

POLICY BRIEF SERIES

# What Does Oil Price Drop Mean for China?

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The soaring demand from China and other developing countries drove up oil price in the past decade, from \$40 per barrel to \$110 per barrel in 2014.

With the exception during the global financial crisis when oil price had a short-term fluctuation between \$61 and \$97, oil prices tripled in ten years. However, the prices plunged to half of their previous value since the second half of 2014, making what the World Bank called “the End of Price Supercycle”.

This brief presents an assessment of the implications of the recent oil price drop for China. What areas are most impacted by price slide? What are the policy implications of a sustained decline in oil prices for China? What are the uncertainties lying ahead?

## Natural Gas Price Reform

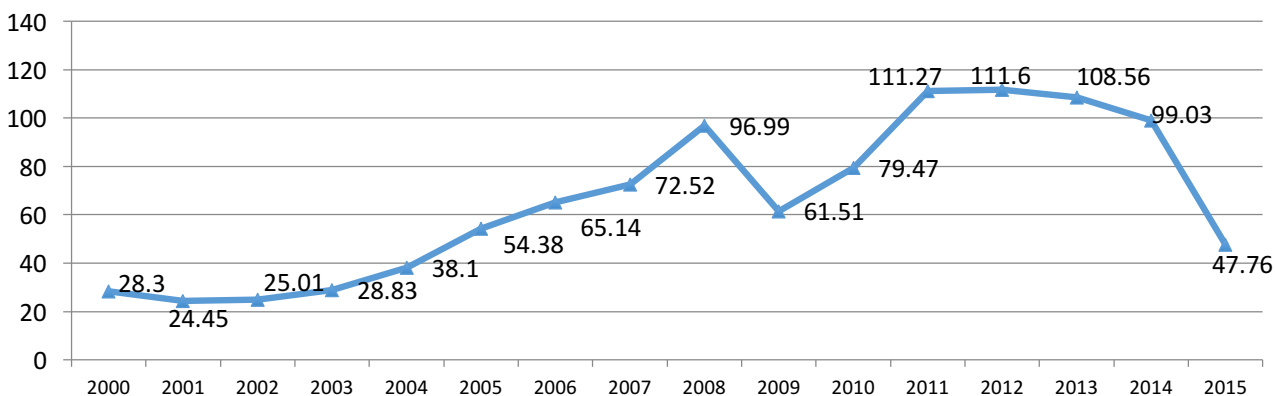
The decline in oil prices would deepen natural gas price reform in China. The longer the price stays at the six-year low, the more they will affect gas prices.

Government control on natural gas contributed to the sluggish growth of the natural gas market in China. The Chinese government has been tactfully setting a price level in order to make natural gas as an efficient substitute for coal. Consequently, domestic gas prices are cheaper than international prices. To make up for the losses gas-importing companies claimed, gas city-gate station prices have been substantially raised in 2013 and 2014, which held back downstream expansion of the gas industry.

**Brent Oil Prices between 2000 and 2015**

Dollars per barrel

Source: Statista



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Many gas-fired power plants and combined cooling heating and power projects were forced to suspend because of unbearably high natural gas prices.

National Development and Reform Commission (NDRC) introduced two-tier pricing structure, or otherwise known as the “existing supply” and “incremental supply” tiers pricing structure in 2013. Prices at the “incremental supply” tier used to be linked to imported fuel oil and LPG prices. NDRC planned, as part of the natural gas price reform, to bring pricing tiers on par by the end of 2015 through gradual increase in the lower-price “existing supply” tier.

The recent drop in oil price allows earlier and easier merge of the two tiers. NDRC announced in February 2015 to merge the two-tier system at the city-gate level for non-residential users from April 2015 onward by raising the prices of existing supply by \$36¢/MMBtu and lowering the prices of incremental supply tier by \$2.52/MMBtu. In Shanghai, for example, the price for the incremental tier decreased by about 13.25% while price for existing supply tier increased only by 1.4% after the merge. This is expected to ease the cost burden of heavily gas-consuming companies in industries such as metal melting, papermaking, ceramic and glass-making; and to incentivize gas distributors to expand downstream industry, which would drive gas demand.

