China's Leadership Transition and the Energy Sector

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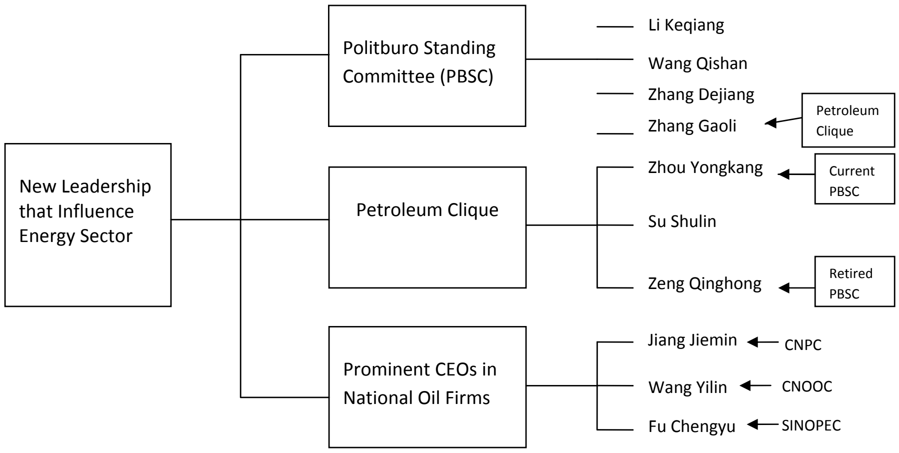
Profiles of Potential Energy Leaders

The composition of the new Politburo and their views regarding the large state-owned enterprises (SOE) will have profound implications for China's socioeconomic trajectory in general and for the energy sector in particular. It would be helpful for China watchers to grasp the biographical backgrounds of the top Chinese leaders who will likely govern the country for most of this decade and beyond.



In that regards, I would like to divide the energy-related Chinese leaders into three groups: Politburo Standing Committee (PBSC), a supreme leadership body that perches atop the China's hierarchy; Petroleum Clique, the politicians who made their political fortune through their careers in the oil and gas industry; and the prominent CEOs in China's large oil companies.

The PBSC Group – Xi Jinping will succeed Hu Jintao as president of PRC after the 18th Party Congress in fall 2012. He has long been known for his market-friendly approach to economic development, yet he has also displayed strong support for China's flagship state-owned enterprises, including China's large energy firms. Thus, these firms may continue to monopolize many major industrial sectors in the country under his tutelage. Moreover, Xi's views concerning China's political reforms appear to be remarkably conservative, seemingly in line with old-fashioned Marxist doctrines.

Although Li Keqiang is in line to succeed Wen Jiabao as premier of the State Council after the leadership transition, he is perceived by some to be somewhat too "weak" to be capable in this position. Li will likely continue to resolve some policy issues like promoting innovation in clean energy technology. In addition, he will succeed Wen as head of the National Energy Administration, the highest agency regulating China's energy industry. However, there is a slight possibility that the premiership might be left to a "tough" leader, Wang Qishan.

Wang is almost certain to obtain a seat in the next PBSC. Although he has strong ties with major state-owned enterprises, it is unclear whether he will favor public ownership of the petroleum sector or promote the private investment. Another PBSC candidate, Zhang Dejiang, may continue to promote policies in favor of state dominance, economic protectionism, and the development of SOEs, among which the national oil companies (NOCs) are the most profitable in China and fit well into this category.

Zhang Gaoli is also believed to be an emerging member for the next PBSC. An economic thinker, Zhang advanced the early stage of his career within the oil industry. Although he has extensive leadership experience in the prosperous coastal areas like Shenzhen, Guangdong, and Tianjin, and is considered instrumental in the economic development of these regions, he takes a low-profile approach, and it is, therefore, unclear what his attitude towards the proper development of the NOCs will be. In general, Zhang is known for his pro-market economic policy orientation.

The examination of the policy preferences of this PBSC group seems to show that the top Chinese leaders for the next decade may help PRC flagship companies obtain the status of leading global companies. This does not exclude the engagement of economic mercantilism and protectionism. We expect to see China's national flagship companies' monopoly and overseas expansion as the most crucial factors in the next phase of China's rise.

Petroleum Clique – The Petroleum Clique is another group that may wield great power over the energy sector after the leadership transition. A current member of PBSC and a key member of the clique, Zhou Yongkang, spent a majority of his life in the oil and gas sector. He used to be vice minister of the Petroleum Industry and president of CNPC. It is well-known that Zhou wields significant influence in the oil sector.

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However, his political impact is tarnished due to his step-down from the incoming 18th Party Congress, as well as his support for the former Chinese politician, Bo Xilai. This may result in his loss of right to select his own successor when he retires from the PBSC in the fall of 2012.

