOOC*, Working paper, Houston: James A. Baker III Institute for Public Policy of Rice University, March 2007. Available at <https://bakerinstitute.org/files/3896/>.



Despite these attempts to clarify responsibilities and functions, the operational divide between the parent company and listed subsidiary remained blurred, with the parent company clearly in the driver's seat. The volume and nature of the business transactions between CNPC and PetroChina during the first decade suggest that the two were not separate entities but rather divisions of the same company, separated by technical and legal distinctions.¹⁴⁹ Funds were exchanged between the two companies in a cyclical fashion: the amounts loaned to PetroChina by CNPC were then repaid through purchases of CNPC subsidiaries, with the funds later recycled as loans at a later date. In 2005, PetroChina acquired the refining and petrochemical business of CNPC, and 50 per cent equity interests in CNPC's overseas subsidiary, CNPC Exploration and Development Company.¹⁵⁰ In 2007, CNPC was the largest supplier to, and purchaser of, products and services from PetroChina. In addition, CNPC offered PetroChina much of its financing through its subsidiary CP Finance. These loans, backed by a *de facto* state guarantee, were made on the basis of low interest rates.

Initially, however, CNPC's overseas investments were executed through CNODC rather than through PetroChina.¹⁵¹ PetroChina was primarily focused on domestic oil and gas operations but gradually began expanding its operations overseas. In April 2002, it made its first overseas acquisition, buying six blocks in Indonesia (from Devon Energy Corporations) for \$262 million. It then continued its expansion in Indonesia the following year, acquiring Block Jabung from Amerada Hess Indonesia Holdings Ltd. These initial acquisitions, while confined to the purchase of stakes from third parties in Indonesia, quickly raised the issue of coordination between PetroChina and China National Oil and Gas Exploration and Development Cooperation (CNODC).¹⁵² CNPC and PetroChina subsequently reshuffled their assets: in June 2005 PetroChina acquired 50 per cent of Newco, a subsidiary of CNODC which had oil and gas production assets in Algeria, Kazakhstan, Azerbaijan, Ecuador, Peru, Venezuela, and Indonesia; pipeline assets in Kazakhstan; and refining assets in Algeria, Canada, Kazakhstan, Chad, Ecuador, and Niger. CNODC transferred its remaining stake in Newco to CNPC. Newco became jointly owned by CNPC and PetroChina, expanding PetroChina's foreign ownership substantially.¹⁵³

A similar need for internal coordination arose in Sinopec as well. Even though the company began its overseas expansion in earnest only in 2001, overseas deals were pursued by individual subsidiaries. Sinopec Group established Sinopec International Petroleum Exploration and Production Corporation (SIPC) in January 2001 in order for it to represent Sinopec and all its subsidiaries in overseas deals. Sinopec Group entrusted SIPC with the oversight for overseas expansion, but SIPC contracted specific deals to its oilfields and subsidiaries, which then lost their ability to engage with foreign companies directly. Unlike CNPC, Sinopec determined overseas territories for its subsidiaries, based on geological characteristics and geographic focuses. Offshore activities were allocated to the Shanghai Offshore Petroleum Bureau; Russian offshore assets fell under Shengli, Zhongyuan, and the Northeast Petroleum Bureau. Onshore assets in Central Asia were to be given to Shengli, Jianghai, and the Northwest Petroleum Bureau, while Henan Petroleum Exploration Bureau and the Southwest Petroleum Bureau were designated to cover West Africa. North African assets would also go to Shengli and Zhongyuan. Finally, Middle Eastern assets came under the purview of Shengli and Jianghai.¹⁵⁴

CNOOC, however, designated its subsidiary to head overseas investments. CNOOC Ltd. acquired the 1994 Malacca oilfield¹⁵⁵ from its parent and continued to spearhead overseas E&P. Just as CNOOC had merged all its upstream subsidiaries in 1998, in 2001 it merged all its petroleum

¹⁴⁹ Jiang Binbin, *China National Petroleum Company (CNPC): A Balancing Act Between Enterprise and Government* op. cit.

¹⁵⁰ PetroChina Annual Report, 2008.

http://www.cnpc.com.cn/en/ar2003/AnnualReport_list.shtml.

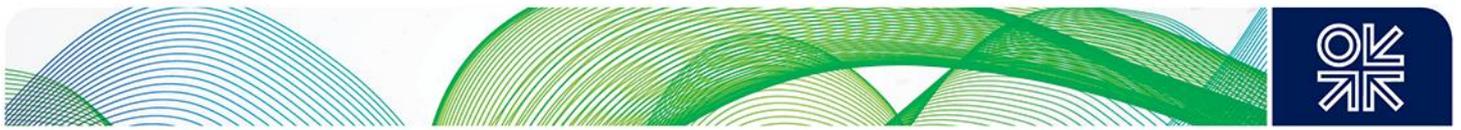
¹⁵² PetroChina annual Report, 2007.

¹⁵³ Bo Kong, *China's International Petroleum Policy*, op. cit., 76–8.

¹⁵⁴ Chen Jibao, 'Deciphering Sinopec's Overseas Strategy', *21st Century Business Herald*, 16 April 2004

<http://www.people.com.cn/GB/jingji/1045/2473270.html>, consulted on 10 April 2011.

¹⁵⁵ Bo Kong, *China's International Petroleum Policy*, op. cit., 78–80.



engineering assets into Offshore Oil Engineering Corporation. Since it had been focusing its efforts and finances on internal restructuring, its overseas expansion slowed down between 1994 and 2002, but after its IPO in 2001 it was better designed and better financed to pursue overseas acquisitions.¹⁵⁶

The corporatization process had, inevitably, to take into account the heavy workforce and social responsibilities assumed by the two big oil companies, as well as the strained balance of interests between the company headquarters, the local subsidiaries, and the local governments.¹⁵⁷ The new structure provided CNPC and Sinopec Group with greater control over their subsidiaries, while also empowering PetroChina and Sinopec Corp. But these holding companies were not the only business interests of CNPC and Sinopec, nor were they, politically, the strongest components in the oil companies.¹⁵⁸ Nevertheless their development and economic success became of the utmost importance to the ‘mother’ companies and to the government, seeing as they provided a hefty share of the corporate – and thus state – revenues. In 2005, CNPC’s revenue stood at RMB133.4 billion, of which a special tax of RMB20.5 billion was paid to the central government. That same year, approximately 56 per cent of CNPC’s profits come from PetroChina, with exploration and production making up the great majority of these profits.¹⁵⁹ Sinopec earned RMB39.6 billion, of which 5.4 billion were transferred to the central government, while CNOOC reportedly earned RMB25.3 billion, of which 3.08 billion were paid to the central government, accounting for 25 per cent of revenues from the centrally owned SOEs.¹⁶⁰ But despite their new nature, and the greater incentive to pursue profit-seeking activities, the NOCs were still bound to the government in a complex network of ties.

5.3 The government–corporation nexus

The NOCs gained greater independence from the government in many aspects including, as mentioned above, production and product pricing. Moreover, their experience both domestically and overseas afforded them the greater technical knowledge that the government then required when formulating policies. But they remained highly dependent on government departments for crude oil pricing, funding, investments policies, and personnel decisions. In its long-term planning functions, for example, the SDPC required that Sinopec, PetroChina, and CNOOC submit estimates for domestic consumption and production levels of crude oil and natural gas, based on which the SDPC set out the production targets for the companies, determined the levels of crude oil imports and exports, and formulated the annual gas supply guidance plan. SETC then allocated the crude oil and import quotas to PetroChina and Sinopec; in addition, MOFTEC issued import and export licences for crude oil and refined products, once they obtained the quotas from SETC. In terms of capital investment, PetroChina and Sinopec had the power to decide on new investments in oil and gas development in China, but they required approval from SDPC and the State Administration of Foreign Exchange (SAFE), among others, for overseas investments.¹⁶¹

One of the most important links between the NOCs and the Party–State became the process of personnel approval by the Party’s Organization Department, its de facto Human Resources department. The chairmen of NOCs are to this day nominated by the Party’s Organization Department, whose decisions are ratified by the Politburo Standing Committee. This authority extends, indirectly, to the firms’ internationally listed subsidiaries, as the general managers of the parent companies concurrently serve as chairmen of the boards of their respective listed companies.

¹⁵⁶ Bo Kong, *China’s International Petroleum Policy*, op. cit., 78–80.

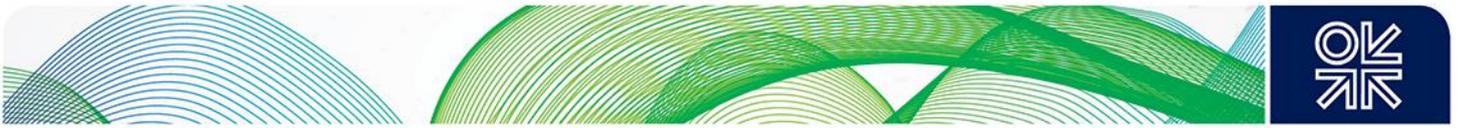
¹⁵⁷ Fereidun Fesharaki and Wu Kang, ‘Revitalizing China’s Petroleum Industry Through Reorganisation Will It Work?’, op. cit.

¹⁵⁸ Sizhi Guo, ‘The Business Development of China’s National Oil Companies: the Government to Business Relationship in China’, Working Paper for the James A. Baker III Institute for Public Policy, Rice University, March 2007; Email correspondence with industry insiders, December 2008.

¹⁵⁹ Email correspondence with industry insider, December 2008.

¹⁶⁰ Steven Lewis, *Chinese NOCs and World Energy Markets: CNPC, Sinopec and CNOOC*, op. cit.

¹⁶¹ Richard Daniel Ewing, ‘Chinese Corporate Governance and Prospects for Reform’, *Journal of Contemporary China*, vol. 14, no 43, 2005, 317–38.



This allows the Party to shape industry, while at the same time making corporate leadership a political position with a seat at the policy making table. NOC leaders reported their opinions and made their requests directly to State Council leaders and the highest ranks of government; they could also lobby for intervention in project approval or other procedural matters that they needed speeding up. Zhou Yongkang, former CNPC president, in his position as minister of Land and Natural Resources, lobbied Zhu Rongji for approval of the West–East Pipeline from Xinjiang.¹⁶² Moreover, many of the highest ranking government officials have ties to the petroleum industry. As the biggest and most important NOC in China, CNPC maintains the strongest ties to the government. Zhou Yongkang, former member of the Standing Committee of the Politburo (2007–12), served as president of CNPC between 1996 and 1998; Zhu Rongji also spent some of his career in the MPI in the late 1970s. Wu Yi, China’s ‘Iron lady’ holds a degree in petroleum engineering and spent the early years of her career in Lanzhou (Gansu province) and in Beijing in the petrochemical industry. She was regarded as Sinopec’s link to the top leadership. Zeng Qinghong spent some of his early years (early 1980s) in CNOOC and in the MPI,¹⁶³ he was the secretary to Yu Qiuli, who served as minister of Petroleum Industry from 1958 to 1970. Zeng subsequently held several positions at CNOOC; his tenure there overlapped with Fu Chengyu, who headed CNOOC and then Sinopec. While these linkages do not mean the revival of a modern day ‘petroleum clique’, they do mean that the NOCs have personal networks that grant them easy access to China’s top leaders.¹⁶⁴

¹⁶² Erica S. Downs, ‘Business Interest Groups in Chinese Politics: The Case of the Oil Companies’, op. cit.

¹⁶³ The full biographies are available at <http://www.cnpec.net/lingdao/lingdao.html>.

¹⁶⁴ Erica Downs and Michal Meidan, ‘Business and Politics in China: The Oil Executive Reshuffle of 2011’, op. cit.



Table 1: Party/Government officials with ties to the oil industry

Name	Party/Government Position	Oil Industry Position
Zhu Rongji	- Prime Minister (1998–2003) - Politburo Standing Committee member of the 15 th CPC Central Committee	Ministry of Petroleum Industry (1975–9)
Zeng Qinghong	- PRC Vice President - Member of the Standing Committee of the Politburo of the 16 th CPC Central Committee - Member of the Secretariat of the CPC Central Committee since 2003	- Deputy Director of the Foreign Affairs Bureau under the Ministry of Petroleum Industry (1983–4) - Vice Manager of the Liaison Department of CNOOC (1983–4)
Wu Yi	- Member of the Politburo of the 16 th CPC Central Committee - Vice Premier State Council 2003 – 2008	Deputy General Manager and Party Secretary of the Yanshen Petrochemical Corporation (1983–8)
He Guoqiang	- Member of the Politburo of the 16 th and 17 th CPC Central Committee - Head of the Organization Department of the CPC Central Committee since 2002 – 2007 - Secretary, Central Commission for Discipline Inspection, 2007 – 2012	Director General, Department of Petroleum and Chemical Industry, Shandong (1984–6)
Zhang Gaoli	- Party Secretary of Tianjin (2007–12) - Member of the Standing Committee of the Politburo of the 18 th CPC Central Committee (2012-)	- General Manager of Sinopec Maoming Petrochemical Corporation (1980–84) - Deputy Secretary Sinopec Maoming Petrochemical Corporation Communist Youth League (1970–77)
Su Shulin	- Minister of the Organization Department of the CPC Central Committee, Liaoning Province (2006–7) - Party Secretary, Fujian Province (2011–15)	- Vice President of CNPC (2003–6) - Chairman of the board, General Manager Sinopec (2007–11)

Table 2: Government officials promoted into the oil sector

Name	Bureaucratic position	Corporate position
Wang Tao	Minister of Petroleum industry	President of CNPC (1988–96)
Zhou Yongkang	Vice Minister of Petroleum Industry (1985–8)	Vice President of CNPC (1988–96) President of CNPC (1996–98)
Chen Geng	Deputy Director of SPCIB (1998–2001)	Vice President of CNPC (2001–3) President of CNPC (2004–6)
Chen Jinhua	Deputy Party Secretary Deputy Mayor of Shanghai Director of Shanghai Planning Committee (1982–3)	President of Sinopec (1983–90)
Sheng Huaren	Director of Planning Department under the Ministry of Chemical Industry (1982-1983)	Vice President of Sinopec (1983–90) President of Sinopec (1990–98)
Qin Wencai	Vice Minister of Petroleum Industry	President of CNOOC (1982–7)

Source: Author's database.