The ultimate goal of gas pricing reform is to establish a dynamic price adjustment mechanism that reflects supply and demand in the gas market through full deregulation and open competition. The merge is a positive step to link gas prices with those of alternative energy sources, which indicates that prices are to be set by a more market-oriented approach.

Besides, the Chinese government should take advantage of the low oil prices to drive

institutional reform, such as third party access to infrastructures such as storage and transportation; and the building of a competitive upstream market and a strengthened gas supply and trading markets.

The decline of gas prices caused by the oil price slide support China’s economic and energy transition. Natural gas will become a mainstream fuel, which contributes to improved energy efficiency, security of energy supply, displacement of traditional vehicle fuels, and the relief on the contentious issue of haze. Generally speaking, deepening gas reform will lead to a bigger role of natural gas as a transitional energy source in China’s quest for addressing environmental challenges while pursuing economic growth.

### Renewable Energy Development

The high oil price is an essential driver for renewable energy, whose development could be impacted under the current market condition. Nevertheless, its influence would be limited to delaying certain projects instead of denting the takeoff of renewable energy. Outlook for renewable energy remains promising.

This is partly because of the subsidy on the renewable energy industry by the Chinese governments. Coal, which has been cheaper than renewables, offers a good example. The decline in coal prices over the past six years has not derailed the expansion of renewable energy business in China. More importantly, renewable energy industry is subsidized by Chinese governments. It is unlikely that the drop of oil prices will discourage governments from investing in renewables. Instead, low oil prices would drive China to keep ditch fossil fuel subsidies.



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China's subsidies for fossil fuel peaked in 2008 at 3.31% of GDP, but reduced to 2.6% in 2013 according to IEA. Resource tax on oil and gas output has been raised from 5% to 6% since December 2014, which can be regarded as an effort to spur renewable investment. China has invested more than 400 billion dollars in clean energy in the past 10 years and surpassed the US to be the world's biggest investor in renewable energy in 2014. According to Bloomberg New Energy Finance, China was the largest investor among major markets for renewable energy, with a 32% increase from 2013 to \$89.5 billion in 2014. The reasons for the surge include the Chinese concerns on climate change and thus, the determination by Chinese government to address its pollution problem. Under the U.S.-China Joint Announcement on Climate Change and Clean Energy Cooperation, China revealed its national strategy on the development of renewable energy sector. The country targets to increase non-fossil fuel share to about 20% of all energy use by 2030, from about 10% in 2011.

It makes good economic sense to invest in the renewable sector. As a key factor for emission reductions, renewable energy could naturally hedge any forthcoming sudden surge in oil prices.

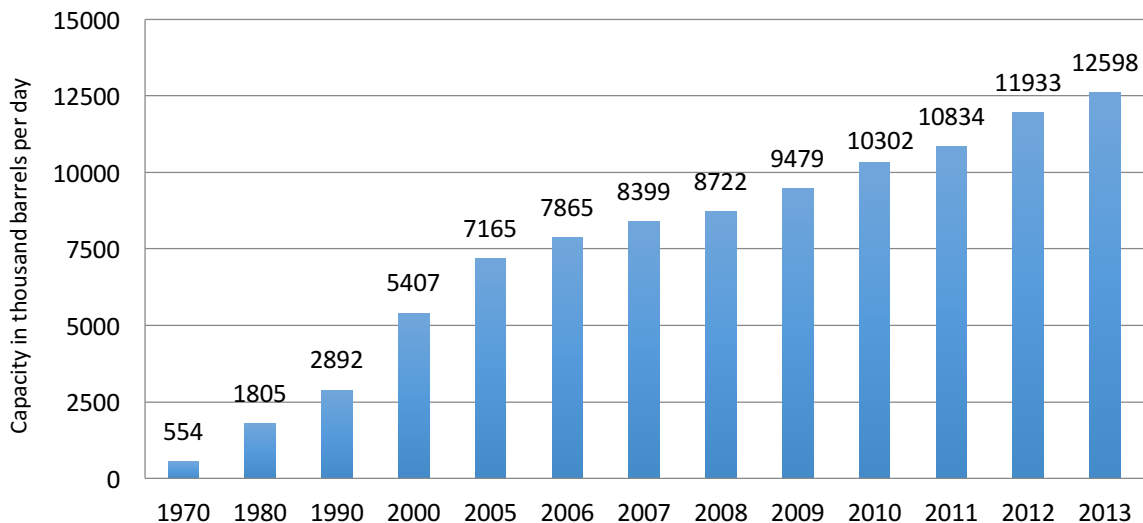
Furthermore, the development of non-fossil power sources such as solar photovoltaics, wind and hydro intend to replace coal as the main power source, which accounts for about 75% of the total power generation currently. It is expected that crude oil price weakness could drive the growth of gas-fired peaking shaving plants which only accounts for 2.1% of total generation now. Eventually it will broaden the share of renewable in electricity generation.