Former PBSC member Zeng Qinghong is the chief of the Petroleum Clique. Zeng spent his early years in the petroleum industry before he was elevated to national leadership by then president Jiang Zeming as his trusted adviser. At the time Zeng was in place, most clique members swore loyalty to him. However, Zeng's influence is currently ebbing as Jiang's faction is gradually phasing out of the political platform.

Another major Petroleum Clique member, Su Shulin, has many years of experience working in China's oil and gas production. He spent most of his time as leader of Sinopec. One of the important accomplishments of Sinopec under Su's leadership was its environmental focus. Also under him, the company actively explored renewable energy sources. Starting in 2011, Su has served as Governor of Fujian Province. Considering his diverse governing experiences and his young age, Su is likely to continue to rise in his political career even after the Chinese new leaders assume power.

This second group of petroleum CEOs-turned political leaders, like Su Shulin, made successful transfers in their lives from oil industry to the political realm. Not top tier yet, they are making their way to the 6th generation leadership after Xi. As the CEOs-turned politicians may further enhance their presence at the 18th Central Committee in 2012, the oil industry is expected to be well represented in the future.

Prominent CEOs in NOCs – This group consists of top leaders from the large national oil companies, like Jiang Jiemin, Fu Chengyu, and Wang Yilin. Jiang is a long-term leader of CNPC and a key figure in China's determined expansion of its energy dominion overseas. Fu had been chairman of CNOOC since 2003 and is currently chairman of Sinopec since 2011. However, both Jiang and Fu have never made the jump from the energy business to politics, and they will most likely never be able to make it because they are approaching retirement age. These limitations diminish their chances to become political stars. Their diminished reputations have been reflected by Fu's failure to be elected as one of the SOE delegates to attend the upcoming 18th Party Congress, as well as by Jiang's probability to at most become an alternate member of the Central Committee. The decline of Jiang's political fortune is further portended by his receipt of a warning as a punishment for his responsibility in a pipeline explosion in Dalian last year. Thus, to some extent, one can say the political careers of current NOCs' leaders such as Jiang and Fu's depend upon the patronage of Zeng and Zhou for their rise.

Despite the lack of political say, the energy companies' financial clout and technical expertise provide them with considerable influence over energy projects and policies in China. Their increasing importance in China's political life has been illustrated by the fact that the number of SOE delegates for the 18th Party Congress has increased 3 folds compared with 10 years ago when SOEs first formed a separate group participating in the 16th Party Congress in 2002. In addition, among the delegates from SOEs, a quarter of them are from the energy segment. Analysts may reasonably expect that one or two top business leaders from China's energy majors are among the candidates for Politburo seats. This group of business elite is well aware of the dilemmas and problems faced by the NOCs, and therefore probably are more in favor of a market approach and price reforms.

The biographical features of the new leadership are a sufficient basis for some preliminary judgments about the tendencies of the energy segment. The new leadership will likely continue to support the large NOCs in achieving leading global companies' status. We expect to see China's energy majors continue to enjoy the monopoly advantage and overseas expansion. However, the internal conflict between price control and market-driven forces may push the new administration to make some adjustments on the oil and gas segment, which will become the subject for the next series.

From Price Reform to Pipeline Construction

As China prepared itself for its 18th Party Congress, the political alignment created an opportunity for energy policy change and an impetus to change. The power transition is not just occurring at the apex of political power, but throughout every level of the institutions. Moreover, it is a generational turnover in economic management agencies. In essence, a generation of managers is now stepping down, a group of individuals who went to university during the 1960s, worked through the Cultural Revolution, and then assumed leadership roles during the 1990s. This generation includes China's "energy czar," Zhang Guobao, retired in 2011; and chairman of State-owned Assets Supervision and Administration Commission (SASAC), Li Rongrong, retired in 2010. This turnover in the economic establishment is part of the generational turnover occurring in Chinese society overall.

At the same time, the holdovers from the 17th Party Congress will see political continuity with past policies in the new Politburo under Xi Jinping. For the Central Committee (371 members), the turnover rate at the 18th Party Congress is expected to be somewhere between 60 and 65%. In the State Council, about 70% of the total members will be replaced, mainly due to their ages. In the next administration, we will see China continue to be governed by an oligarchy similar to the Jiang and Hu eras and a growing difficulty in establishing consensus among the leaders.

The aforementioned change-in-the-context-of-continuity dynamics driven by the Chinese leadership shift will have profound impacts upon various aspects of the oil and gas industry.

Oil product pricing reform: China's oil product pricing reform targets reasonable profit margins of around 5% for the Chinese refiners. Effective since December 16, 2011, China took a small step towards natural gas price reform by implementing a trial in the southern Guangdong and Guangxi provinces. The implementation of a permanent pricing reform could be opportune in that the sustained period of lower oil prices helps restrain inflation. However, the odds of a pricing reform in 2012 are believed to be low given the political environment. Yet, it is good news for domestic gas producers that the NDRC has acted, and we expect a nationwide roll-out to fully liberalize wellhead prices before 2015.

