Gradual Reform across the Value Chain
China Oil & Gas Reform Series I
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100

Making another century of impact

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Welcome to Deloitte’s series on China Oil & Gas Reform. Over the coming months we will be reviewing each of these reforms in turn. A global trend of reduced commodity prices, the importance of environmental concerns and the technology imperative are driving China’s oil & gas reform beyond its own domestic concerns.

China has been studying the sector for a long time as oil and gas assets are considered strategic assets of the country. Despite the importance and necessity of the reform it also comes with its own set of struggles, making it the most difficult task for the top authorities. There is an intertwined relationship between geopolitics and economics, volatile international and domestic market dynamics, and different interests of state ownership and private investors. So when China announced its long-awaited oil and gas reform summary - Opinions on China Oil and Gas System Reform (“the Opinions”) - in May¹, it makes sense that the reforms will be gradual and pilot-based, containing a compilation of plans and programs already underway.

China’s oil and gas reform aims to push market-oriented reform across the entire value chain. The key issues facing the sector are:

- **Upstream**: exploration and exploitation is the foundation of oil and gas industry, and it is the most capital intensive, lucrative and monopolized sector;
- **Midstream**: the separation of pipelines is the key issue;
- **Downstream**: reform of downstream sector is under great pressure, but the completion of the pricing mechanism and introduction of mixed ownership may be breakthrough achievements.

Although the detailed reform plan is yet to be announced, the Opinions outline eight tasks covering the entire oil and gas industrial chain:

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1. Exploration and exploitation
Traditionally, the government allocated upstream blocks based on applications from the four state-owned oil companies - China National Petroleum Corp (CNPC), China Petrochemical Corp (Sinopec), China National Offshore Oil Corp (CNOOC) and Shaanxi Yanchang Petroleum. The "Big Three" (CNPC, Sinopec and CNOOC) together owns 96.7% of registered exploration territory and 99.2% of registered exploitation territory. This "elite club" has given a rise of inefficiency in resources allocation. The latest data released by the upstream watchdog Ministry of Land Resources, showed that China's newly discovered proven oil in place was 914 million tonnes (6.7 billion barrels) in 2016, the first time in 10 years that annual newly discovered reserves were less than 1 billion tonnes. Hence, there is a need for new exploration.

According to the Opinions, government will open up the mineral rights by changing the registration system to a bidding system, relax the restrictions regarding the development qualifications of exploration and exploitation, increase the holding cost and strictly control the exit mechanism of exploration rights, and establish a mineral rights transfer system.

Three types of oil and gas companies are expected to gain access to exploration of onshore conventional oil and gas:
- provincial SOEs located in oil and gas resources-rich provinces;
- private oil and gas companies who owns overseas assets with overseas exploring experience; and
- oil service companies with domestic oil field service experience.

State oil companies may face higher costs in obtaining exploration right due to the rising competition. As reform goes on, they will need to be prepared for shareholder structure change, which will bring disruptions in production, operation and management for the organization.

Foreign oil and gas companies may set up JV with domestic players to participate in the exploration and exploitation of conventional resources, however, considering China's complex geological conditions and limited oil and gas resources, foreign participation in upstream sector will likely remain limited.

2. Import and export management
The reform of imports and exports will impact refiners the most. The government plans to develop a system to more actively monitor crude import by quota holders, both state-owned companies and independent refiners.

The imports restriction relaxation is already underway. Independent refiners were granted crude import quota and allowed to imports crude oil since 2015. Their participation in the market has been putting pressure on state-owned refineries, and pushing them to improve efficiency. However, under the new system, independent refiners may come under tighter scrutiny and supervision, including whether they are adhering to all taxation regulations.

The government also plans to improve the policy for exports. Currently, the oil product exports quota are confined to four state-owned companies – CNPC, Sinopec, CNOOC and Sinochem. Independent refineries are eager to restart product exports after they were denied to get export quota late last year.

China’s oil companies export through two routes -- the processing trade route and general trade route. Under the processing route, exported oil products are tax exempt but highly restricted to the refined products using imported crude oil from specific refineries. Under the general trade route, which was resumed in January 2017, state-owned trading companies are free to export oil products from both internal and external refineries using domestic or imported crude, and a rebate on VAT and consumption tax can be claimed.

