

China's Local Governments, State Energy Companies, and the Development of the West-East Gas Pipeline

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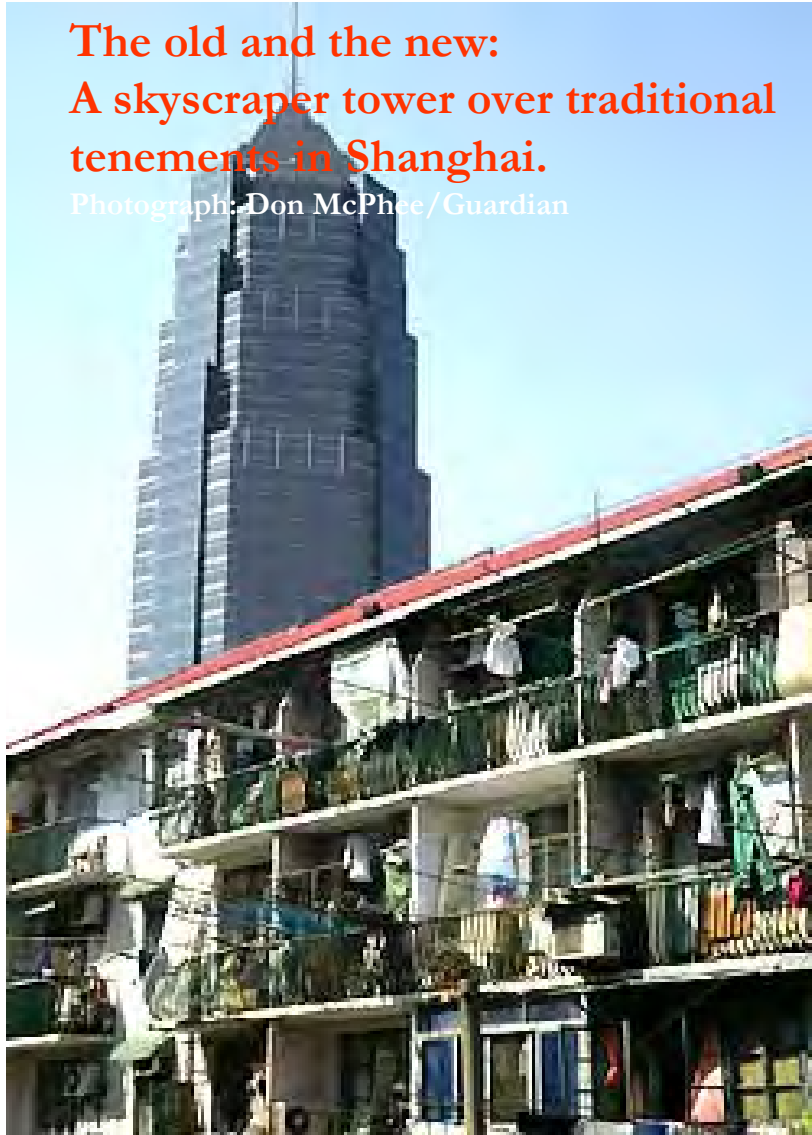
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Houston, TX

China: Contradictions in Harmony

**The old and the new:
A skyscraper tower over traditional
tenements in Shanghai.**

Photograph: Don McPhee/Guardian



**Stepping out:
An elderly couple enjoy an early morning
dance on the corner of a Shanghai street.**

Photograph: Dan Chung/Guardian

China: a Country of Contradictions

- **China's global impact is growing, and China is not eager to do things the American ways.**
- **The current transition in China is full of contradictions.**
 - i.e., China is politically communist, but economically embraces capitalism with Chinese characteristics.
- **Despite committing considerable time, money, energy and using the best talents and global experiences, most foreign companies are struggling in their efforts to developing their energy businesses in China.**

More Contradictions

- Yin and Yang (two extremes balance out, in harmony)
- Personal (relationship) vs. Professional (favor)
- Personal (favorable) vs. National (view of Americans)
- Political (communist) vs. Economic (capitalist)
- Individual (capable) vs. Collective (silly)
- Risk-Averse vs. Adventurous
- Revenue vs. Rate of Return
- Resources in west vs. market in east (long distance)