### Strategic Energy Reserve

Another benefit China receives from the drop of oil price is that a greater opportunity is provided to build strategic reserve in China. Because of massive dependence on foreign oil, Chinese government should capitalize on the current low oil prices to enhance its supply security.

### China Annual Oil Import

Source: EIA





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A little historic perspective is appropriate. It was as early as 2001 during its Tenth Five-Year Plan that China started to plan its strategic reserve in order to mitigate temporary oil supply disruptions. National Oil Reserve Center was established at the end of 2007 under NDRC to construct SPR and oil procurement. In November 2014, the National Bureau of Statistics announced the completion of the first stage in building China's strategic reserves holding 12.43 million tons (91 million barrels of crude oil) which is enough to slake Chinese domestic thirst for imported oil for 10 days. Comparatively, the current reserve in the U.S. is 112 days. It is expected that by 2020 with the completion of the third-stage strategic reserve, a 90-day supply will be established meeting the IEA requirement.

The major source of the strategic reserve so far comes from domestic oilfields run by state-owned oil giants, for example, Nanbao oilfield in Hebei Province which plays a critical role in the supply of strategic reserve with its large proven reserve and high daily capacity per well. However, considering the sluggish oil prices and the slowdown of domestic economic growth, China should take this opportunity to gobble up cheap oil to refill the reserve to its full capacity.

The tumbling oil prices since second half of 2014 sparked China oil buying spree. According to Bloomberg, China's net imports of crude oil in 2014 rose 7.8% to 6.74 million barrels per day despite declining demand. The amount of super tanks have surged to the highest on record in 2014. Total crude supply in China including imported and domestic production exceeded the amount processed by Chinese refineries by about 1.25 million barrels per day in 2013. This is a clear indication of the beefing-up of the strategic reserve.

With decreasing demands in the global oil markets and the decision of producers, OPEC in

particular, not to cut output, a key factor to determine the resilience of oil producers in surviving the current oil price slump is the capacity to store crude oil. The Chinese government should strike a deal with one or more oil producers on mutually beneficial terms either to lease some of their storage capacity or set up reserve bases in the producing countries to guarantee oil supply. But the building up of overseas energy reserve bases needs to go through careful evaluation on strategic location, bilateral relations, geopolitical risks in the host countries, etc. Potentials for collaboration exist between China and various Central Asian, Middle East and South America countries. A recent move of China to finance the modernization of the oldest and largest Iranian refinery, for instance, can be leveraged for further negotiation with Iranian government on the possibilities of setting up a reserve base in the country.

Besides national strategic reserve, China should plan strategically and diversify reserve sources by increasing oil inventory of local governments and setting a minimum inventory for commercial reserves by state-owned and private companies to maintain the long-term stability of the domestic oil market.

### **Rethinking Going-out Strategy**

The one-decade "going-out" strategy should be revisited in light of oil price slump. Chinese oil companies have been responding differently to the low oil prices – Three big oil and gas state-owned enterprises are staying on the fence; while private companies are playing an increasing role in foreign purchases.