The imports and exports reform will trigger more market-driven changes in trade and sales markets and help to establish a market more accurately reflecting the oil prices.

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2 Impact of oil and gas market access reform on giant state-owned petroleum and petrochemical enterprises in China, Liu Yinghong, Xu Dong, Tang Guoqiang, Sinopec Development and Planning Department, PetroChina Planning and Engineering Institute, Natural Gas 2017-37 http://www.oilfun.com/industry-view/4954

3. Pipeline reform
According to the Opinions, China aims to gradually separate the oil and gas pipeline business from state-owned oil majors and further open oil and gas pipeline networks and facilities for the third party access.

Separation of pipelines to break the monopoly is the most discussed topic in midstream reform.

The total length of China’s onshore oil and gas pipelines is approximately 120,000 kilometres, including 23,000 km of crude oil pipeline, 21,000 km of refined products pipeline and 76,000 km of natural gas pipeline. CNPC, Sinopec and CNOOC monopolise the market by possessing approximately 98% of the market shares.

Pipeline reform is already under progress as the oil majors have set up pipeline companies in anticipation of the separation. In November 2016 CNPC split its gas sales and pipeline business. However, we think the establishment of an independent national pipeline company is unlikely in the short-term as the implications are too significant.

Oil and gas pipelines, oil wharfs, liquefied natural gas receiving stations and the provincial and interprovincial networks are in a fragmented state, which has led to insufficient competition and wasted resources. Despite the challenges and slow pace, fair and open third-party access would be beneficial to allowing new capital to enter the oil and gas field.

Meanwhile, expanding the infrastructure access will lower the operator’s cost. For example, granting third-party access to national oil companies’ LNG terminals and opening up the pipeline network would enable gas operators to diversify their supply sources at cheaper prices, which is positive for demand. In short, creating competition will create efficiency.

4. Downstream competition
China is expected to deepen the reform of downstream competition to enhance the supply and production of high value products.

Government aims to set higher standards on product quality, safety, environmental protection and energy efficiency. It also plans to better control new entrants in the refining sector and speed up the phase-out of old capacity to reduce excess capacity.

The opinions also addressed the fair competition in the natural gas distribution market to boost the natural gas usage. In this regard, it is still an open question regarding whether the new plan will be applied to the city gas distribution market.

China’s city gas distribution networks have been rapidly expanded over the last decade and will continue to expand with further urbanization. Numerous gas distribution companies were established, many owned or associated with central and/or local government entities, which enable and accelerated buildout of the networks. Annual sales volumes growth was 20% over this period, although growth rates have declined in recent years. Approximately 35% of medium and large-size cities (240 million people) in China had access to piped natural gas in 2015, leaving a large unserved potential market for city gas distribution.

Existing city gas distributors will need to prepare for increasing competition and adjust their business models as necessary.

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2. China’s total mileage of onshore oil, gas pipes reaches 120,000 km, People’s Daily Online, 2015-08-24 http://en.people.cn/n/2015/0824/c30000-8940666.html
3. China to push for reform on oil and gas pipeline operations, Xinhua, 2017-09-05 http://www.chinadaily.com.cn/business/2017-09/05/content_31594245.htm
5. Pricing Mechanism
China intends on improving the pricing mechanism of refined oil products while giving full play to the role of the market to determine prices and reserving the government’s right to regulate the abnormal fluctuations in prices. A challenging task. It intends on promoting non-residential gas price liberalization, and fine-tuning the residential gas pricing mechanism. It also is encouraging the development of oil and gas trading platforms in order to eventually achieve market-driven prices.

The oil and gas markets in China are at different stages. The oil pricing mechanism changes more frequently than gas prices do and is therefore more reflective of global prices, though price movements are still determined by the government. The next step would be to reduce the role of the state in price setting, but this is unlikely to happen in 2017 and will only be achieved gradually.

The main constraint of China’s natural gas development is price. Without taking account of environment costs, the price of natural gas is much higher than that of coal. In the gas market, the next steps will be reducing pipeline tariffs and removing cross subsidies among end users.