Case Study: a Routine Energy Project

China's West-East Gas Pipeline Project

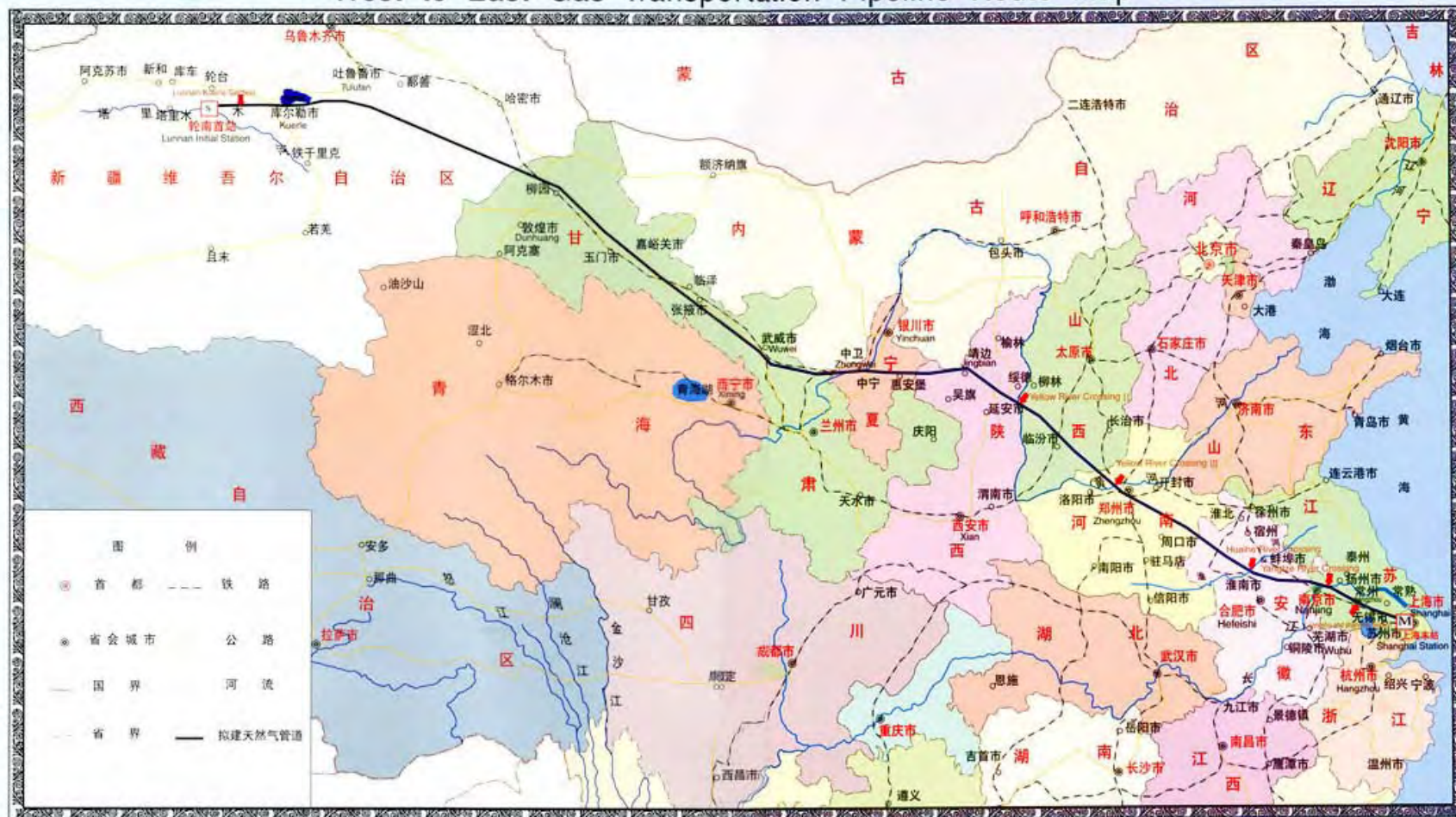
- Identified ten major non-financial factors important to foreign investments in China's energy infrastructure.
- For each factor, analyzed what and why Chinese thought and acted, and how those impacted foreign investment.
 - i.e., analyzed how Chinese companies could lose interest in foreign investments and what Chinese people would think about foreign investors.