Moreover, since the CEOs of the big companies were nominated by the Party, they were aware of the 'revolving door' between industry and a political career: Wei Liucheng, former president of CNOOC, was promoted to the post of governor of Hainan Province, as a reward for his successful tenure at CNOOC. Chen Geng, who headed CNPC between 2004 and 2006, started his career in the MPI and assumed several senior government positions, including the deputy directorship of the State Bureau of Petroleum and Chemical Industry, before joining CNPC as vice-chairman in 2001. Chen's successor, Jiang Jiemin, started his career with CNPC, becoming a vice president of PetroChina, CNPC's publicly listed subsidiary, in 1999. He then served as vice governor of Qinghai Province before returning to CNPC as vice chairman in 2006.

Table 3: Promotions from industry to government

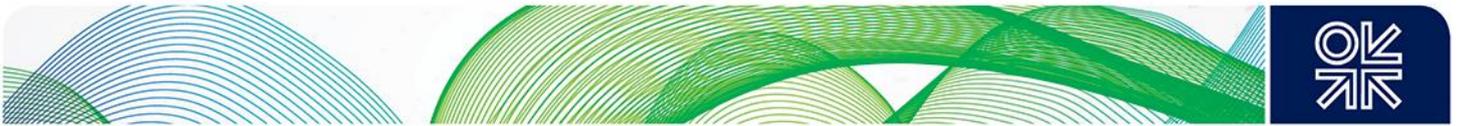
Name	Industry position	Party/State function
Zhou Yongkang	Vice President of CNPC (1988–96)	- Minister of Land and Natural Resources (1998–9) - Minister of Public Security - Member of the Politburo of the 16 th CPC Central Committee - Member of the Secretariat of the 16 th CPC Central Committee - State Councillor 2003–12
Ma Fucai	President of CNPC (1998–2004)	- Deputy Director of the Office of National Petroleum Leading Group since 2005 - Alternate member of the 16 th CPC Central Committee
Chen Jinhua	President of Sinopec Group (1983–90)	- Director of State Commission of Economic System Reform (1990–3) - Director of SPC (1993–8)
Sheng Huaren	President of Sinopec Group (1990–8)	- Director of STEC (1998–2001) - Vice Chairman of the Standing Committee of the National People's Congress since 2001
Li Yizhong	President of Sinopec Group (1998–2003)	- Party Secretary General and Deputy Director of SASAC (2003–5) - Director of State Administration of Work Safety since 2005 - Member of the 16 th CPC Central Committee
Su Shulin	Vice President of CNPC (2003–6)	- Minister of the Organization Department of the CPC Central Committee, Liaoning Province
Wei Liucheng	President of CNOOC (1999–2003)	- Party Secretary of Hainan Province - Alternate member of the 16 th CPC Central Committee

Source: Author's database.

Former Sinopec chairman, Chen Tonghai (2003–7) had been a vice minister of the State Planning Commission and had held other government positions earlier in his career before joining Sinopec. CNOOC officials, by contrast, came mostly from the energy industry.

The top executives have always been very much aware of the fact that their promotion depends on the Party. Su Shulin, former Sinopec chairman (2007–12), was a rising star in the Chinese system and slated for a top position in CNPC, where he rose through the ranks of Daqing oilfield between 1997 and 2006 before becoming its youngest senior vice president. However, Su Shulin had a temporary setback in the petroleum business following unrest in the Daqing oilfield, due to his failure to keep it at bay.¹⁶⁵ He ultimately took over Sinopec from Chen Tonghai, who resigned amidst rumours of corruption, and managed to improve his record during his tenure at Sinopec. An important

¹⁶⁵ Interview with industry insider, Beijing, November 2007. Others estimate that it was internal fighting with Jiang Jiemin that led Su Shulin to leave CNPC, see Chen Wenxian, 'Behind Chen Tonghai's resignation', *Xinhua China Oil, Gas & Petrochemicals*, 9 July 2007.



accomplishment under Su's leadership was its environmental focus, which had become the leadership's newest mantra: Sinopec's CO₂ emissions declined by 16.3 per cent in 2009.¹⁶⁶ In 2011 he was appointed governor of Fujian province – a province in which many of China's future leaders cut their teeth. But he was ousted on corruption charges in late 2015.

Another example is Li Yizhong, Sinopec president between 1998 and 2003, who had managed unrest in Shengli refinery in a satisfactory fashion and climbed quickly to the top of the company's management,¹⁶⁷ later rising to fill leading government positions at organizations which included the State-owned Assets Supervision and Administration Commission (SASAC), followed by ministerial positions at the Ministry of Industry and Information Technology created in 2008¹⁶⁸. He was also made a full member of the CCP central committee, whereas Ma Fucai, general manager of CNPC, was only appointed as an alternate.¹⁶⁹ Ma's political fortunes waned because of his company's failure to secure the Angarsk–Daqing oil pipeline from Russia to China before the Japanese intervened, and because of a gas explosion at a CNPC field in Sichuan in 2003 that killed 242 people and injured more than 10,000, after which he resigned from his position.¹⁷⁰ Prior to this disaster, Ma had been slated to become governor of Shandong Province, but he was then appointed to a less prestigious position in the central government.¹⁷¹ The individual careers of NOC leaders therefore have been, and remain, highly dependent on both their performance and that of their companies, bearing in mind both political and commercial goals.

While the most significant source of the Party's control is personnel appointments, the government can also issue guidance to the NOCs by using administrative means and Party documents. During the 1998 reforms, the government gave direct orders to the presidents of both companies on the future course to take and on their options in terms of voluntary redundancies, temporary layoffs, and transfers to external service companies.¹⁷²

The modes of interaction between government and industry have evolved alongside the successive waves of reform. Despite its drawbacks, this relationship has also been beneficial for the companies. Beyond the personal links between NOC leaders and government officials, the institutional ties and common interests allowed NOCs to apply for preferential financing (especially for domestic projects),¹⁷³ or to receive exemptions from import tariffs on equipment and machines required for exploration and development of crude oil. The government also granted: oil and gas E&P rights, oil import rights, exclusive sales rights, and jurisdiction rights for service stations to the NOCs, thereby helping them maintain their monopoly over the domestic oil and gas business.

But as the NOCs' financial and political clout increased, they became more selective about the government guidelines to which they chose to adhere. And as the companies became wealthier and better versed in the international oil business, they were more effective in lobbying for reforms to support strategic goals. Their desire to expand overseas was promoted in the late 1990s, when the NOCs argued that these moves enhanced China's oil security; they also argued that competition from private firms (and sometimes from foreign investors) would hamper economic reform, when they sought to maintain their monopoly status in the domestic market.

¹⁶⁶ Cheng Li, 'China's Midterm Jockeying: Gearing Up for 2012', (Part 4: Top Leaders of Major State-Owned Enterprises), *China Leadership Monitor*, no. 34, Winter 2011, <http://media.hoover.org/sites/default/files/documents/CLM34CL.pdf>.

¹⁶⁷ Interview with industry insider, Beijing, November 2007.

¹⁶⁸ For biographical details see www.chinavitae.com.

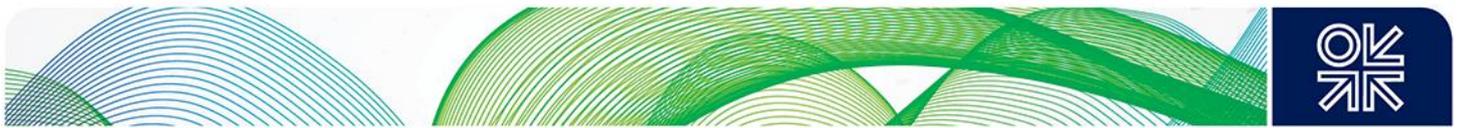
¹⁶⁹ Erica S. Downs, Energy Security Series: 'China', op. cit.

¹⁷⁰ Wang Yichao, 'Ma Fucai steps down', *Caijing*, no. 106, 20 April 2004, 26–8; Wang Jianing, 'Ma Fucai and the system of taking blame and stepping down', *Zhongguo jingji zhoukan*, no. 16, April 2004.

¹⁷¹ Erica S. Downs, Energy Security Series: 'China', op. cit.

¹⁷² Sizhi Guo, 'The Business Development of China's National Oil Companies: the Government to Business Relationship in China', op. cit.

¹⁷³ This is especially true for the early years, the NOCs currently have profits that allow them to reinvest without necessarily seeking government or other external financing. See Erica Downs, Energy Security Series: 'China', op. cit.



In the early 2000s, the reform process that had sought to clarify the roles and responsibilities of government and industry only brought them closer together, albeit in a state of ambiguous interdependence. Not only were the limits between the parent company and the subsidiaries vague, but also the relationship between the government and the mother companies was fraught with ambiguity. It quickly became clear that the listed subsidiaries were not truly independent entities but a division of the parent companies. To this day, there is a great degree of overlap between the leadership in the parent company and its listed subsidiary, while top officials are still nominated and supervised by the Organization Department within the Party. Funding practices seem to indicate asset swaps and bail outs in the form of state support, rather than commercial transactions as practised in Western corporations. Major decisions are, however, made within the parent companies, with the listed subsidiaries serving as important divisions: on one hand, they are the most lucrative assets the NOCs own (and are thus encouraged by the NOCs and the government to remain as such), and on the other hand, they are the NOCs' bargaining chip for greater autonomy, in order to be more attractive to foreign investors. Overall, however, the NOCs are far from being independent from Party–State intervention, a fact that became both a constraint and an opportunity.

6. Revamping the institutions ... again

After another round of ministerial reshuffles, during which the SETC was abolished, the Chinese leadership created, in 2003, an Energy Bureau under the NDRC.¹⁷⁴ While the leadership had wanted to create a ministerial-level agency to oversee the energy sector (a Ministry of Energy of sorts), it faced strong opposition both from the SDPC (now renamed NDRC) which was loath to relinquish its power to another ministry, and from the state-owned energy companies which were reluctant to report to another 'mother-in-law'. Moreover, the idea of creating a new ministry ran counter to the Chinese leadership's objective of streamlining the bureaucracy.¹⁷⁵ As such, establishing the Energy Bureau under the NDRC served the interests of the NDRC and the energy companies alike, as it allowed the NDRC to retain its influence over the energy sector and prevented the creation of another layer of authority over the energy companies.

However, as many of the proponents of the establishment of a formal Ministry of Energy feared, the Energy Bureau did not have the political clout or the financial and human resources to effectively manage China's energy sector.¹⁷⁶ Consequently, the Energy Bureau was unable to coordinate the conflicting vested interests in the energy sector or to regulate the NOCs effectively.¹⁷⁷

NDRC officials also began expressing their frustration with their own inability to manage the country's energy sector without support from the central leadership.¹⁷⁸ Although the NDRC was the most powerful agency in China's energy policy-making apparatus, it did not have the authority to coordinate directly with other ministries. In the spring of 2004, Ma Kai began to convene a series of informal meetings within the NDRC to discuss management of the energy sector. These sessions, which were also attended by executives from China's NOCs, gave rise to the idea of creating a higher-level body to oversee the energy sector.

The Chinese leadership had reached a consensus on the creation of a new energy authority by the end of 2004, which would include an energy leading small group (ELSG) and a state energy office (SEO). 'Leading small groups' are high level informal interagency decision making bodies created by the Party. Some are permanent, while others are temporary task forces created to deal with specific

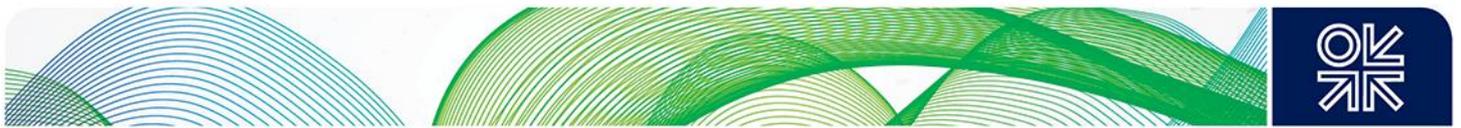
¹⁷⁴ 'The New Energy Institution: Ministry of Energy or Energy Commission?', *China Entrepreneur*, 6 February 2005, <http://www.iceo.com.cn/zazhi/2005/0228/187827.shtml>

¹⁷⁵ Chen Aizhu, 'China appoints economist to steer energy policy', *Reuters*, 6 May 2003, *Factiva*.