Establishing trading platform will increase competition among gas suppliers and gradually lower the gap between international gas prices and China’s higher domestic gas prices. The establishment of the Shanghai Petroleum and Natural Gas Exchange in November 2016 and the Chongqing Petroleum and Natural Gas Exchange in January 2017 were key infrastructure enablers facilitating long-term market pricing. Gas purchased through the exchanges carried a 6%-7% price discount compared to regular domestic prices in 2016, as estimated by gas distributors.

6. SOE reform
China will continue pushing the reform of state-owned oil majors by introducing mixed ownership, improving corporate governance and streamlining operations, including going for mergers and acquisitions.

We expect increased restructuring and integrations in state-owned oil giants’ specialized business as engineering companies and oil and gas equipment manufacturers are encouraged to work as independent enterprises. CNPC will spend the next 2-3 years restructuring its enormous services division and aim to set up three or four companies covering oilfield drilling, refinery engineering and financial services, with a target to list them on the stock market in the near future.

The mixed ownership reform is already starting to play out, but so far having a limited impact on the oil and gas market given that the oil giants are deeply entrenched in the upstream and midstream markets.

7. Storage and Distribution
Government aims to secure oil supplies and develop a storage system serving both government and private enterprises. It also seeks to improve the investment mechanism by encouraging private investment in storage capacities.

Following the Opinions, in a draft of new regulations published on July 19 2017, the government proposed to lower the minimum storage capacity requirements from 500,000 cubic metres (cm) down to 200,000 cm to distribute and store crude oil and from 200,000cm down to 20,000cm for distribution and storage of refined products. Experts and traders believe those requirements are in line with industry average.

Eased regulations for firms to enter the domestic distribution and storage industry may spur private storage capacity growth, as well as improve the liquidity needed to advance China’s long-held plan to launch its own crude oil futures contract.
8. Safety & environmental protection
China aims to enhance the safety and clean operation of the entire industry. It will strengthen the safety supervision of oil and gas development and utilization and improve the risk management.

The refining sector, especially the medium and small sized refiners, will be under tighter scrutiny. The government has started sending teams of environmental officials and experts to Shandong, where the most independent refiners locate, to make regular but unscheduled visits for environmental and safety check. Some 30 independent oil refineries and an unspecified number of chemical plants in Shandong have been shut since mid-July. Some of them may not be able to resume operation as the upgrade costs would render them unable to compete with imports.

Understanding the economic fundamental drivers and their implications will help us anticipate how the oil and gas reform will evolve and at what pace. We think the low oil price environment and China’s structural change are the two most critical drivers.

Low oil price environment
While the timeline for the oil price to rebound is difficult to project, it is likely that the low oil price will be a new reality. This stimulates China oil and gas reform by:
• allowing crude imports of independent refiners;
• providing an opportunity for fuel pricing reform;
• bringing both opportunities and challenges to natural gas; and
• forcing Chinese oil and gas companies to emerge stronger.

Bloomberg Consensus Brent and WTI Forecast (USD/BBL)

Source: Bloomberg, Deloitte Research
The tumbling oil prices since the second half of 2014 sparked China’s oil buying spree to fill its strategic reserves. The government began granting license and import quotas to independent refiners to allow them to take advantage of the low oil prices as well.

Under the current pricing mechanism, if international crude oil prices change by more than 50 yuan per ton and remain at that level for 10 working days, the prices of refined oil products such as gasoline and diesel in China will be adjusted accordingly. The government intends to closely monitor the effects of the current pricing mechanism and roll out pricing reform in response to changes in the global market.

As global oil prices continue to stay at a level below $50 per barrel, Chinese oil and gas companies are confronted with more challenges than their international counterparts because the production costs for many wells in China are above competing international production prices. Against this backdrop, SOEs have to learn how to operate in a lower price environment, returning to a healthier focus on capital and operating cost discipline. In addition, SOEs will be more open to private investors to improve cash flow and efficiency.

China’s structural change

Although China’s rapid growth in the past decade is unlikely for the next 10 years, it still has resilience thanks to the booming consumption and private investment.

The transformation to a consumption-driven model may not be able to offset the slowdown in investment, it is definitely altering the pattern of energy use. The residential and transport portion of energy demand will grow, while the proportion consumed by industry and the commercial sector will decline.

In the short to medium terms, the most pressing problem facing China’s economic transformation lies in de-leveraging consequences. The central government may reduce corporate debt via reforms by introducing mixed ownership. Meanwhile, as credit is becoming more expensive, business are seeking ways to squeeze more cash out of their operations to repay what they borrowed or to avoid taking on new loans.