Project Background

- **Built and owned by CNPC/PetroChina (1998-2005)**
 - Commercial operation 01/01/2005;
 - 2,500 miles, 10 provinces (city), cost US\$18 billion (ongoing gas field development, completed main pipeline, ongoing network of downstream pipelines).
- **On 08/02/2004 proposed foreign consortium (Shell/ExxonMobil/Gazprom) withdrew.**
 - Each to have 15% of WEP ownership and for 45 years, but no control in upstream and downstream.

Pipeline Route

West to East Gas Transportation Pipeline Route Map

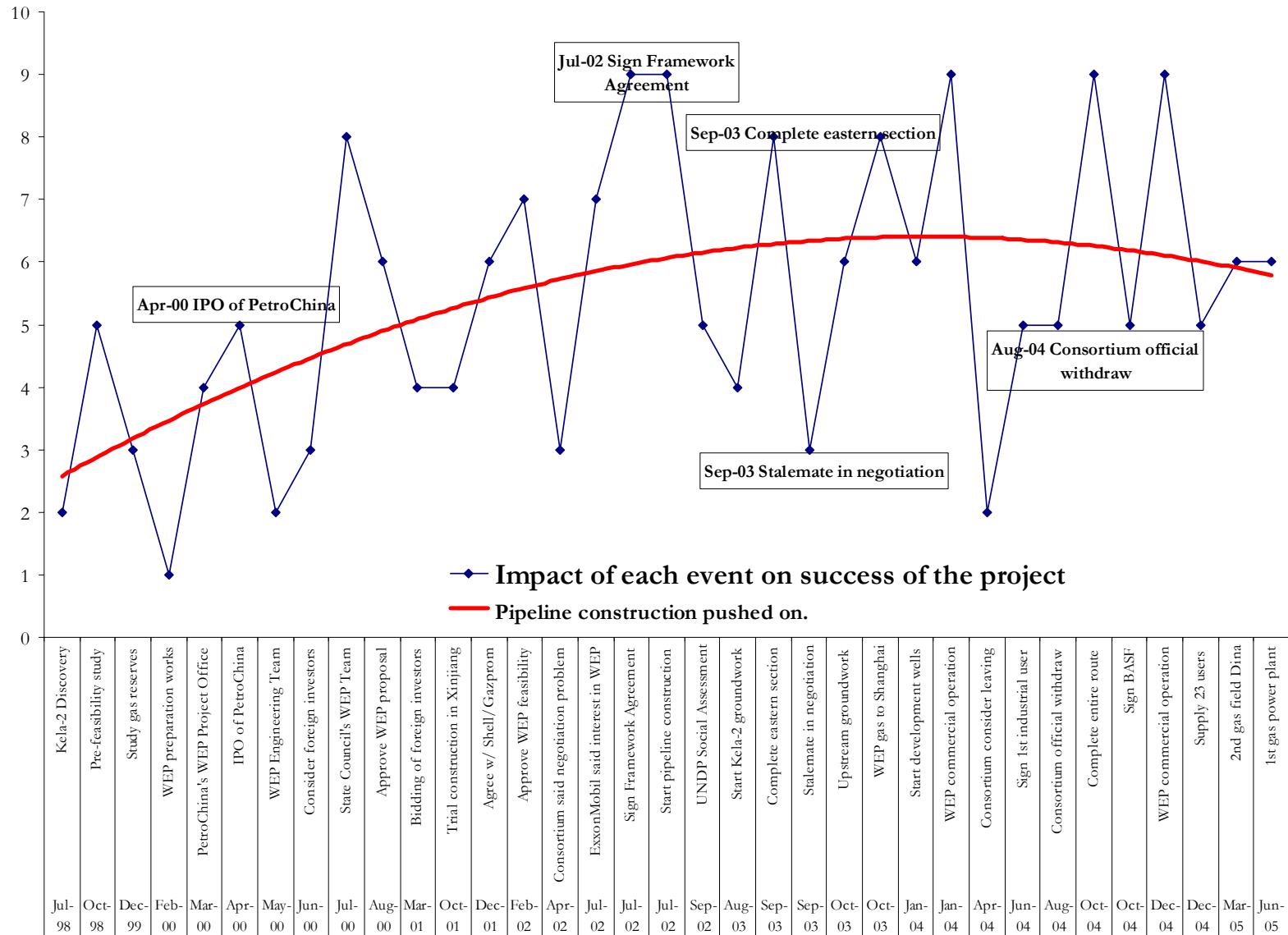


West-East Gas Pipeline Project: A Microcosm of China Energy in Transition

- **The West-East Gas Pipeline (WEP) project became a victim of China in transition:**
 - WEP may have started as a commercial project, but it ended up with a solid political and strategic project as a result of various forces.
- **Foreign consortium was a victim of the typical Chinese way of “learn as the project develops” approach.**