¹⁷⁶ 'China delays setting up Ministry of Energy due to complexity of problems', *Agence France Presse*, 3 December 2004, *Dow Jones Factiva*.

¹⁷⁷ Michal Meidan, (ed.), *Shaping China's Energy Security: The Inside Perspective*, Paris: 2008.

¹⁷⁸ For the argument that Ma Kai worked to push energy issues up the Chinese government's agenda, see Simon Wardell, 'China to Establish New Energy Agency', *Global Insight Daily Analysis*, 28 April 2005, *Dow Jones Factiva*.



questions. Leading small groups cover areas like foreign affairs, national security, finance, and the economy, among others. The mandate of the ELSG was to study major energy issues such as energy development, conservation, energy security, and energy cooperation and to provide policy recommendations and advice to the State Council.¹⁷⁹ The SEO, the administrative office for the ELSG, functioned as a research and consultative body. Its primary responsibility was the drafting of reports and laws that impacted the energy sector as a whole; this required feedback and coordination with 15 government departments as well as numerous outside experts.¹⁸⁰ The SEO had no formal authority over other stakeholders in China's energy sector and therefore remained bureaucratically, and practically, under the influence of the NDRC and the state-owned energy companies. The SEO staff included representatives of the NDRC and the energy companies, while the NDRC leadership reportedly strove to ensure that the SEO did not undermine the NDRC's interests.

The process of strengthening the country's energy institutions began with the establishment of the ELSG and the SEO. First, the creation of these bodies was symbolically important; it demonstrated that the Chinese leadership was serious about improving energy management. Second, the ELSG facilitated horizontal communication among the various ministries: prior to the creation of the ELSG, if the NDRC minister wanted to hold a formal meeting with the minister of commerce to discuss an energy policy issue, he would have had to request approval from the State Council. Now, ministers could convene a meeting in the name of the ELSG. Third, the ELSG increased transparency among members of the group by setting up formal decision making procedures and forcing members to reach decisions as a group rather than by cutting deals on specific issues through back channels.

However, the ELSG and the SEO were not a panacea for China's energy bureaucracy. The ELSG had no power to enforce the policies that it drafted. The debate over how to strengthen the country's energy institutions therefore continued and subsequently focused on the question of whether China should create a Ministry of Energy (MOE). The mainstream position favoured the establishment of an energy ministry – or another ministerial-level body that would centralize management of the energy sector.¹⁸¹

After the creation of the SEO and the Energy Leading Group, the Chinese leadership was ready to move forward with the creation of a MOE, and this was slated for the March 2008 meeting of the National People's Congress, the country's rubber stamp parliament. The Ministry of Energy was set to absorb energy-related units within the NDRC and the State Council, and oversee the SOEs in sectors including oil and gas, coal, electricity, and nuclear energy. The Ministry of Environmental Protection (MOEP) – the upgraded, ministerial version of the State Environmental Protection Administration (SEPA) – was also supposed to inherit the functions of the Ministries of Construction and of Water Resources, as well as those of Land and Natural Resources. MOEP was meant to formulate the nation's strategies on issues ranging from global warming to the pace of urbanization.¹⁸²

Yet the outcome of the March legislative session was a far cry from the intended result: the government created a National Energy Commission but failed to establish the powerful ministry Beijing had envisioned: First, the National Energy Commission was tasked with developing national energy strategies, but it was not to have control over the State-owned oil, gas, and electricity companies. Second, it was designed as a consultation bureau, independent from the NDRC.¹⁸³ Finally, a new energy bureau was reconstituted under the NDRC with the goal of administering the energy sector.¹⁸⁴ This new Energy Bureau – which would later become today's National Energy Administration – consisted of nine departments in charge of: energy policy, project planning, project

¹⁷⁹ Wang Ying, 'Wen Heads New Energy Group', *China Daily*, 27 May 2005.

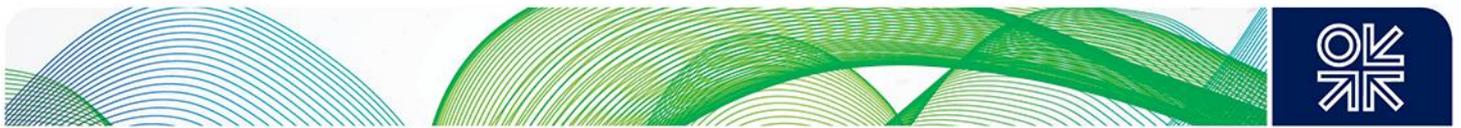
¹⁸⁰ 'China sets up task force to draft energy law: report', *Platts Commodity News*, 29 January 2006, *Factiva*.

¹⁸¹ Huang Hui, 'Creation of the National Energy Leading Small Group is only the first step', *Liaowang News Weekly*, no. 23, June 6, 2005, 40–42; Dong Xiucheng, 'From decentralization to centralization: an inquiry into the establishment of a State Energy Commission or a Ministry of Energy', *China Petroleum Enterprise*, No. 4, 2006, 108–10.

¹⁸² Willy Lam, 'Beijing Unveils Plan for Super Ministries', *China Brief*, Volume 8, Issue 1, 4 January 2008.

¹⁸³ Fu Jing, 'Energy management reshuffle starts', *China Daily*, 7 July 2008.

¹⁸⁴ Jim Yardley, 'China Retools Its Government in Efficiency Push', *New York Times*, 12 March 2008.



approval, electricity, coal, oil, nuclear power, alternative resources, and international cooperation, and its manpower was to be progressively increased to 120. Thus, despite the government's desire to reorganize the institutional oversight of the energy industry, the country's industrial interest groups managed to come out of this reform untouched.¹⁸⁵

Indeed, throughout the various stages of reform, the NOCs managed to maintain their power. Originally, their political clout stemmed from their bureaucratic ranking and their ties to the top leadership but over time, as they became increasingly profitable, their leverage over the government was strengthened by their financial clout. The NOCs could argue in favour of retaining a greater percentage of profits to further invest in their development programmes, which then granted them greater autonomy in financing overseas transactions. Moreover, access to foreign capital was also becoming a source of operational autonomy.¹⁸⁶

The power of the NOCs was further bolstered by their human resources, in terms of both quality and quantity. At the end of 2005, PetroChina had 424,175 employees and Sinopec had 389,451 employees while the NDRC's Energy Bureau and the SEO had 57 and 24 employees respectively. Thus, the Chinese government had no choice but to rely on the companies for manpower and expertise in policy planning, policymaking, and administration for the energy sector. Furthermore, the top positions within the energy administration were held by former NOC managers, who relied readily on their former colleagues for their expertise on different policy issues. Chinese energy officials also periodically met with energy firms to enhance their understanding of particular issues. The NOCs were therefore agenda setters, and they weighed in heavily on the decision making process. Yet at the same time, the appointment and promotion system of the Party's Organization Department ensured that the heads of the NOCs remembered to keep a political cap on as well.¹⁸⁷

6.1 The Strategic Petroleum Reserve

The balance of powers between the NOCs and the Party-State was such that in some cases the NOCs had to set aside commercial considerations for political calculus, but they remained mindful of protecting their commercial interests when government-set strategies were harmful to their corporate goals. The country's Strategic Petroleum Reserve (SPR) – is a case in point.

The first debates on the creation of an SPR in China date back to the mid-1990s, following a mention of the US strategic oil reserve in a study by the State Council's think tank. The idea of building China's strategic oil reserve system was raised again in 1997, on the eve of the corporate restructuring of 1998. The NOCs had been hit financially by low global oil prices, which had forced them to cut production, but at the same time the lack of commercial storage capacity prevented them from taking advantage of those same low prices to buy up stocks. In 1998, therefore, the SDPC identified some possible storage sites and a year later, four were suggested to the State Council.¹⁸⁸ But with the broader ministerial and corporate reshuffle, the government had 'too many headaches to give the strategic oil reserve its full attention'¹⁸⁹ and the SPR was sidelined.

The NOCs reiterated their request for the creation of oil storage sites in 2000, when the country's imports were increasing rapidly. At that point, the SDPC also recognized the need for a strategic reserve and the government tasked CNPC and Sinopec with building it.¹⁹⁰ The companies then asked that the government provide firmer policy guidance, including incentives for them to invest in

¹⁸⁵ Russel Hsiao, 'Big Ministries System and Deputies Get Nod at Second Plenum', *China Brief*, Volume 8, Issue 5, 29 February 2008.

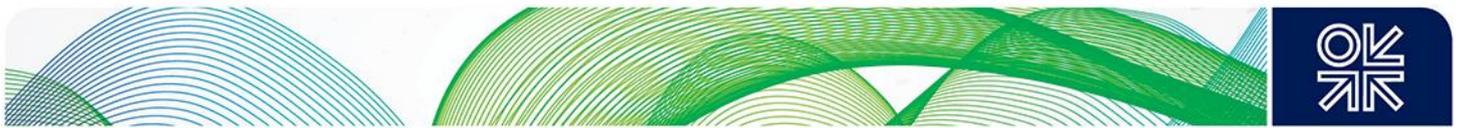
¹⁸⁶ Even though Western financial institutions find it difficult to work with Chinese NOCs and do not offer terms which are as profitable as State banks and financing institutions. Interviews with representative of Western financial institutions, Beijing, January 2007.

¹⁸⁷ Erica Downs and Michal Meidan, 'Business and Politics in China', op. cit.

¹⁸⁸ Erica Downs, *China's Quest for Energy Security*, op. cit.; Xu Yichong, 'China's Energy Security', *Australian Journal of International Affairs*, Vol. 60, No. 2, 265–86, June 2006.

¹⁸⁹ Chen Aizhu, 'Pressure mounts for China strategic oil reserve', *Reuters News*, 3 March 2000, Factiva.

¹⁹⁰ Ibid.



expensive infrastructure and in the purchase of reserve oil. In 2002, with war in Iraq looming and uncertainties in the global oil markets, building the SPR was firmly at the top of the policy agenda and there were renewed government demands that the companies build it. However, with the rising global costs of crude oil, the NOCs were reluctant to assume all of the financial burden. The board of directors of Sinopec Ltd. expressed apprehension about participating in China's national SPR because it would undermine the company's ability to maximize shareholder value.¹⁹¹ The company then argued that it was a 'government duty', in response to claims in the official press that Sinopec was undermining national security.¹⁹² The Chinese government finally decided to finance the construction of the SPR by funding \$1.6 billion in construction costs and paying fees to Sinopec, CNPC, and Sinochem for overseeing construction of the four SPR sites. Beijing also committed to paying for the oil that would fill the SPR, in three phases. After two years of further negotiations, in 2004, the companies agreed to contribute oil to the newly established SPR, committing in principle to help fill the SPR with equity oil from their overseas projects. However, in exchange for this commitment, the NOCs won a 40 per cent increase in the price cap on domestic retail prices, something they had long sought.¹⁹³ The plans for the SPR defined it as both strategic government reserves and corporate forward cover. Yet the government also required the NOCs to hold oil stocks in commercial oil reserves.¹⁹⁴

6.2 The government gets behind outbound investments

The close links between the oil and industry and the government had numerous disadvantages, but when the government decided that outbound investments were in the country's interest, it increased its diplomatic and financial support for global M&As considerably. In 2004, China's policy banks became financiers for the NOCs outbound investments. In addition to providing access to below-market rate loans, both Eximbank and the China Development Bank (CDB) began offering direct capital contributions, as well as subsidies associated with the official aid programmes, to companies engaging in projects designated on the list of 'preferential projects'. Other major state-owned commercial banks also bankrolled financing to projects according to the political goals and guidelines formulated by the government. The 2002–4 emphasis on 'going out' in the energy sector was therefore not lost on China's financial institutions: Eximbank agreed to offer Sinopec a loan credit of \$9.7 billion in January 2002 and a \$14.6 billion loan to CNPC in August 2003, to support their global expansion.¹⁹⁵ The Industrial and Construction Bank of China (ICBC) offered a long-term soft loan of \$7 billion to China National Offshore Oil Corporation (CNOOC) in support of its attempt to acquire UNOCAL, as well as for the acquisition of PetroKazakhstan by PetroChina.¹⁹⁶ CNOOC also obtained favourable loans from Eximbank to acquire assets in Nigeria in 2006.¹⁹⁷

Additional support for overseas investments, in a bid to mitigate political and operational risk, came from CDB and the China Export and Credit Insurance Corporation (Sinosure), which were tasked by the NDRC to provide firms with risk assessment, insurance, and protection against currency fluctuations in host countries.¹⁹⁸ Incentives to invest were also accompanied by attempts to facilitate projects. The government began issuing information and guidance to companies investing overseas. In July 2004, MOFCOM, jointly with the Ministry of Foreign Affairs, released the first *Guidelines for*

¹⁹¹ Chen Aizhu, 'Pressure mounts for China strategic oil reserve', *Reuters News*, 3 March 2000, Factiva; Erica S. Downs, Energy Security Series: 'China', op. cit.