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Continuous overseas investment
China’s overall energy demand will steadily grow at 2-3% annually by 2020, however, with domestic oil production declining, imports and overseas investment will inevitably rise further. In light of this, China will continue supporting national oil companies’ investment in oil and gas fields overseas, as well as by offering loans to producer countries which are repaid with oil. China will learn from prior investments and take tighter controls on investment activities.

Chines oil companies, both state-owned and private, are very active in the “Belt and Road” initiative. For upstream, it will be the oil and gas oilfields. For downstream, it will be the refining, chemical, or marketing projects.

Get smart with technology
The oil and gas industry, despite its age, is one of the most technology-driven industries. Horizontal drilling and fracking technologies have helped drive oil prices down from an all-time high of $145 per barrel in 2008 to about $50 today. Supply has become much more responsive to market conditions, undercutting OPEC’s ability to influence global oil prices15.

It was mentioned several times in the Opinions that China aims to improve supply, efficiency, and product quality. Technologies will help oil companies to boost productivity and flexibility:

Outlook

Based on the above analysis of the macro trends, we see a positive outlook in the oil and gas sector. This view translates into the following sector outlook:

Bigger role of natural gas
The reform will drive the growth of natural gas market for two reasons. One reason is economic since natural gas will become more affordable. Another is environmental. People living in China will benefit from increased natural gas consumption as it produces less pollution.

China plans to increase the share of natural gas as the primary energy mix from 6% to 8.3%-10% by 2020. To achieve this goal, the government has decided to launch the coal-to-gas program, open the infrastructure access to third parties, lower the threshold for storage capacity, and extend natural gas pipelines to all cities with a population of 500,000 residents13. It’s expected that China’s natural gas demand will grow at an average rate of 6% per annum over 2017-2026, with the fastest growth continue coming from residential users. A recent report from the IEA claimed that worldwide demand for natural gas is expected to grow and China is a key driver of increased demand. IEA predicts that natural gas consumption in China will, by 2022, be five times the current usage14.

Oil and gas reform will lead to bigger role of natural gas as a transition fuel in China’s quest for diversifying energy supply and addressing environmental challenges.

China’s natural gas demand grows faster than oil, coal and renewables

Oil and gas reform will lead to bigger role of natural gas as a transition fuel in China’s quest for diversifying energy supply and addressing environmental challenges.

13 China plans to expand oil, gas pipeline networks, Xinhua, 2017-7-12 http://news.xinhuanet.com/english/2017-07/12/c_136438633.htm
15 The next energy revolution: The promise and peril and high-tech innovation, David G. Victor and Kassia Yanosek, 2017-06-3 https://www.brookings.edu/blog/planetpolicy/2017/06/13/the-next-energy-revolution-the-promise-and-peril-of-high-tech-innovation/
Conclusion

We are entering a period of lower economic growth and policymakers and business leaders need to manage the implications of a new world of cheaper energy. China’s oil and gas reform will be a gradual process that balances the social needs with the economic needs. Eight tasks listed in the reform opinions are no news to the public, and some of them are already underway. Looking forward, as more reform measures unfold, we expect a bigger role for natural gas, continuous overseas investment echoing the “Belt and Road” initiative, technology driven innovation, and slimmer but stronger SOEs.

Slimmer but stronger SOEs
A modern corporate system, which separates government administration from business operations and spinoffs social responsibilities, will allow SOEs to function as efficiently as other business entities.

Diversifying SOE’s shareholder structure is one of China’s key targets in 2017. The state-owned oil companies CNPC, Sinopec and CNOOC will see more re-organization as private investment comes in.

In addition, all three state-owned oil giants posted stronger than expect results in 1H 2017. They will be focusing on the corporate value and maintain the debt level at a reasonable level. These companies are holding abundant cash flow in the aim of responding to market changes and volatility.

• smarter management of complex systems allowing companies to become more efficient while drilling for oil and gas in ever more complex geological environments;

• data analytics makes it easier for companies to find oil and gas and manage production, “predictive maintenance” reduces unplanned downtime; and

• mobile apps and mobile payment provide a personalized and loyalty building shopping experience to customers at petro stations.