Project Development Timeline of China's West-East Gas Pipeline Project

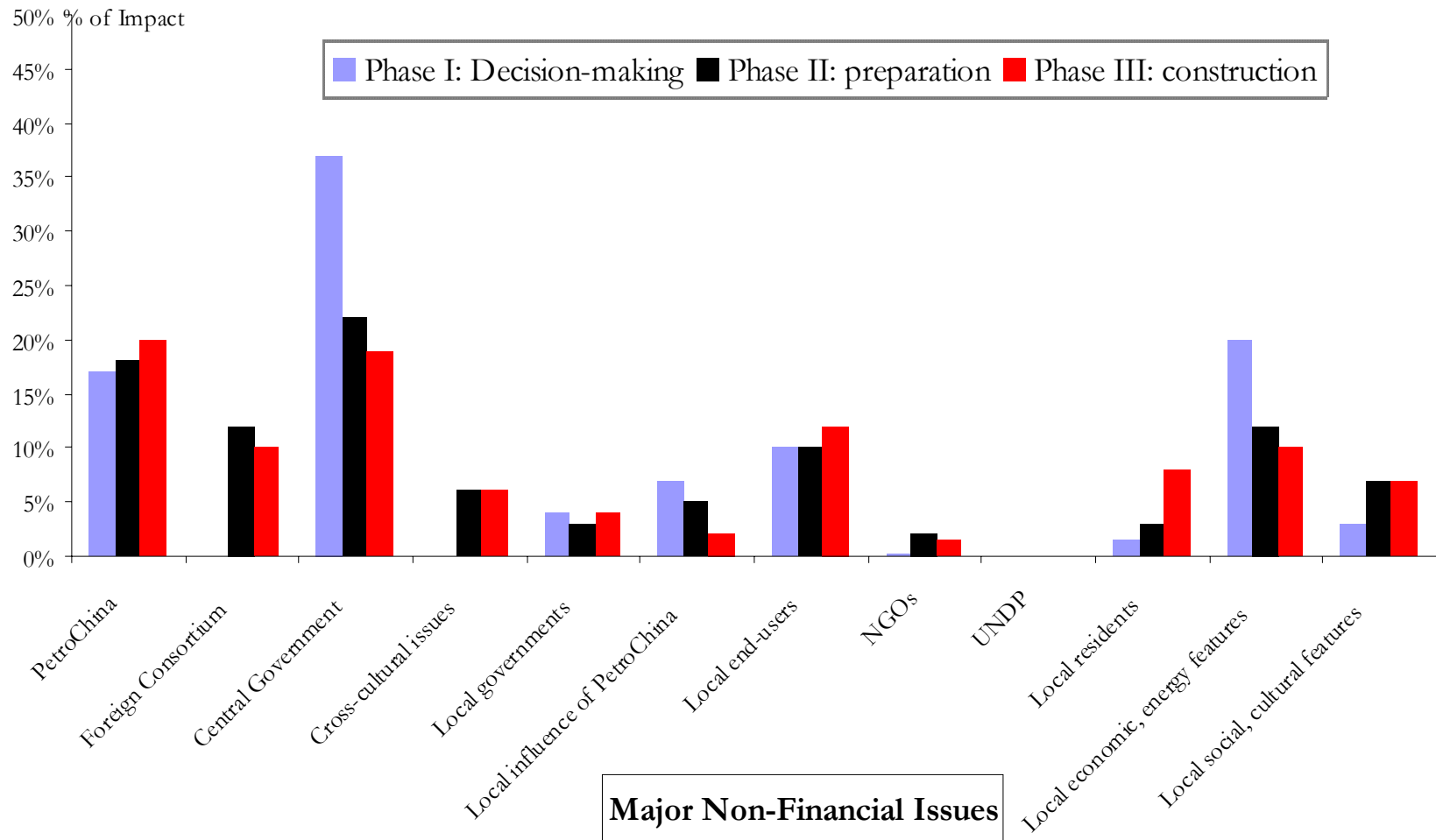
Impact



Ten Major Non-Financial Factors Important to Foreign Involvement and the Project

- **PetroChina** (its interest in foreign investment)
- **Foreign consortium** (cultural and human issues)
- **Central government** (strategic priorities, political issues)
- **Cross-cultural issues** (languages, culture, nationalism)