¹⁹² 'Endangering China's Energy Security? Sinopec criticized for reducing its stock inventory', *China Business*, 31 October 2002, <http://finance.sina.com.cn/b/20021031/1315273448.html>.

¹⁹³ Interview with analyst of politics in China, Potsdam, January 2007.

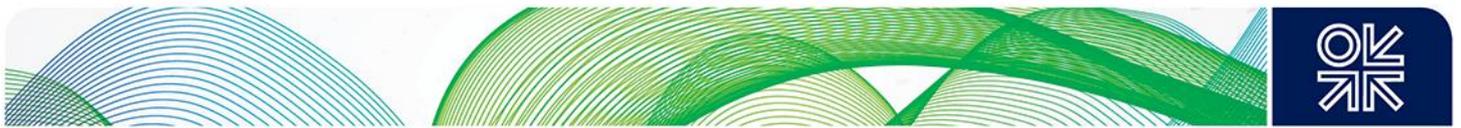
¹⁹⁴ 'China's SPR: Massive Buildup, Policy Imperatives', *Reuters*, 2 April 2007; 'Sinopec Renting China SPR Tanks For Commercial Use', *Dow Jones Energy Service*, 30 March 2007.

¹⁹⁵ Bo Kong, *China's International Petroleum Policy*, op. cit., 68.

¹⁹⁶ OECD Investment Policy Reviews, China, Paris: OECD, 2003., 90–92, <http://www.oecd.org/daf/inv/investment-policy/oecd-investment-policy-review-of-china-2003.htm>

¹⁹⁷ Bo Kong, *China's International Petroleum Policy*, op. cit., 68.

¹⁹⁸ United Nations Development Programme (UNDP), *Asian Foreign Direct Investment in Africa: Towards a New Era of Cooperation among Developing Countries*, 53–5.



Investments in Overseas Countries' Industries in which a catalogue list of recommended industry sectors for China's ODI was presented for each of 68 host destinations. In 2005, it added an additional 25 countries. This list was used as a basis for MOFCOM to approve and administer ODI projects.

Chinese embassies provided additional support to foreign-investing firms by conducting feasibility studies to evaluate the chances of success of proposed Chinese investment projects in the host country. The State Council for its part began granting export tax rebates, financial assistance, and foreign exchange assistance as well as other incentives for Chinese enterprises wishing to tap overseas markets.

Starting in 2004, therefore, Chinese firms were actively encouraged to invest overseas. Moreover, the NOCs received official support through high-level bilateral visits. In February 2004, for example, President Hu Jintao visited Egypt, Gabon, and Algeria. Following these visits, PetroChina signed investment agreements with Egypt and Algeria, while Sinopec started importing oil from Gabon for the first time.¹⁹⁹ Also, in May 2004, the visiting Kazakh President Nursultan Nazarbayev signed a joint communiqué with Hu Jintao, paving the way for a strategic energy partnership between the two countries, which later also led to the signing of a number of oil deals. This also helped kick-start building the Kazakhstan–China oil pipeline.²⁰⁰ Then, during the visit of Premier Wen Jiabao to Russia in September 2004, a key agenda item was Russia's Far East oil pipeline,²⁰¹ but despite Wen's pledge to increase investments in the Russian energy sector, the pipeline deal was not signed the following month during President Putin's visit to Beijing.²⁰² The deal later materialized thanks to a loan granted by the CDB.²⁰³

Finally, during President Hu Jintao's tour to Chile, Argentina, Brazil, and Cuba in November 2004, China signed numerous investment deals in infrastructure, energy, and mining and promised an investment plan totalling \$100 billion in Latin America over the following ten years.²⁰⁴

These official visits were, at times, the starting point of a collaborative framework (in oil and gas or other extractive industries) while at others, they were the culmination of negotiations between the corporate entities. In Gabon for example, Sinopec and Total Gabon had been negotiating a supply deal for several months and used Hu Jintao's visit to the country as an opportunity to officially sign the deal ceremonially. Chen Tonghai, president of Sinopec, reportedly timed his visit to Gabon to coincide with that of Hu Jintao.²⁰⁵ The momentum created during his visit was seized upon and Hu Jintao also oversaw the signing of an agreement between Sinopec and the Gabonese Energy Ministry covering exploration and production as well as a 'memorandum of agreement aimed at showing the parties' desire to develop exploration, exploitation, refining and export activities of oil products'; this memorandum of agreement also involved staff training and technology sharing between the two countries.²⁰⁶ Sinopec subsequently received three blocks to develop: LT2000, located some 200 km southeast of Gabon's economic hub, Port Gentil, and DR200 and GT2000, around 100 km north-east

¹⁹⁹ 'Total Gabon and China's Sinopec sign oil deal', *Agence France Presse*, 31 January 2004, Factiva.

²⁰⁰ 'Kazakhstan economy: Playing hardball on the Chinese line', *The Economist Intelligence Unit*, 18 May 2004, Factiva.

²⁰¹ Nailene Chou Wiest, 'Wen's Russian trip lays groundwork for Beijing summit; Co-operation on energy and trade are expected to be high on the agenda', *South China Morning Post*, 28 September 2004, Factiva.

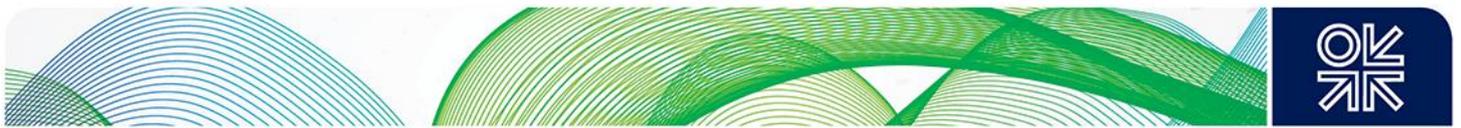
²⁰² 'Russian oil interests come first, Putin says en route to China', *Agence France Presse*, 13 October 2004, Factiva.

²⁰³ Erica Downs, *Inside China, Inc.: China Development Bank's Cross-Border Energy Deals*, John L. Thornton China Center Monograph Series, Number 3, March 2011.

²⁰⁴ Hu's visit was primarily aimed at discussing Market Economy Status but investments in energy and mining figured prominently. Hilary Burke, 'In Latam, Chinese president's visit means business', *Reuters*, 11 November 2004, Factiva. Also see Kevin P. Gallagher and Roberto Porzecanski, 'China Matters: China's Economic Impact in Latin America', *Latin American Research Review*, Vol. 43, No. 1, 2008, 185–200.

²⁰⁵ 'Sinopec Hopes Hu's visit will Settle Gabon oil package deal', *Interfax China*, 2 February 2004.

²⁰⁶ Aymeric Vincenot, 'China, Gabon sign three trade accords, including on oil', *Agence France Presse*, 1 February 2004.



of Port Gentil.²⁰⁷ At the same time, the visit also paved the way for Sinopec's peer and rival, CNPC, to acquire refining businesses in Gabon.²⁰⁸

Similarly, in Algeria, Sinopec signed a contract in 2002 to develop the Zarzaitine oilfield, a deal estimated at \$525 million, and in 2003 CNPC purchased a number of Algerian refineries for \$350 million and signed a deal to explore for oil in two blocks. PetroChina also signed a contract with Algeria's Hydrogen Carbide to develop oilfields jointly and build a refinery. While officials became more involved in supporting overseas investments, they were still initiated, for the most part, by corporate entities. Nonetheless, the combination of administrative support, financing, and export credits led to a surge in outbound investments. It quickly became a successful model for investments in Africa, where many regimes needed financing and infrastructure development, and had upstream energy assets to offer.

While outbound investments were gaining momentum, there was also a growing contingent of critics of the 'going out' strategy, claiming it focused excessively on physical control of oil and gas, irrespective of international political consequences.²⁰⁹ Overseas, there was also greater scrutiny of the NOCs' investments, and indeed one of the most spectacular failures of the 'going out' strategy was CNOOC's attempted takeover of Unocal, an American oil company, which set off a political storm in the USA.

As early as January 2005, there was talk of a \$13 billion bid by CNOOC for the US-based Unocal. Many reservations were raised about the financial feasibility of such an undertaking, even within CNOOC Ltd.'s board,²¹⁰ and as discussions within the company were ongoing, Chevron was contemplating putting in a bid for Unocal.²¹¹ In April, CNOOC dropped its bid after observers had speculated that the merger would be financially risky and difficult to execute, clearing the way for Chevron to put in an offer of \$16.5 billion. A month later, CNOOC was back in the picture.²¹² Speculation within the USA about the nature of the deal quickly emerged: some claimed that with its already exceptional production growth prospects, good exploration potential, and a reputation as a low-cost producer, CNOOC did not need the deal. Analysts argued, therefore, that the true force behind the deal was the Chinese government (the majority shareholder of CNOOC) which eyed Unocal's estimated 12 trillion cubic feet of untapped gas reserves. These would go a long way to meeting China's fast-growing liquefied natural gas demand, while Unocal's Caspian assets would also satisfy a long-standing (and previously thwarted) Chinese desire to expand its presence in that region.²¹³ In June 2005, CNOOC put in a counter bid for Unocal, this time for \$18.5 billion in cash and a promise to take on \$1.6 billion of the US energy group's debt.²¹⁴ The offer was the third-largest cash offer in history, and could only be undertaken with the financial backing of CNOOC Ltd.'s parent company and state banks. But the acquisition provoked protectionist reactions in Washington, calling for legislative measures to review, and subsequently block, the deal on the grounds that it was a

²⁰⁷ 'China's Sinopec signs evaluation deal for three oil blocks in Gabon', *Agence France Presse*, 3 February 2004.

²⁰⁸ Peter Hamsen, 'Oil diplomacy near top of the agenda as China's Hu goes to Africa', *Agence France Presse*, 27 January 2004.

²⁰⁹ Hu Shuli, 'CNOOC, Unocal and the "Going-Out Strategy"', *Caijing Magazine* 139, July 2005, <http://english.caijing.com.cn/2005-07-26/100013798.html>.

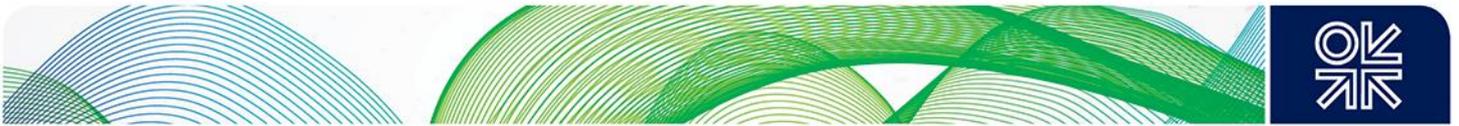
²¹⁰ Four of its eight board members are non-executive directors, all of whom are foreigners. One of the foreign board members expressed reservations about the move. Kate Linebaugh, Matt Pottinger, Greg Hitt, and Jason Singer, 'After Earlier Fumbles, Cnooc Uses Wall Street Tactics in Unocal Bid', Learning Curve: *The Wall Street Journal*, 27 June 2005, Factiva – 'Chinese Oil Company Mobilizes Raft of Lobbyists, Bankers, Other Firms Watch Closely – Advisers Head To "War Rooms" '; Some observers suggest that the board's reservations were due to the fact that Fu Chengyu decided on the deal alone, and suggested as much to Unocal, without consulting the board first.

²¹¹ James Norman, 'ChevronTexaco's proved reserves off 11percent; Fuels speculation on possible bid for Unocal', *Platts Oilgram News*, 4 March 2005, Factiva.

²¹² Interviews with industry observers, New York, December 2010.

²¹³ Lex: CNOOC/Unocal, *Financial Times*, 7 June 2005, Factiva.

²¹⁴ 'China's CNOOC to bid 67 dollars a share for Unocal: state media', *Agence France Presse*, 23 June, 2005, Factiva.



potential threat to national security.²¹⁵ CNOOC's CEO, Fu Chengyu, tried to play down the role of the Chinese government and national interests in the company's acquisition strategy, saying the bid was made on the merit of commercial considerations. He suggested that Chinese government approval for the bid was indirect, coming in the form of permission for state-owned lenders to loan money to CNOOC.²¹⁶ CNOOC advisers set up active lobbies in Washington and Beijing to cope with the political response to the bid and to win the backing of Unocal shareholders,²¹⁷ but to no avail.