However, the transition won’t be straight forward. As the technology revolution unfolds, it brings new challenges in terms of infrastructure, talent, and cyber security, which need to be addressed today.
Office locations

**Beijing**
8/F Tower W2
The Towers, Beijing Oriental Plaza
1 East Chang An Avenue
Beijing 100738, PRC
Tel: +86 10 8520 7788
Fax: +86 10 8518 1218

**Changsha**
20/F Tower 3, HC International Plaza, No. 109 Furong Road North, Kaifu District, Changsha 410008, PRC
Tel: +86 731 8522 8790
Fax: +86 731 8522 8230

**Chengdu**
Unit 3406, 34/F Yanlord Landmark Office Tower
No. 1 Section 2, Renmin South Road
Chengdu 610016, PRC
Tel: +86 28 6789 8188
Fax: +86 28 6500 5161

**Chongqing**
36/F Deloitte Tower
8 Corporate Avenue, 10 Ruitian Road
Yuzhong District
Chongqing 400010, PRC
Tel: +86 23 8823 1888
Fax: +86 23 8859 9188

**Dalian**
Room 1503 Senmao Building
147 Zhongshan Road
Dalian 116011, PRC
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297

**Guangzhou**
26/F Yuexiu Financial Tower
28 Pearl River East Road
Guangzhou 510623, PRC
Tel: +86 20 8396 9228
Fax: +86 20 3888 0575

**Hangzhou**
Room 1206-1210
East Building, Central Plaza
No.9 Feiyunjiang Road
Shangcheng District
Hangzhou 310008, PRC
Tel: +86 571 8972 7688
Fax: +86 571 8779 7916 / 8779 7916

**Harbin**
Room 1618, Development Zone Mansion
368 Changjiang Road
Nangang District
Harbin 150090, PRC
Tel: +86 451 8586 0060
Fax: +86 451 8586 0056

**Hong Kong**
35/F One Pacific Place
88 Queensway
Hong Kong
Tel: +852 2852 1600
Fax: +852 2541 1911

**Jinan**
Unit 2802-2804, China Overseas Plaza Office
No. 6636, 2 Ring South Road, Shizhong District
Jinan 250000, PRC
Tel: +86 531 8973 5800
Fax: +86 531 8973 5811

**Macau**
19/F The Macau Square Apartment H-N 43-53A Av. do Infante D. Henrique
Macau
Tel: +853 2871 2998
Fax: +853 2871 3033

**Mongolia**
15/F, ICC Tower, Jamiyan-Gun Street
1st Khoroo, Sukhbaatar District, 14240-0025 Ulaanbaatar, Mongolia
Tel: +976 7010 0450
Fax: +976 7013 0450

**Nanjing**
6/F Asia Pacific Tower 2 Hanzhong Road
Xinjiekou Square
Nanjing 210005, PRC
Tel: +86 25 5790 8880
Fax: +86 25 8691 8776

**Shanghai**
30/F Bund Center
222 Yan An Road East
Shanghai 200002, PRC
Tel: +86 21 6141 8888
Fax: +86 21 6335 0003

**Shenyang**
Unit 2005-2006, Forum 66 Office Tower 1
No. 1-1 Qingnian Avenue, Shenyang District
Shenyang 110063, PRC
Tel: +86 24 6785 4068
Fax: +86 24 6785 4067

**Shenzhen**
13/F China Resources Building
5001 Shenman Road East
Shenzhen 518010, PRC
Tel: +86 755 8246 3255
Fax: +86 755 8246 3186

**Suzhou**
23/F Building 1
Global Wealth Square
88 Su Hui Road, Industrial Park
Suzhou 215021, PRC
Tel: +86 512 6762 3338 / 6762 3318

**Tianjin**
45/F Metropolitan Tower
183 Nanjing Road
Heping District
Tianjin 300051, PRC
Tel: +86 22 2320 6688
Fax: +86 22 8312 6099

**Wuhan**
Unit 2, 38/F New World International Trade Tower
568 Jianshe Avenue
Wuhan 430022, PRC
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032

**Xiamen**
Unit E, 26/F International Plaza
8 Lujian Road, Siming District
Xiamen 361001, PRC
Tel: +86 592 2107 298
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