- **Local governments**
- **Local influence of PetroChina and gas end-users**
- **NGOs and UNDP**
- **Local communities and residents**
- **Local economic, energy and ethnic features**
- **Local social and cultural issues, history, and customs**

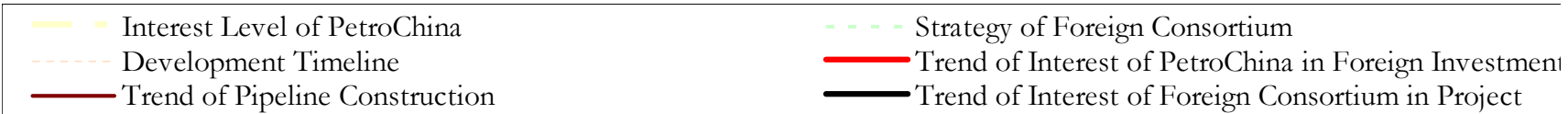
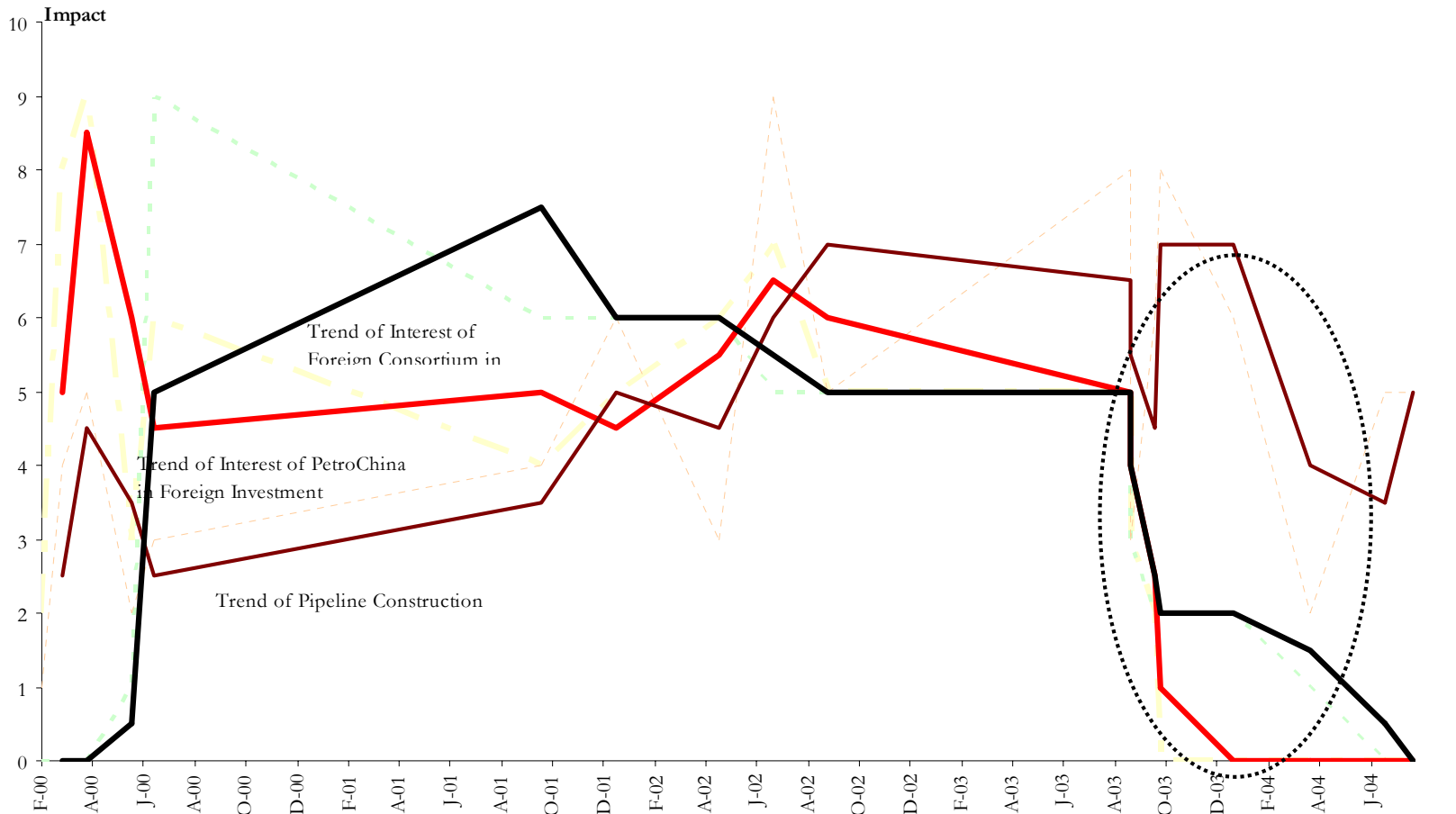
The Impact of Major Non-Financial Factors on Success Chances of the Project