In August 2005, CNOOC Ltd. withdrew its bid following requests to do so from the Chinese leadership, despite receiving approval from the board to increase the bid to \$19 billion.²¹⁸ The leadership had reportedly never been enthusiastic in supporting the bid, for fear of damaging the bilateral relationship and the planned visit to the USA in September 2005 by Hu Jintao.²¹⁹

The failed Unocal takeover also provided insights into the relationship between CNOOC and decision makers: the bid was clearly initiated by CNOOC and not by the Chinese government,²²⁰ and although government leaders were informed of the move, they reportedly did not actively back it, but did not oppose it either. Some of CNOOC's board members were also sceptical about the takeover but Fu Chengyu, the company's CEO, reportedly pushed strongly for the bid; this was a marked change from the management style of his predecessor, Wei Liucheng, a fact that may also have antagonized the board. Once the bid was initiated, CNOOC used the administrative measures at its disposal to gain financing from its state-owned parent company and banks, but financing approval was a procedural matter that did not necessarily involve the highest political ranks. Finally, while the Ministry of Foreign Affairs publicly backed CNOOC, in private it favoured withdrawing from the deal from fear that it would sour Sino-American ties.²²¹ Political leaders and diplomats gave Beijing's relationship with the USA priority over the acquisition of foreign oil assets by a Chinese NOC – a fact that angered the top leadership at CNOOC²²² – and were able to put enough pressure on Fu to back out of the deal.

6.3 Oil-backed loans

While the links between the Chinese government and its corporate stakeholders remained tight, the degree of coordination varied considerably. As China's global footprint expanded, the number of actors engaging in business and those regulating it also multiplied. In 1985, the number of Chinese enterprises investing abroad was 143 and they were worth \$170 million; by the end of 2006, more than 5,000 domestic Chinese investment entities had established nearly 10,000 overseas directly invested enterprises in 172 countries or regions, with accumulated outward foreign direct investment stock valued at \$90 billion.²²³

This also afforded Chinese firms and officials an intimate knowledge of working in conflict zones. Chinese workers were targeted, as rebels hoped that this could put pressure on host governments to alter their policies. This was the case in Nigeria, Ethiopia, and Sudan in 2007. Especially in Africa,

²¹⁵ Paul Blustein, 'Many Oil Experts Unconcerned Over China Unocal Bid', *The Washington Post*, 1 July 2005; Editorial, 'National security, China and the Unocal deal', *The Washington Times*, 5 July 2005; Steve Lohr, 'Unocal Bid Opens Up New Issues Of Security', *The New York Times*, 13 July 2005, Factiva.

²¹⁶ Russell Gold, Matt Pottinger, and Dennis K. Berman, 'China's Cnooc Lobs In Rival Bid To Acquire Unocal – Oil Firm's \$18.5 Billion Offer Aims to Knock Out Chevron; Concerns in Washington', *The Wall Street Journal*, 23 June 2005.

²¹⁷ Kate Linebaugh, Matt Pottinger, Greg Hitt, and Jason Singer, 'After Earlier Fumbles, Cnooc Uses Wall Street Tactics in Unocal Bid', op. cit.

²¹⁸ Eric Ng and Neil Gough, 'CNOOC pulls out of running for Unocal; Unjustified political opposition in US to blame for withdrawal of bid, says oil firm', *South China Morning Post*, 3 August 2005.

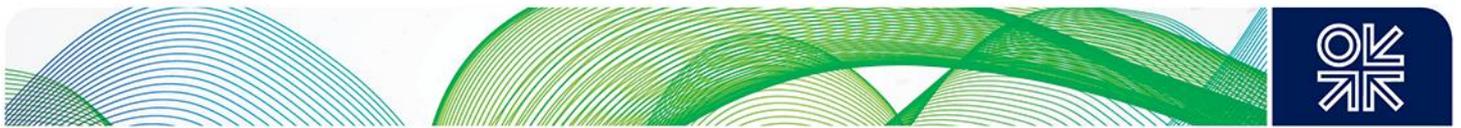
²¹⁹ Francesco Guerrera, 'CNOOC lacked Beijing backing on Unocal bid: Government reported to have given takeover battle a wide berth', *Financial Times*, 6 August 2005, Factiva.

²²⁰ Wang Xiaobing, 'The development of the "go out" policy', *Caijing*, no. 142, September 2005; Dai Qing, 'Energy Choices: In Search of a new path', *Caijing*, no 140, 20 August 2005.

²²¹ Interview with foreign policy analyst in Beijing, December 2005.

²²² Interview with industry observers, Beijing, December 2012.

²²³ Ministry of Commerce of PRC, National Bureau of Statistics, and State Administration of Foreign Exchange, 2007, 2006 *Statistical Bulletin of China's Outward Foreign Direct Investment*, 51; available at <http://hzs.mofcom.gov.cn/accessory/200709/1190343657984.pdf> (last accessed on 14 March 2008).



Chinese interests were more exposed to physical insecurity (affecting their workers), to economic risk (losses due to flawed cost analysis when bidding for projects), and to political risk.²²⁴

At the same time, the bureaucratic rivalries and overlapping administrative mandates in Beijing made investing overseas a cumbersome and lengthy process, with ministerial and diplomatic entities ill-equipped to respond quickly and efficiently to the concerns of investors. For Chinese diplomats, ensuring that the country's diplomacy supported China's national interests became an increasingly daunting challenge, especially since the clout wielded by the Ministry of Foreign Affairs within the system declined gradually.²²⁵

But perhaps the most successful example of effective coordination between diplomatic, financial, and corporate stakeholders for securing energy supplies and gaining access to upstream investments was the energy-backed loans (EBLs) that were initiated in the aftermath of the 2008/9 financial crisis. Between 2009 and 2010, the China Development Bank (CDB) extended lines of credit totalling almost \$65 billion to energy companies and government entities in Brazil, Ecuador, Russia, Turkmenistan, and Venezuela.²²⁶

The EBL structure was not new, indeed Japan had given China loans in the 1970s which were used for purchasing Japanese technology and were repaid with oil²²⁷ and Beijing had also made use of EBLs in 2004, when CNPC loaned Rosneft \$6 billion as an advance payment for future oil supplies. EBLs were therefore a tried and tested policy alternative that were now being used at a larger scale and quantity, when resource-rich countries needed financial flows but were reluctant to sell assets.²²⁸ The collapse in the price of oil from a high of \$147 per barrel in July 2008 to less than \$40 per barrel in December 2008 (it then settled at an average of around \$61–62 per barrel in 2009), combined with tightening credit markets globally, left major oil and natural gas producers around the world struggling to raise funds to sustain investment programmes, to refinance short-term debts, and to maintain the robust social spending that they needed.²²⁹

While each deal had unique terms of repayment, all the CDB deals were structured similarly: Each EBL was secured by revenue earned from deliveries of oil or natural gas to a Chinese oil company. The Chinese oil company deposited its payment for the oil and natural gas deliveries into an account held by the borrower at CDB, from which CDB could withdraw the interest, principal, and other fees it was owed. The deals also led to different degrees of NOC involvement in the host countries: Some deals involved infrastructure projects, others led to upstream contracts for Chinese firms, and some to the purchase of Chinese equipment.

The China Development Bank's EBLs involved a fairly high degree of coordination between government and business: the bank, alongside the NOCs and senior government officials, worked together to negotiate agreements, with the CDB functioning as the primary coordinator. The EBLs succeeded because they responded to a number of interests: first, the energy backed loans

²²⁴ Bo Kong, *China's International Petroleum Policy*, op. cit., 98–114; Economic risk has also become more frequent as host governments ask for investments in projects with added value, mainly in downstream projects, which are often less profitable than upstream.

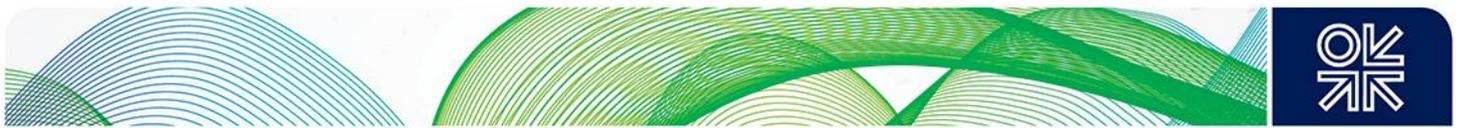
²²⁵ Linda Jakobson, Dean Knox, *New Actors in China's Foreign Policy*, SIPRI Policy Paper no. 26, September 2010, available online at: <http://books.sipri.org/files/PP/SIPRIPP26.pdf>; Linda Jakobson, 'China's diplomacy toward Africa: drivers and constraints', *International Relations of the Asia-Pacific*, Volume 9, 2009, pp. 403–433.; Lu Ning, *The Dynamics of Foreign-Policy Decision Making in China* Boulder: Westview Press, 1997.

²²⁶ Julie Jiang and Jonathan Sinton, *Overseas Investments by Chinese National Oil Companies*, IEA Information Paper, February 2011.

²²⁷ Kevin P. Gallagher, Amos Irwin, and Katherine Koleski, *The New Banks in Town: Chinese Finance in Latin America*, Inter-American Dialogue Report, February 2012, available at http://www.thedialogue.org/wp-content/uploads/2012/02/NewBanks_FULLTEXT.pdf.

²²⁸ Julie Jiang, Jonathan Sinton, *Overseas Investments by Chinese National Oil Companies*, op. cit.; Kevin P. Gallagher, et al., *The New Banks in Town: Chinese Finance in Latin America*, op. cit.

²²⁹ Kevin P. Gallagher, et al., *The New Banks in Town: Chinese Finance in Latin America*, op. cit.; Erica Downs, *Inside China, Inc.*, op. cit.



supported the CDB's agenda, which included growing profits, increasing the bank's own domestic profile (especially in the wake of the global financial crisis), and growing its international business.²³⁰ Second, the EBLs advanced the government's goals of enhancing China's access to energy and diversifying China's foreign exchange reserves.²³¹ Third, CDB's loans helped China's NOCs acquire assets abroad.

Yet most projects originated from the CDB or the government: the loan extended to Petrobras, for example, originated with the CDB and rose to the attention of the central government, while the EBLs to Rosneft and Transneft were initiated through government-to-government talks. Moscow and Rosneft approached the State Council and CNPC, which then turned to the CDB to finance the deal. Ultimately, the EBLs were the first truly effective mechanism for advancing China's energy security, by earmarking set volumes of oil to China. Agreements with Brazil, Ecuador, and Venezuela amounted to roughly 1 million bpd of supplies in 2012, representing one fifth of China's oil imports in 2010 and allowing for a steady flow of energy for a decade (though the actual yearly quantities vary according to the terms of the contracts). Furthermore, EBLs also facilitated Chinese firms' access to upstream assets in, for example, Turkmenistan's South Yolotan gas field and Venezuela's Orinoco belt, offering the NOCs additional means to diversify supply sources, in line with the government's emphasis on supply security.

EBLs were certainly useful for the CDB, but they were not the NOCs' preferred method for gaining foreign supplies: contracts could be voided if there were a change of government, or the lender may not supply the promised quantity.²³² Moreover, even for China's policy banks there were risks involved, for example, if the borrowers threatened to cut off oil supplies, CDB had limited recourse to recover oil or revenues. While the deals generated a steady flow of oil supplies to China they did not shield Chinese buyers from price fluctuations, since most of them were pegged to market prices, though the loan to Venezuela was reportedly negotiated at lower prices.

7. Fighting corruption at the oil companies

After almost a decade of increased international spending, by the second decade of the twenty-first century China's NOCs were gaining more international experience and autonomy from the government. Yet there was a growing sense that the NOCs were becoming too powerful and unwieldy. In 2011, Beijing reshuffled top executives at all three NOCs: Fu Chengyu, the former party secretary and general manager of CNOOC, was appointed chairman and party secretary of Sinopec Group²³³ while Wang Yilin, a deputy general manager of (and the number three official at) CNPC became chairman and party secretary of CNOOC.

This oil executive reshuffle was a blatant reminder of the CCP's control over China's flagship firms. It was part of Beijing's attempt to reassert control over its corporate assets, amid growing concerns about the NOCs' disproportionate power in the system. Indeed, the Chinese leadership had been trying to curb the power of the top leaders of the NOCs in order to stop them becoming too independent and accumulating power in corporate fiefdoms. The government hoped the reshuffle would help curb corruption and support its efforts to promote reforms aimed at enhancing the profitability and operational efficiency of the NOCs.²³⁴

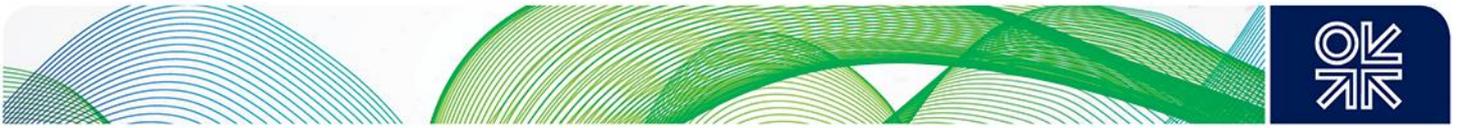
²³⁰ Erica Downs, *Inside China, Inc.*, op. cit.

²³¹ Ma Xin and Philip Andrews-Speed, 'The Overseas Activities of China's National Oil Companies: Rationale and Outlook', *Minerals and Energy*, Vol. 21, No. 1, 2006.

²³² Julie Jiang, Jonathan Sinton, *Overseas Investments by Chinese National Oil Companies*, op. cit.; Kevin P. Gallagher, et al., *The New Banks in Town: Chinese Finance in Latin America*, op. cit.