SASAC's corporate governance reforms - SASAC has begun to exert more influence over the large state-owned firms, including the NOCs. For the next few years we expect to see less severe corruption in the national oil firms, as fighting corruption is one of the goals set out by the SASAC. The power of the corporate leaders in the oil firms might be curbed to prevent them from accumulating too much power to become independent corporate fiefdoms. We also expect to see an establishment of independent boards in the next leadership that will promote the profitability and operational efficiency of the NOCs.

Super Energy Ministry: One of the new developments in this discussion is the creation of a Super Energy Ministry, which we expect to occur in 2013. The objective of this new agency would be to take the energy-related responsibilities of the NDRC, National Energy Administration, SASAC and various other local, provincial and state agencies and roll them into one. However, the two most important controls – pricing setup and investment approval authorities – are said to remain in the NDRC for the time being. Without these two commands, we may wonder about the true effectiveness of the prospect Energy Ministry. In addition, establishing a full ministry not only requires numerous subordinating agencies and staff nationwide, but also needs legal validity. China's *Energy Law* has somehow never been released, although the drafting process was begun long ago by Premier Wen Jiabao in 2005, and the actual documents came into form in 2008. Furthermore, the formation of the Energy Ministry is said to cause tremendous objections from NOCs and other interest-vested organizations as a result of their influence being largely reduced. All this indicates that the setting-up of a Super Energy Ministry is an important and challenging task for the next generation of Chinese leaders, and it may take as long as 10 years to fulfill this mission.

Natural gas and pipeline construction: China has recently begun the construction of the third West-East Gas Pipeline that starts in Xinjiang and takes mainly Central Asian gas to Fujian Province in Southeast China. A fourth pipeline has been planned while discussions to build the fifth are underway. PetroChina may begin the construction of a third cross-border gas pipeline in 2013, and the project may take 2-3 years to complete. In addition, China hopes to double the share of natural gas in its overall energy mix to 8% by 2015. China has recently sped up its pace of shale gas development and will continue to do so in the future. On March 16, 2012, China's National Energy Administration published a shale gas development plan that set ambitious five-year production targets with 6.5 bcm/year by 2015 and 60-100 bcm/year by 2020. Moreover, in December 2011, China issued the 12th Five-Year Plan for coalbed methane development and utilization. From these, we can tell promoting clean energy technology will continue to enjoy a priority for the next administration.

Undergoing an economic slowdown: It is widely agreed that China is facing an economic growth slowdown. This is partially because of economic conditions in Europe, which is the biggest single contributor to the slowdown in Chinese exports. A more fundamental reason is China itself; it is moving out of the long-term phase of high growth. China's labor force is growing at a dramatically slower pace, and in just a few years the labor force will begin to shrink. Moreover, the past consistent high investments led to an abrupt drop in growth.

To prevent such an abrupt transition to slower growth, the government is likely to continue sponsoring or funding large investments in oil and gas projects. At the same time, China's leaders understand that they need to be flexible in order to handle the coming challenges. This awareness may lead to a heightened uncertainty, which will, in turn, generate unexpected changes in oil and gas policy. In addition, the unprecedented economic circumstances may increase pressure upon the incoming leaders to look for ways to break with business as usual, and this may open up opportunities for energy reformers.

Business elites in the party leadership: The CEOs of large national oil firms have become more ambitious in their jockeying for power in the leadership of the Chinese Communist Party. The remarkable presence of senior executives of NOCs among the top national leaders reflects an important trend in elite recruitment in present-day China. The political transition in 2012 will be an important test for the future importance of business interests in Chinese politics, this perhaps foreshadowing a new phase of transformation of state-business relations in this rapidly changing country.

In conclusion, we expect more energy-related policy initiatives to be implemented during the 12th Five-Year Plan of 2011-2015 despite a leadership turnover, and the 13th Five-Year Plan to fine tune the provision of energy in the growth of the Chinese economy. In the second half of 2011, China launched some key changes to the taxation system like a resources tax and a special oil gain levy and some changes to the pricing such as natural gas, and we expect tax adjustments and pricing liberalization to continue throughout 2012-14. However, we do not expect major changes in energy policy to be made between now and a year after the new leadership takes office. The economic issues will likely only gradually head toward resolution in the fall of 2013. That is when the 18th Central Committee is scheduled to hold its Third Plenum. Traditionally, the Third Plenum has been the venue at which a new administration, having consolidated its power and worked out its program, presents ambitious new economic policies, including those for the oil and gas segment.