PetroChina: a Confused NOC

- **Like many other confused NOCs (National Oil Companies), PetroChina is searching for its domestic and global identity:**
 - No. 1 and monopoly in China vs. a light-weight player globally;
 - Wooed by oil majors in China vs. mercilessly contained globally;
 - Domestically challenged by majors vs. globally failing to break into majors' markets;
 - Working politically as part of energy diplomacy vs. emphasizing business goal;
 - Professionally rich vs. personally not wealthy.

The Decreasing Interest of PetroChina in Foreign Investment



Major Non-Financial Factors Important to PetroChina's Decision of Going Solo

- **Disputed with:**
 - Majors overseas (ignored, perceived arrogant, silly: poisoning in home turf);
 - Consortium in the project.
- **Competed with:**
 - LNG, offshore gases;
 - Post-WTO competition (monopoly of global majors).
- **Had need to get gas delivered quickly.**
 - Market development (first needed, later barriers: return, gas price, NDRC role, speed);
 - No matching power plants ready.
- **Had ability to do:**
 - Cash from surging oil;
 - No need for technology, skill;
 - Felt no need to compromise on return for cash.
- **Had support:**
 - Government support;
 - Energy crisis, security;
 - Strategic reserve.
- **Growing opposition inside (limit foreign control);**
- **Leadership change; strategy shift.**

Benefits of having foreign involvement diminished. PetroChina lost patience.

Central Government: the Impact of Evolving National Strategic Goals on Foreign Investment

	Energy Supply Project Development	West development	Energy restructure	Energy security	Political, social stability	Environment Protection	Economic development	Deepen the reform
Jul-98							Build more infrastructure, create more jobs	Attract foreign capital, build global companies, enhance image of the reform
Jun-00							1 of 4 super infrastructure	
Oct-01	Permit full participation of foreign investors, offer favorable policies	WEP is central piece	Develop gas industry, reduce reliance on oil imports, diversity energy sources					
Mar-02			Reduce reliance on oil imports, deemed as a strategic weakness		Independence movement, deemed as national security	Clean energy fuel		Build global companies
Jun-02	Strategic significance: "winning the heart of the public" project. Strategic decision: make sure to build the WEP, whether it is economically viable; China would not hesitate to pull all resources together for a project of national security.							
Feb-03	Technology not necessarily needed Not allow guaranteed rate of return							
Sep-03	Pricing set by NDRC, as a political task Feel foreign investment redundant		Develop LNG, gas, overseas	National energy				
Oct-03	Firm on return no more than 12% NDRC stay above negotiation, as implicit support Feel higher return and foreign involvement could hurt the project PetroChina speed up project, due to competition pressure			Develop strategic reserve				Promote post-WTO market competition
Aug-04	Issue letter of termination							

The Impact of the Leadership

- **Influential power of the industry and its association: need a more prominent decision-maker like Li Peng from the power industry:**
 - WEP Leadership Team were all deputies.
- **Need a strong leader like Zhu Rongji in supporting foreign investments and reform:**
- **Negative impact of leadership change:**
 - Zhu Rongji (waning support of foreign involvement);
 - Management shuffle in PetroChina (3 CEOs in 4 years) and CNPC (Ma Fucai);
 - Management change in foreign consortium.