²³³ 'Fu Chengyu parachuted into Sinopec, Wang Yilin takes over as chairman of CNOOC', *21st Century Herald*, 8 April 2011, <http://money.163.com/11/0408/13/714CBRL000253B0H.html> (Chinese)

²³⁴ 'Sinopec, CNOOC create boards of directors', *Beijing News*, 12 April 2011, <http://money.163.com/11/0412/02/71DG2P1B00253B0H.html>.



For a number of Chinese leaders, the ‘number-one boss’ culture at centrally administered enterprises highlighted the limits of the government’s power over the oil industry, as well as the flawed corporate governance structure.²³⁵ This also dovetailed with the goals outlined in the twelfth FYP (2011–15), in which the government sought to redistribute wealth from its corporate entities to households, in part by increasing dividend payments from SOEs and curbing employee salaries and benefits. Achieving these goals would require stronger government oversight and better bookkeeping in the companies. A number of top leaders used examples of corruption to press for centrally administered enterprises to establish boards of directors, an initiative that started in 2004 but failed to make headway in the oil sector. The 2011 reshuffles weakened the corporate bosses and allowed the government to proceed with changes to the NOCs’ management structures.

Up until that point, a corporate leader at the NOCs could hold several positions in the same company: party secretary, chairman of the board (in companies that already had boards), or alternatively general manager or president.²³⁶ The separation of roles at China’s national oil companies began in August 2010 when Fu Chengyu stepped down as chief executive of CNOOC. Yang Hua, who had been president and chief financial officer of CNOOC Ltd., stepped in to replace him.²³⁷ Fu, however, retained his positions as general manager and party secretary of CNOOC, and as chairman of the board of CNOOC Ltd.

Yet on the day of Fu’s nomination to head Sinopec Group, the company established a board of directors and separated the posts of chairman and president. While Fu remained the most important decision maker at Sinopec – given that he retained the function of party secretary – the government moved towards creating a more professional board aimed at boosting corporate profitability and performance by overseeing financial decisions.

Finally, the oil executive reshuffle was an attempt to level the playing field in the oil industry: the rotation of executives within an industry in order to manage competition between firms has been a standard practice of the CCP. One example took place in 2004, when the government reshuffled the executives of China’s ‘big three’ telecommunications companies, China Mobile, China Unicom, and China Telecom.²³⁸ According to the then head of China Netcom (a fourth telecom firm),

... the competition was very furious. It’s like three brothers fighting each other for no clear objective. The parents say: ‘Let’s change your seats. You will see each other from another angle. You had better behave yourselves from now on’.²³⁹

Similarly, the CCP’s reshuffling of China’s oil executives – the appointment of Fu Chengyu (widely recognized inside and outside China as having done a stellar job at the helm of CNOOC) as the new ‘number one boss’ of Sinopec – may have been partly aimed at enhancing Sinopec’s competitiveness with respect to its domestic peers. In 2010, Sinopec’s internationally listed subsidiary (Sinopec Corp.) had not performed nearly as well as the internationally listed subsidiaries of CNOOC (CNOOC Ltd.) and CNPC (PetroChina).²⁴⁰ In 2010, Sinopec Corp.’s year-on-year growth of net profit was 13.7 per cent, far below the 41.5 per cent increase posted by PetroChina and the 84.5 per cent jump posted by CNOOC Ltd.²⁴¹ Sinopec Corp.’s poor performance was primarily due to the fact that as China’s largest refiner, the company was hardest hit by state-set prices for diesel and gasoline. However, Sinopec Corp. and Sinopec Group also struggled more than their domestic peers did to maintain oil output at home and grow production abroad. Fu Chengyu’s track record at CNOOC suggested that he

²³⁵ ‘Leadership changes at the Big Three, Transition in China’s oil industry’, *21st Century Herald*, 13 April 2011.

²³⁶ Cheng Li, ‘China’s Midterm Jockeying: Gearing Up for 2012’, *op. cit.*

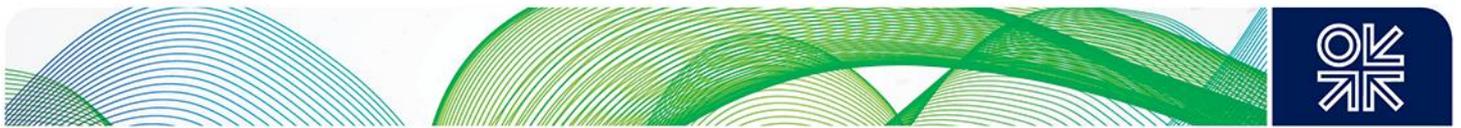
²³⁷ Leslie Hook, ‘CNOOC’s Fu to step down as chief executive’, *Financial Times*, 19 August 2010.

²³⁸ ‘China to reshuffle telecom bosses – sources’, *Reuters*, 29 October 2004; Guo Jian’er and Chen Zhiming, ‘China Mobile to have new manager’, *China Daily*, 2 November 2004.

²³⁹ Richard McGregor, *The Party: The Secret World of China’s Communist Rulers*, Harper Collins, 2010, 89.

²⁴⁰ For an assessment of the performance of CNOOC, CNPC, and Sinopec in 2010, see Tom Grieder, ‘Senior Personnel Reshuffles Announced at China’s NOCs Following Annual Results Announcements’, *IHS Global Insight Daily Analysis*, 11 April 2011.

²⁴¹ CNOOC Ltd., *Annual Report 2010*, 2.



could help remedy Sinopec’s weaknesses: first, Fu had presided over a 237 per cent increase in CNOOC Ltd.’s net oil and natural gas production between 2004 and 2010.²⁴² Second, Fu’s substantial international exposure was intended to bolster Sinopec’s efforts to build its global exploration and production portfolio.

Table 4: China’s Oil Executive Reshuffle, 2011

Name	Previous Positions	Current Positions
Su Shulin	General Manager, Sinopec Group Party Secretary, Sinopec Group Chairman, Sinopec Corp.	Acting Governor, Fujian Deputy Party Secretary, Fujian
Fu Chengyu	General Manager, CNOOC Party Secretary, CNOOC Chairman, CNOOC Ltd.	Chairman, Sinopec Group Party Secretary, Sinopec Group Chairman of the Board of Directors, Sinopec Corp.
Wang Yilin	Deputy General Manager, CNPC Party Committee Member, CNPC Non-executive director, PetroChina	Chairman, CNOOC Party Secretary, CNOOC Chairman of the Board of Directors, CNOOC Ltd.

7.1 The NOCs’ fall from grace

But shortly after the oil executive reshuffle, China’s NOCs faced by far the most significant attack on their political power. Shortly after President Xi Jinping came to power in November 2012, he launched one of the deepest and longest-running corruption clean ups seen in China, targeting first and foremost the oil sector and its former patron, Zhou Yongkang.

Xi Jinping’s heavy focus on Zhou Yongkang and his family from the summer of 2013 onwards was informed by three main factors, it was:

- a purge of a potential political challenger to Xi Jinping;
- an attempt to reduce resistance ahead of additional reforms planned for the oil and gas industry;
- a continuation of previous efforts to tackle corruption in the oil and gas companies, and in state-owned companies more broadly.

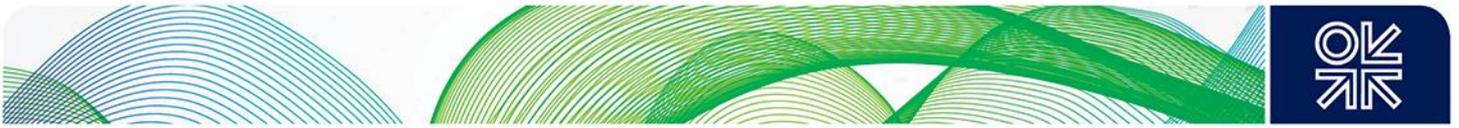
Zhou Yongkang, as mentioned above, was a key figure at PetroChina and instrumental in the corruption that had become deeply rooted in it. He was chairman of CNPC (1996–8) before being appointed Minister of Land and Natural Resources (1998–9).²⁴³ During his time as Minister of Land and Natural Resources he helped secure CNPC’s approvals for the West–East pipeline project and he was then nominated as the Sichuan party chief (1999–2002). He later returned to Beijing to head the public security apparatus. But Zhou had allegedly conspired with the ousted Bo Xilai to orchestrate a *coup d’état* in March 2012,²⁴⁴ which was most probably the immediate trigger for his downfall.

In the oil industry, Zhou had worked over the years to place his family connections in key positions at PetroChina and its subsidiaries, or to allocate lucrative oilfield service contracts to his family members. His son, Zhou Bin, was a key beneficiary of his father’s position, having a sprawling business empire in Iraq, Sudan, and Canada. Zhou Yongkang had promoted several key people in

²⁴² CNOOC Ltd., *Annual Report 2008*, 3; and *Annual Report 2010*, 3.

²⁴³ Zhou Yongkang’s full career data can be found on the China Vitae website: www.chinavitae.com/biography/Zhou_Yongkang/career.

²⁴⁴ Jamil Anderlini and Lucy Hornby: ‘Captured in a Chinese tiger hunt’, *Financial Times*, 31 March 2014, www.ft.com/cms/s/2/5a324b70-b0e5-11e3-bbd4-00144feab7de.html#axzz3td6686gG.



the oil industry (including Jiang Jiemin who headed CNPC between 2004 and 2013), throughout his years in government, and they then helped anchor Zhou's family business in the oil industry.

Zhou's downfall (culminating in his sentence to life imprisonment in June 2015 and the seizing of his family's assets) and the fact that China's oil patch was now left without a powerful backer within the political elite, then allowed Xi Jinping to pursue two additional goals: first, making reforms to the oil and gas sector (including efforts to allow more private investment in the heavily monopolized sector) that would improve corporate governance and increase oversight over top-level decisions. This move stemmed from a view that the NOCs' monopoly inhibits efficient growth in the domestic oil and gas industry and hampers the companies' own international competitiveness. Second, purging Zhou was also a means towards tackling the corruption which had become pervasive at CNPC and was increasingly a topic of public and media commentary, noting the NOCs' privileges and lavish expenditure.

The corruption probes into Zhou Yongkang, his family and protégés laid bare the extent of corruption in the oil sector,²⁴⁵ which revolved around asset stripping, pursuit of investment projects that benefitted family members and close friends as well as nepotism. The extent of state asset stripping was substantial. During Jiang Jiemin's time at CNPC, transfers of state assets to private companies were pervasive, but they led to increased production at PetroChina's largest oilfields and were therefore regarded favourably by the political elite – Jiang's bosses and the main shareholders. Under Jiang, oilfield managers would lease out or sell lucrative oil and gas fields to private oilfield service companies under the pretence that they were of poor quality. Once the fields increased output, they were resold to CNPC, allowing the private company to make a whopping profit. The development of Changqing oilfield is a case in point: between 2003 and 2007, Changqing's output increased from 10 mt (0.20 mb/d) to 20 mt (0.40 mb/d) before surging to 30–40 Mt (0.60-0.80 mb/d). By 2012, Changqing's oil and gas output surpassed that of Daqing, China's largest oilfield, gaining its managers substantial praise given the leadership's aspiration for energy independence. At the same time, Zhou Bin, who oversaw many of the oilfield service companies involved in developing Changqing, made RMB550 million when he resold the blocks back to CNPC, when oil prices were soaring in 2008.²⁴⁶

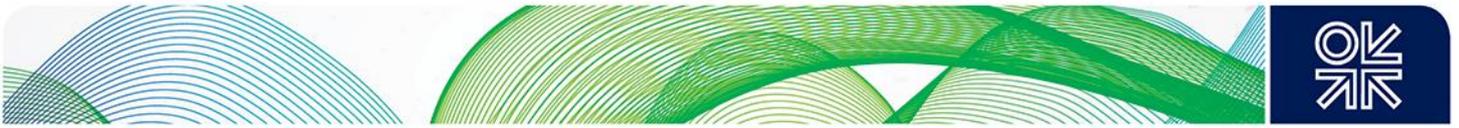
These practices extended overseas as well. In Iraq, for example, CNPC would run the construction, service, and equipment bidding for the big Iraqi projects. The fee would be paid by CNPC, and the Iraqi owner would pay back the fees in oil after production started. Zhou Bin and his associates would then purchase the oilfield service equipment from various Chinese manufacturers, and try to sell it at a profit in Iraq. But since the Iraqi companies were often reluctant to buy Chinese goods, fearing that they were of low quality, they would be shipped to the USA first and then to Iraq, through Zhou Bin's web of companies. The pieces of equipment were worth between US\$20,000 and US\$100,000 each.²⁴⁷

In addition, CNPC officials pursued investments in petrochemical projects, benefitting personal or business allies. One of the most notorious examples of this is PetroChina's Pengzhou petrochemical complex in Sichuan that led to the downfall of a number of businessmen in Sichuan province. Plans for building a petrochemical plant in Sichuan dated back to the early 1990s, but the decision to build it in Pengzhou was taken only in 2001. It took several more years of feasibility studies and discussions between the local government and CNPC to decide on the design of the petrochemical complex that PetroChina was looking to start in 2010. But there were numerous complications, the most important of which was the 2008 earthquake in Sichuan that generated concern about the risks involved in

²⁴⁵ For more on Zhou Yongkang's background and various positions see Jamil Anderlini and Lucy Hornby: 'Captured in a Chinese tiger hunt', op. cit.