It is noted that oil and gas acquisitions by Chinese state-owned enterprises have been less aggressive since 2014. Chinese national oil companies used to be the biggest contributor in energy acquisitions overseas in the recent



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years, involving \$22.2 billion in 2013, compared to the total global oil & gas upstream acquisitions of \$140 billion. However, according to the CNPC Economic & Technology Research Institute, total investments in overseas assets in 2014 by the big three state-owned oil giants plummeted 90% from the 2013 figure.

Oil price slump might not be the primary cause for three giants to optimize overseas assets portfolio. Instead, it contributed to the uncertain investment environment facing the Chinese state-owned enterprises community. Under CNOOC 2015 Business Strategy and Development Plan, the company plans to cut its 2015 budget by 26% to 35% given the low oil price. Li Fanrong, CEO of CNOOC, confirmed the company's strategy to store its capacity and bide its time. "We will control our costs and strive for the effective implementation of our capital expenditure plan in order to improve the overall performance of the Company."

Meanwhile, Chinese private enterprises are gaining a foothold in foreign energy markets. IN 2014, there were nine acquisitions for a total value of US\$2.2 billion by Chinese private enterprises, most of which were located in politically and economically stable countries and regions.

he momentum continues. A consortium led by Xinjiang Zhudong Petroleum Technology Co. Ltd is negotiating an acquisition of Roxi's equity and debt interests in the Galaz Contract area in Kazakhstan for \$20.72 million. Meidu Energy just completed acquisition of Manti oilfield block in the Eagle Ford region from Manti Equity Partners for \$141 million in January 2015. Polymer Bio-Chemicals completed its previously announced acquisition of a 51% stake in Rally Canada Resources in July 2014.

Historically waves of market consolidation will follow oil market downturn. With the current oil

price plunge, acquisition in upstream industry of oil and gas may take an even stronger track in 2015, especially for offshore and shale gas projects which yield low profits, if not a loss, with the current price.

The outlook on oil prices is still not clear due to a complex interplay of economic and geopolitical factors such as any changes in OPEC production, the likelihood of reduced shale production in the US, the possibility of lifting the sanctions against Iran, etc. Since it takes at least months to close a transaction, oil prices might have moved very differently upon completion of any acquisition. Thus, the oil price slump should act as the leverage for negotiations rather than deemed as opportunities in boosting acquisition.

It is out of question that both national oil companies and private companies have the financial strength to play a significant M&A role in 2015. But it should be noted that slump in oil prices has also posed risks to overseas oil investments by Chinese oil companies with a relatively high marginal costs of production. What sits behind the risk would be the prevailing blind optimism among Chinese investors toward a bullish future for oil prices over the past decade. The uncertainty about when and whether oil prices might recover remind Chinese investors of two critical questions when adjusting their "going-out" strategies: when to start acquisition and when to start exploration and production. What remain critical to the decision are oil prices stability and the ability to navigate strategically fit, good-quality assets.

On the policy level, with the hovering of low oil prices, it is time for the Chinese government to work from long-term strategic perspectives instead of focusing on the short-term interests of oil companies. The logic behind a healthy long-term strategy is to establish a more



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market-oriented mechanism. New moves by Beijing to streamline approval for outbound investments, to relax foreign exchange control and to instill its influence over international oil price are vital to nurture market-oriented mechanism in China.

### **Conclusion**

The precipitous decline of oil prices has sent mixed signals. While the timeline for the price to rebound is difficult to predict, the short-term impacts are largely positive to China. Economist predicted that every \$1 drop in the oil price brings China an annual saving of \$2.1 billion. The recent fall reduced the import cost by \$60 billion in China. The long-term effects will be mixed. The longer oil prices stay at its trough, the greater the influences would be on non-fossil fuel development and China's energy transition.

However, what matters most in China is not price uncertainty but policy uncertainty. Capturing the great opportunities in various sectors from low oil prices requires strategic thinking from the central government and localized effort. How the government comprehend and act on these changes will determine China's energy and economic future.