Chinese Perceptions of Cultural Clashes

- **Sense of time: “It’s too early to tell” about French Revolution.**
- **Nationalism vs. rationality:**
 - “Throw an ax over the head of the devil” sung by Chinese chief negotiator during break: contradiction of glorious history vs. humiliated modern days;
 - West-East Pipeline: the Great Wall (security, national pride, glory) and Silk Road (commercial exchange, superiority);
 - Chinese companies are accustomed to “grasping for stones to cross the river” and “learn as we go along.”
- **How to define the word “big” in a letter of comfort on July 4, 2002:**
 - The story of “a big change” in dealing with the future change to tax system.

Chinese Perceptions of Foreign Consortium

- **Strategic issues:**
 - About face in “Political investment” in the WEP (initially cultivate market, gain a foothold, gateway to other projects, and win political favors);
 - Should have known beforehand about the return risk (BP withdrew), and that the value it brought to the project was not necessarily needed;
 - Conspiracy theory: plan to sell gas from Sakhalin, Russia and Central Asia by raising the WEP gas price.
- **Cultural issues:**
 - Timing (different decision-making procedures and long process – annual review);
 - Tough task to handle cultural issues within the consortium

The Role of National Agencies

- **Political project vs. commercial one (if rate of return lower than 12%, CNPC would take the project).**
 - Strategic shift to concerns of energy security and crisis.
- **Planned-economy project vs. market-economy consumers:**
 - Pricing: Political task (to buy WEP gas);
 - Coordinated parties in disputes;
 - Planned matching gas-fired power plants;
 - Implicitly support PetroChina in going solo and getting into the negotiation details.
- **Mismatch of NDRC's (National Development & Reform Commission) strategic goals with PetroChina's corporate goals.**
- **Lack of a specialized natural gas regulatory agency (NDRC energy bureau is not competent and lacks resources), lack of long-term industrial policies.**

The Role and Impact of Local Governments

- Compensation issues: **compensation for the use of land and potential conflicts.**
 - Local attitudes toward the use of land (temporarily or permanently) vary, due to the disparity of local economic structure and social and human environments;
 - The compensation issue determines the attitude of a certain interest group toward the WEP and impacts its view of the future project sponsored by the government.
- Coordination issues:
 - Local governments responsible for planning the use of the land; if the government is not capable, it can create problem between the construction teams and local residents; and if the compensation funds are not fully paid to local residents, conflicts can deepen.
- Information issues:
 - Local residents and government officials have very limited knowledge of the West-East Pipeline;
 - Some local residents do not know where to obtain the information of the WEP pipeline route.

The Local Influence of PetroChina

- The impact of local presence of PetroChina/CNPC:
 - Transit Regions in the territory of PetroChina: PetroChina has very strong political and economic influence in Northwest and North, where it has oil and gas companies, large refineries and petrochemical companies, and petroleum sales companies in each location.
 - PetroChina Lanzhou Petrochemical Company: No. 1 taxpayer in Gansu province, with US\$1.5 billion in assets and 13,000 employees.
 - PetroChina Changqing Oilfield Company: Paid tax US\$300 million in 2004, with US\$4.2 billion in assets and 11,500 employees in Shaanxi province.
- The impact of local end-users/competitors on the project:
 - End-User Regions in the territory of Sinopec, with refineries and petrochemical plants of Sinopec.
 - Harder to develop downstream market, control urban networks of pipelines;
 - Before its commercial operation, the WEP gas price was reset three times, largely due to resistance and pressure of local gas companies and large industrial users.