²⁴⁶ 'Zhou Yongkang's thirty red and black: The corruption plaguing CNPC', *Caixin*, 22 October 2014, <http://china.caixin.com/2014-10-22/100742015.html> (Chinese)

²⁴⁷ Huang Kaixi and Yu Ning, 'CNPC Scandal Has Links to Oil Fields in Iraq', *Caixin*, 22 November 2013, <http://english.caixin.com/2013-11-22/100608540.html>.



setting up a petrochemical complex in an earthquake-prone area.²⁴⁸ But the project manager, with support from Jiang Jiemin who was now at CNPC headquarters, pushed the investment project through and designated a host of local companies – all linked to Zhou Bin and his company – to complete the construction work²⁴⁹ even though it met with substantial local resistance and seemed to make little economic sense for PetroChina.²⁵⁰ Nonetheless, it was strategically important given that it allowed PetroChina to encroach on Sinopec's traditional territory and was therefore pursued. The provincial governor, Guo Yongxiang, who had previously been Zhou Yongkang's private secretary, helped cut through the red tape for project approval while also ensuring that these companies became main suppliers for CNPC.²⁵¹

Zhou's connections were not limited to CNPC given that Shengli oilfield – where Zhou Yongkang formed his initial networks – is currently a Sinopec asset. But corruption at Sinopec was targeted by the government in 2007 with the highly public ousting of the then Sinopec chairman Chen Tonghai. Chen was known for extravagant expenditure, and also for trying to promote price reforms that were at odds with the government's agenda.

The fallout from the corruption investigations was substantial, however. For two years, overseas mergers and acquisitions (M&A) virtually ground to a halt, while the turnover in personnel also paralysed the companies. Managers would disappear overnight, taken for investigations. Between November 2012 and April 2015, the Central Commission for Discipline Inspection – the country's anti-corruption watchdog – investigated a total of 108 executives from state-owned enterprises; of which 26 are in the energy sector, eight of them being from CNPC.²⁵² Foreign interlocutors also noted that the investigations were turning decision-making into a slow and extremely cautious process, and this was impacting their relations with their Chinese counterparts. Finally, the combination of Xi Jinping's frugality campaign and the anti-corruption drive meant that Chinese industry executives were loath to travel.

7.2 Corporate musical chairs

Finally, in May 2015, the NOCs announced another round of changes to their top managements, suggesting that the big ticket purges within the oil companies were drawing to an end, even though investigations of mid-level executives continued.²⁵³

In this latest round of musical chairs, Sinopec chairman Fu Chengyu retired and was replaced by Wang Yupu. During his four years at Sinopec, Fu had turned investor sentiment around, giving the company a clear focus on shale and leading the boldest privatization effort of all the three oil companies. Yet many within the company were reportedly uncomfortable with the pace of change. The choice of Wang Yupu to replace Fu signalled a return to a more technocratic leadership: Wang Yupu had spent most of his career at Daqing oilfield in Heilongjiang, where he worked with Su Shulin (the former Sinopec chairman) after which he took on administrative and political roles at the Chinese Academy of Engineering and as vice governor of Heilongjiang, only to return to the oil patch four years before retirement age.

CNPC chairman Zhou Jiping also retired and was replaced by the outgoing chairman of CNOOC, Wang Yilin. Wang was, however, no stranger to CNPC given that he had spent most of his career

²⁴⁸ Liu Yiman, 'Pengzhou petrochemical project: A fait accompli?', *China Dialogue*, 16 July 2015, <https://www.chinadialogue.net/article/show/single/en/8066-Pengzhou-petrochemical-project-A-fait-accompl-i>

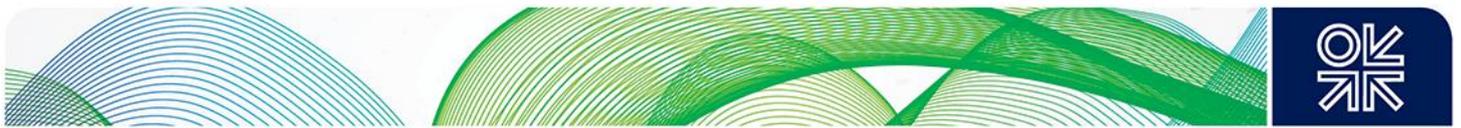
²⁴⁹ 'Sichuan businessman Wu Bing embroiled in Pengzhou Scandal', *Caixin*, 5 September 2013, <http://politics.caixing.com.cn/2013-09-05/113263797.html> (Chinese)

²⁵⁰ Huang Kaixi and Yu Min, 'CNPC Pushes ahead with Controversial Sichuan Refinery Project', *Caixin*, 14 April 2014, <http://english.caixin.com/2014-04-14/100664958.html>.

²⁵¹ Yu Ning and He Xin, 'Three Officials at Center of Graft Scandal Were Secretaries to Ex-High Official', *Caixin*, 7 September 2014, <http://english.caixin.com/2014-07-09/100701774.html>; David Lague, Charlie Zhu, and Benjamin Kang Lim, 'Inside Xi Jinping's purge of China's oil mandarins', *Reuters*, 24 July 2014.

²⁵² Rosealea Yao, 'Trembling Giants', *Gavelal Dragonomics*, 21 April 2015.

²⁵³ Lucy Hornby, 'Doubts cast on managers' influence at Chinese oil groups', *Financial Times*, 5 May 2015.



rising through the ranks at CNPC in Xinjiang. He had been transferred out of CNPC and into CNOOC in 2011, having reportedly failed to secure his coveted job as head of Sinopec. His biggest achievement at CNOOC was completing the Nexen takeover – though his successor and long-time CNOOC executive Yang Hua was the architect of the deal. Wang is also four years short of retirement age, which gives the company a chance to proceed with reforms. While he is very much an onshore oilman, his time at CNOOC will have given him experience with the gas market (offshore and LNG) which could help the company's gas segment. Nonetheless, he came back to a company deeply transformed in comparison to the one he left, and he is not considered a charismatic or visionary leader.

At CNOOC, Wang Yilin was replaced by Yang Hua, a long-time veteran of the company, having been employed there since its creation in 1982. Yang worked closely with Fu Chengyu and was the driving force behind many of the company's M&As. His takeover of CNOOC had long been anticipated, and since he was still nine years away from retirement age, the expectation was that he would stay on at the company for some time to come.

The leadership changes at the heads of the oil companies marked an end of the big ticket purges. Although investigations of mid-level officials will continue, the new chairmen of the companies are unlikely to be probed for corruption. Nonetheless, their ability to focus on corporate strategies remains inhibited by uncertainty surrounding two distinct reform agendas that will impact them: the first is the oil and gas reform plan and the second is the SOE reform initiative.

8. NOC reform 3.0

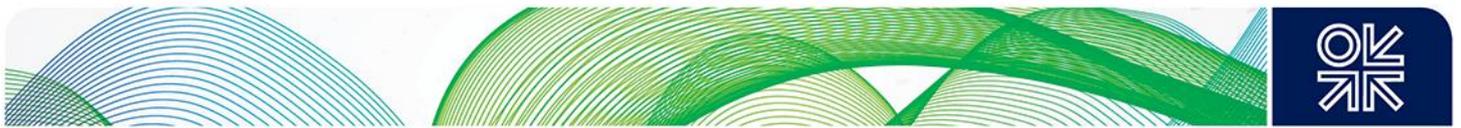
Throughout the years, Beijing has been experimenting with different managerial and bureaucratic structures that would allow it to enhance the competitiveness of the oil and gas industry while also maintaining adequate control of it. But increasingly, the government's pledges to allow markets to play a 'decisive' role in the economy are at odds with its affirmation of the 'dominant role of the public ownership system'. In other words, if market forces are 'decisive', then state-owned enterprises (SOEs) cannot remain dominant and should be allowed to lose out to competition from private and foreign firms. And if the government wishes to maintain the strength of the state-owned economy, markets will inevitably be suppressed and be unable to play a leading role. These inherent tensions, if left unclarified, could further inhibit the already slow process of SOE reform in China.²⁵⁴

In theory, the square can be circled with Chinese exceptionalism. Unlike the situation in advanced economies, where markets are the underlying principle organizing economic activity, in China, the default setting is direct control by the Party-State. The role of markets is only to organize economic activity where the state does not need to assume a large leadership role and increasingly, even in state-dominated sectors, the market is also viewed as a means of improving the economic efficiency of state-owned assets by forcing them to maintain a reasonable degree of productivity. In other words, the market is a mechanism for setting prices but not for reassigning control of assets.²⁵⁵ The recently published thirteenth FYP (2016–20) reiterates these goals and emphasizes the need to open the economy to private investors and to improve the efficiency of state-owned companies. While the problems associated with the state-owned enterprises (SOEs) – including poor returns on investment, rising debt, and widespread corruption – are well understood in Beijing, there are disagreements about how best to resolve these issues. This will likely hinder the implementation of any reform proposal, even the most conservative.

In the previous round of SOE reform (between 1997 and 2003), the government closed or privatized many underperforming SOEs and created new opportunities for the private sector. So when press

²⁵⁴ Scott Kennedy (ed.), *State and Market in Contemporary China: Toward the 13th Five-Year Plan*, A Report for the CSIS Freeman Chair in China Studies, March 2016, available at http://csis.org/files/publication/160303_Kennedy_StateMarketChina_Web.pdf.

²⁵⁵ Scott Kennedy (ed.), *State and Market in Contemporary China: Toward the 13th Five-Year Plan*, op. cit.



reports suggested that Xi Jinping and Li Keqiang were planning to reduce the number of SOEs from 121 to 40, there were renewed hopes that another round of transformative changes to the SOEs was ahead. But after lengthy delays, the SOE reform plan that was finally issued in September 2015 did not indicate that this would be the chosen strategy. Instead, the SOE reform plan includes a mixture of initiatives including changes to the management and supervision structures of the SOEs, as well as partial privatization; this suggests that Beijing will adopt a more incremental approach than it did in the late 1990s. For now, the government intends to differentiate between ‘public interest’ firms and ‘commercial’ SOEs, further dividing the latter into ‘market competitive’ sectors – such as retail, foods, consumer manufacturing, auto, construction, and chemicals, where less government oversight is required – and those tied to the ‘national interest’ – including, among others, infrastructure, mineral resources, oil and gas pipeline networks – over which the government will retain close control.

The priority for ‘national interest’ SOEs is to increase their efficiency and financial discipline by focusing on corporate governance and experimenting with ‘mixed ownership’ – a vague catch phrase referring to partial privatization and divestments. Additional decrees have followed, and in December 2015, the government announced its intention to launch pilot programmes that will increase the powers and responsibilities of boards of directors, bring changes to hiring practices and compensation schemes, and examine mergers and restructurings.

The vagueness of the plan suggests that implementation will be spotty. The SOE reform plan is hindered by the divergence of views within the bureaucracy: For example, the NDRC has been advocating ‘mixed ownership’ that will allow private investors to become shareholders in the SOEs. But the Ministry of Finance is focusing on extracting higher dividend payments from the SOEs by creating state-owned asset management companies that would set financial performance targets for the companies without intervening in their management. Finally, the State-owned Assets Supervision and Administration Commission (SASAC, the agency that currently supervises SOEs) wants to merge and consolidate them in order to create national champions that would become instruments of the government’s industrial policy designs.²⁵⁶ No one is advocating privatization. Even the notion of ‘mixed ownership’ seems to be getting scaled down, given the State Council’s warning that mixed ownership should not result in the loss of state assets (likely rooted in the concern that privatization in the past has simply been a way for elites to buy state assets at a low cost).

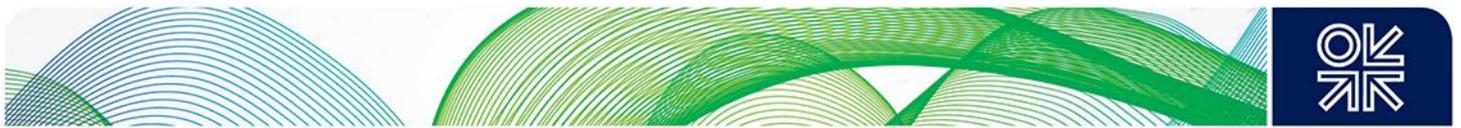
8.1 The NOCs will adapt to a slightly more competitive landscape

At the same time, political and public pressure has been building for an overhaul of China’s national oil companies (NOCs). Once powerful political players, the tide had turned in 2013 and the collapse in oil prices has also added to their woes. Their earnings have declined along with oil prices, at a time when their balance sheets were already under strain from their overseas buying binge. And indeed, since Zhou’s ousting, the NOCs’ ability to inform national policies has been greatly reduced and a slew of changes – including the deregulation of natural gas prices and challenges to the companies’ monopoly over oil and gas imports – are testament to a change in mood.