The Impact of NGOs and UNDP

- NGOs (Non-Governmental Organizations):
 - Human rights groups concerned whether or not ethnic minorities will share the benefits of the economic development;
 - Environmental groups (Friends of Nature) concerned with local fragile ecosystems on the pipeline route.
- UNDP (United Nations Development Program) Social Impact Assessment:
 - Published by UNDP on September 6, 2002 and sponsored by Shell;
 - Significance of the report: Future national super-major infrastructure projects must undertake social impact assessment;
 - Objective of the assessment: Understand what the affected think about the project and what their expectations are.

Local Communities and Residents

- **Nearly 30 million people live in areas affected by the West-East pipeline.**
- **Safety issues:**
 - Illegal coal mine digging along the WEP route;
 - Improper tree planting and fence building on top of the WEP pipeline;
 - The location of factories (fireworks) too close the pipeline;
 - Coal yards and mines standing on the pipeline route.

The Impact of Local Residents: Expectations

- **Local residents have primary positive assessment of the WEP, a strong "benefit of the doubt" view of the WEP.**
- **Assumptions:**
 - Majority of local residents supported the WEP pipeline construction, because the project was important to China and beneficial.
- **Expectations:**
 - The construction of the WEP pipeline may promote local economic development, add employment opportunities, and develop use of natural gas as a fuel.
- **Concerns:**
 - Losses of land, damage to properties and other buildings; degrade soil fertility and reduce crop production; withholding and abuse of compensation for affected households and communities.

Source: UNDP China Social Assessment of West-East Pipeline

The Impact of Local Residents: Challenges

- The major challenge: how to ensure the local communities will benefit from such a project.
- There is a risk that "benefit of the doubt" could become doubt or even active opposition if expectations are not met and concerns are confirmed by facts and what happens on the ground;
- Lack of information a potentially serious threat to good will;
- The need to allay fears about the pipeline's safety and the threat of leakage or explosions.

Source: UNDP China Social Assessment of West-East Pipeline

Local Social, Cultural, Historical Features

	Xinjiang	Gansu	Ningxia	Shaanxi	Shanxi	Henan	Anhui	Jiangsu	Zhejiang	Shanghai
Economy	Underdeveloped western and central regions.							Economic development regions		
# of firms	6 upstream 7 chemicals	2 upstream 5 chemicals	4 chemicals	2 upstream 2 chemicals	PetroChina/CNPC has no major oilfields or plants.					
Territory	PetroChina					Sinopec				
Religion	Ethnic Muslim			Ethnic Han (95% of total Chinese)						
Culture	Silk Road (outside exchange, superiority, alternative)				The Great Wall (national pride, security, unified China)					
WEP Pipeline	Primary gas source	Pass-through (1/4 of route)	Pass-through	Backup gas source	Pass-through	Customer				
Resources	Oil/Gas	Oil		Oil/Gas	Coal	Coal/Oil		Chemicals		
History	Rebellious state	Forgotten land	Forgotten land	Ancient glory	Mercantile	Ancient civilization	Forgotten land	Rich	Rich	Oriental Pearl
National status	Go West center	Desert	Forgotten land	Tourism city	Coal city	Piracy city	Mountain town	River beauty	Leaders town	American town
Political power	Ethnic independence	Limited	Very limited	Limited	Limited	Limited	Very limited	Strong	Very strong	Extremely Strong

Colors: shows how complex non-financial issues are.

Local Economic, Energy and Ethnic Features

- The project is a singular or rare opportunity for those regions to develop their economy and for local industries.
- Almost all pass-through regions are rich in oil, gas, coal and other resources, but are extremely underdeveloped.
- Along the route of the Great Wall and Silk Road, there are large ethnic minority groups, especially Muslims (Social and ethnical unrest, terrorist threat, independence movements).

The Impact of Local Social, Cultural Factors

- **Local social, cultural, environmental factors changed the original route:**
 - Wild camel migration;
 - Memorial place of a revolutionary local leader in Shaanxi;
 - Protection of irrigation channels in Yan'an;
 - Protection of historic sites and local heritage;
 - Pierced the Great Wall 14 times;
 - Other environmental issues.
- **SARS slowed down the project for months (“100-day” campaign to catch up).**
- **Adjusted the thickness of the pipeline wall to prevent leakage, explosion or theft, considering characteristics of local regions.**

Thank You!

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