The oil companies have also increasingly realized that they must toe the political line. The fuel specification changes are one example: in early 2013, the government set a timetable for introducing China IV fuel quality standards which would entail changes to refining equipment in order to produce higher quality products, but Sinopec and CNPC dragged their feet on upgrades, complaining that their weak refining margins (due to the state-set pricing mechanism) were impeding their ability to invest in the upgrades.²⁵⁷ Since 2014 and the beginning of the corruption probes, Sinopec and CNPC have tried to outdo each other in meeting targets early. Sinopec’s experiment with ‘mixed ownership’ is another case in point. Sinopec sold a 29.99 per cent stake in its retail fuels business, including over 23,000 gas (petrol) stations, for \$17.5 billion in 2014. While such actions highlight the companies’ willingness to fall in line with political directives, it is also telling of the limits of these reforms. Of the

²⁵⁶ Andrew Batson, ‘The Flailing State of Enterprise Reform’, *Gavekal Dragonomics*, 15 September 2015.

²⁵⁷ Sui-Lee Wee and Hui Li, ‘Politics of pollution: China’s oil giants take a choke-hold on power’, *Reuters*, 2 February 2013.



25 new shareholders in Sinopec Sales, 16 are other state-owned entities; however, these entities own only 20 per cent of Sinopec Sales, with no individual investor controlling more than 2.8 per cent, and none of them represented on Sinopec's board of directors.

Finally, the unprecedented liberalization of oil and gas import rights is also a significant achievement in this context. In February 2015, China's regulators allowed non-state refiners (currently accounting for roughly 3.5 mb/d, or a third of the domestic downstream) to apply for quotas to use imported crude oil. This was a significant change, as previously the 100 or so independent refiners (nicknamed 'teapots' because of their small size and basic equipment) could not import oil directly but had to buy it from a licensed, state-owned importer. For the government, allowing 'teapots' to import crude serves multiple purposes: it aims to promote consolidation and upgrading to higher fuel standards, as shutting inefficient capacity is a condition for qualifying for import licences; and to increase the competitive pressure on state-owned refiner Sinopec to become more efficient. By increasing the number of participants in the market, it also lays the groundwork for this year's planned launch of oil futures trading in Shanghai.²⁵⁸

Many industry participants initially doubted that the Chinese government was serious about opening up imports, but in July 2015 the NDRC issued 700,000 bpd of crude import quotas to independent refineries, equivalent to more than 10 per cent of China's crude oil imports in 2014. Private traders' initial scepticism toward the openings in the oil and gas sector has now given way to an active search for new opportunities. Private LNG traders have also been granted LNG import rights, to the dismay of the state-owned giants.

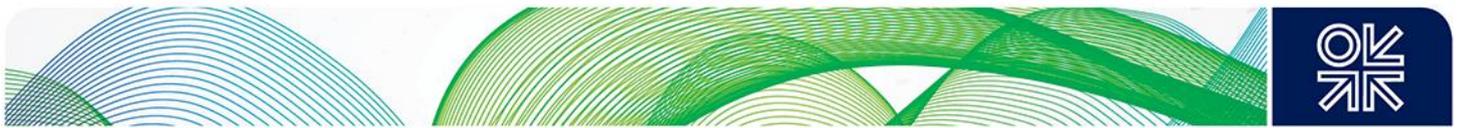
The government's support for the 'teapots' is therefore unlikely to wane in the near term, given that it sees competition from them as a way to impose discipline on the NOCs. To be sure, the initial stages of liberalization look like anything but discipline, in light of the scramble for market share: while the independent 'teapots' that now have access to crude as feedstock are raising runs, the state-owned majors are also maintaining their refining throughput and looking to expand their retail outlets to fend off competition from the 'teapots'. Ultimately, market dynamics could force some mergers and consolidations among 'teapots' as the smaller ones will find it costly to maintain high volumes of crude imports when the domestic market for oil products is looking increasingly oversupplied.

8.2 Beijing will open the upstream, but production is set to decline

The NOCs, in response, will focus their limited Capex on more lucrative segments. And in line with the 'mixed ownership' rhetoric, they will likely spin off some of their pipeline assets and oilfield service subsidiaries. At the same time, the government will pursue its efforts to open the upstream to private investment. In July 2015 the Ministry of Land and Resources opened tenders for six oil and gas blocks in Xinjiang to private firms. The bidding was greeted with little enthusiasm and only attracted domestic investors with limited upstream experience, given the relatively poor quality of the assets. However, even though it will not erode the NOCs' dominance, it is a step towards opening the oil industry further to private capital.

But even new investors in China's upstream are unlikely to reverse China's declining domestic output. While the thirteenth FYP may include an objective to maintain or even increase domestic production from bases in Xinjiang or in the South China Sea, the reality of low oil prices is pointing toward a decline in output: indeed, based on the 2015 results of China's oil and gas majors, domestic production is set to fall by 0.17 mb/d (4 per cent) in 2016. Investment in production has been falling, from a peak of \$54.4 billion in 2014, to \$39.4 billion (-27.6 per cent y/y) in 2015, and now \$33.5 billion (-15.1 per cent) this year. In 2016, Petrochina's output will shrink by 90 thousand b/d (4.1 per cent) as it will shut down aging and high-cost fields which have 'no hope' (according to company officials) of making a profit in the current oil price environment. This marks an acceleration from the 66 thousand b/d (2.1 per cent) decline in 2015, and cuts will most likely come from Daqing (0.8 mboe/d) and

²⁵⁸ Michal Meidan, 'In Focus – Cracking China's Teapots', *Energy Aspects*, February 2016.



Changqing (1 mboe/d). Domestic upstream Capex likely fell by \$10.5 billion (33 per cent) in 2015 to \$20.8 billion, and is expected to fall a further 13 per cent this year to \$18.2 billion.

CNOOC's domestic production is expected to fall by 40 thousand b/d y/y, albeit from a high base in 2015. In total, Chinese production cuts will likely reach 0.17 mb/d in 2016. CNOOC's growth in 2015 was driven primarily by offshore domestic assets in the Bohai Bay, off China's north-east coast (+74 thousand b/d or 18.3 per cent y/y growth) and the Eastern South China Sea (+49 thousand b/d or 35 per cent y/y growth), while its overseas acquisitions, especially Nexen, have pushed up its overall cost of production. The company pegged operating expenses for Chinese operations at \$8 per boe in 2015, compared to nearly \$13 per boe for overseas assets. So, CNOOC will seek further Capex reductions in its overseas assets, whilst it will continue to focus on its domestic offshore reserves in Bohai, Caofeidian 6-4, Luda 16-3 and 16-3S, and Bozhong 34-9 that mainly produce light crude.²⁵⁹

Sinopec, which has the most mature E&P portfolio of the Chinese SOEs, saw domestic production decline by 40 thousand b/d (4.7 per cent) in 2015, and in 2016 oil production is expected to fall by an additional 34 thousand b/d as the focus shifts away from high-cost mature assets. To reflect the mature asset base, Sinopec reduced group reserves by 26.4 per cent to 2.2 billion barrels at the end of 2015 (from 3.1 billion barrels a year earlier). Finally, Shaanxi Yanchang – a locally owned SOE with assets in the coal-rich Shaanxi province – will reduce production by 4 thousand b/d, bringing the company's total output to 0.25mb/d in 2016, according to company guidance. Whilst not significant from a volume standpoint, the reduction symbolizes the broader trend of marginal high-cost production being cut back.

In total, Chinese production cuts will likely reach 0.17 mb/d in 2016. This is a significant change in thinking: maintaining high output from these flagship fields has been key to the government's goal of limiting its dependence on imported oil. The government even set a target for crude oil imports to stay below 61 per cent of total consumption in the twelfth FYP. Import dependence was far from this ceiling up to 2013, but started to rise in 2014 following the collapse in global oil prices and in 2015, the share of imported oil reached 65 per cent.

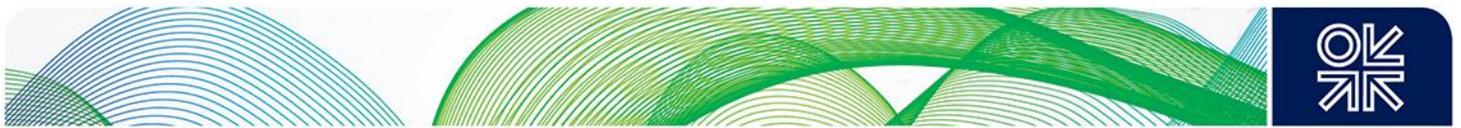
8.3 The NOCs go global, again

The NOCs are therefore adapting their strategies to these new commercial and political realities. In the past, China's decision makers were reluctant to rely solely on markets to secure oil supplies. They supported the oil companies' purchase of oil and gas assets abroad on the (untested) theory that, in times of crisis, these resources could be shipped back to China. So the priority now is not to lock up assets that are no longer particularly scarce, but to obtain the best price on global markets. And indeed, the trading arms of PetroChina and Sinopec, ChinaOil and Unipecc, have stepped up their presence in global trading platforms significantly. This change has been developing over the past year: in late 2014, career traders were promoted to the top spots at both ChinaOil and Unipecc, replacing corporate planning officials and refinery managers. And since October 2014, both have been increasing their levels of activity in the Platts window. In the past, ChinaOil and Unipecc conducted most of their trades through direct bilateral arrangements that were rarely revealed to other market participants. Yet increasingly, the two have been more active in the Platts window and impacting the market. While these are still early and relatively experimental stages, the goal is to become more dominant in global benchmarks and impact global oil prices actively.²⁶⁰

Alongside China's growing appetite for trading, the NOCs will gradually resume their outbound investments, joined no doubt by newcomers to the sector. China's NOCs are setting their sights on assets that they hope will be cheaply valued in Iran, Brazil, and Africa. CNPC chairman Wang Yilin announced in March 2016 that his company is considering expanding its presence in Russia and Iran, while CNOOC is reportedly looking to purchase Petrobras' petrochemical company Braskem. Yet after having weathered the corruption storm by sitting on the sidelines of international M&A, China's

²⁵⁹ Company reports.

²⁶⁰ Michal Meidan, 'From Empire Builders to Traders', *Gavekal Dragonomics*, 17 September 2015.



NOCs will be more cautious about their spending. This is due to three reasons: first, because even though they are cutting upstream Capex, their finances remain limited, plagued also by the uncertainty surrounding the trajectory of crude oil prices; second, the NOCs remain in 'wait and see mode' over the future of the SOE reform plan and corruption probes. The audit of Sinopec's \$10 billion investment in Angola from 2008 through mid-2015 is a case in point. Sinopec reportedly earned no returns on its investments while it seems to have exaggerated reserves, leading to the arrest of former Sinopec President Su Shulin for corruption last year. So now that China's NOCs are aware that unsuccessful overseas acquisitions are likely to attract the attention of Xi's anti-graft authorities, the companies are likely to be more selective shoppers. And third, because the Chinese leadership is less anxious about supply security, the companies will receive less support from the increasingly stretched state-owned funds. Political support will also be limited to Xi's key foreign policy priorities (namely, the 'Belt and Road Initiative'). Nonetheless, the view in Beijing remains that China should increasingly become a price maker in global oil markets, and this implies a greater presence across the global supply chain, though not exclusively in the upstream.

9. Conclusion

The relationship between China's state owned energy giants and the government has, since the industry's creation, been a story of successive waves of centralisation and decentralisation. The structure of the industry and its guiding principles were defined during the Maoist era and the emphasis on state control as well as supply security remained the overarching goals throughout the reform era. But the tension between state control and market liberalisation has varied according to the policy preference of China's top leaders and the political developments in global markets.

Fundamentally, the Chinese oil and gas industry remains a strategic asset for the government, responsible for ensuring supplies of oil and gas but also for generating tax revenues and employment as well as expertise and policy advice, allowing it to shape policies and determine strategies, escaping at times central government control.

Nonetheless, the oil industry has never achieved full autonomy from the Party-State. Even though the NOCs have tried to develop commercial strategies and adapt to global practices as they have become more closely integrated in global markets, they have had to do so within the confines of a state that controls the purse strings and personnel appointments. Moreover, state support has helped them gain access to third markets and offer compelling financial deals to producers.

When state control was deemed to be impinging on operational efficiency and financial discipline, waves of decentralisation ensued. It was perhaps during the liberalisation push that spanned the decade between 2002 and 2012—which also saw the rise of influential individuals such as Zhou Yongkang in the context of a fragmented bureaucracy—that the oil industry's political power was at its height. It is also during the period that rampant corruption and state asset stripping became endemic in the industry. Various government efforts to curb corruption and rein in the state owned giants failed, until the arrival of Xi Jinping and Li Keqiang to power in 2012.

This latest episode in the history of the Chinese oil industry—which has also coincided with the collapse in global oil prices—has once again altered the dynamics between the Party-state and the industry. In the aftermath of the corruption probes and the appointment of new technocratic leaders to head the NOCs, central control has increased substantially. Their power has been clipped, but at the same time, their mandate is increasingly to find ways of becoming more efficient and increase their role in global markets, throughout the value chain. And with the government opening the sector to non-state actors, China's NOCs are pushed toward new segments of the business, including global refining and trading.

As China's NOCs prepare to embark on another round of global M&As, their international peers will see changes in their partners and competitors: They will come across more Chinese companies—both state owned and private—that will be more risk-conscious but also more aggressive as they benefit from substantial state support.