



A Provisional Evaluation of the 1998 Reforms to China's Government and State Sector: The Case of the Energy Industry

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1. Introduction

1.1 Aims of the reforms

In the Spring of 1998 the Chinese government announced a wide-ranging package of reforms to the structure of both government institutions and state industries. Of the many stated objectives, two stand out. First, to reduce the cost of government by closing or merging ministries and government departments and dismissing excess staff. Second, to more clearly separate the functions of government from those of the commercial management of industrial enterprises. A third objective was also implicit in the reforms: to improve the effectiveness of government.

The first objective is quite likely to be achieved, at least to some degree, providing the required staff redundancies are effected. The second objective has already been achieved, in form at least. It remains to be seen to what extent government departments and state industries do indeed stick to their principal tasks. However it is the third of these objectives, enhancing the effectiveness of government, which is the subject of this paper.

As the role of markets in China's economy increases, so must the role of government change. In the past, the government's task in the centrally-planned economy was to manage vertical, command-and-control relationships throughout the economy. The gradual spread of market elements in the economy has had two affects on government performance. First, the government's ability to 'control' has diminished. Second, the government has been required to take on new responsibilities, particularly with respect to supervising or regulating horizontal, contractual relationships. The government's response has been largely instinctive, to remedy the first defect without sufficiently addressing the second. The value of any reform of institutional structure in China today will depend on the degree to which the reform addresses the second issue. Only by changing the way the government works will its effectiveness increase.

An appropriate institutional structure is a prerequisite for the reform and possible eventual liberalisation of China's energy sector. With a strong institutional framework, mistakes or undesirable consequences arising

during the reform of the energy sector can be corrected. With a weak or unsuitable framework, errors in the restructuring may be unrecoverable for decades.

1.2 Significance of the energy sector

The reforms of 1998 affected most industrial sectors of the Chinese economy. A total of fifteen ministries were abolished, and the structure of many industrial sectors was changed in order to separate the functions of government and enterprise management. Few sectors were more profoundly restructured than the energy sector.

China's energy sector is at once a special case amongst the countries industries and a classic illustration of the problems of moving towards the market from a planned economy.

Energy plays an important role in China's economy. First, it employs at least ten million people and accounts for some 15% of sales revenue from all industrial enterprises in China (State Statistical Bureau, 1998). Second, an effective energy industry is vital for any economy. As China becomes increasingly dependent on energy imports, the quest for security of energy supply rises high on the list of government priorities. Energy is treated as a strategic good rather than as a commodity. Third, China is now one of the world largest emitters of atmospheric pollutants. The main sources of these are energy transformation and consumption, especially the burning of coal. Finally, though a deliberate move towards the market might address many of these problems, the energy sector has a number of characteristics which make such a step more difficult than for other industries.

The energy industry in any country is characterised by large capital investment, a relatively high level of risk in the early stages of projects (exploration and construction) and long pay-back periods. More importantly, some forms of energy transport are considered to be a natural monopoly. These include oil and gas pipelines and electricity transmission and distribution networks. In countries with limited road or rail networks and a need to transport coal over large distances (such as China), the coal transport system itself may be treated as a natural monopoly. For these reasons, combined with the perceived strategic nature of energy, the energy sector is dominated by state ownership and control in many developing and transition countries, and is the often last of the industrial sectors to move towards the market.

1.3 Constraints on and structure of this evaluation

This evaluation of the reforms announced in the Spring of 1998 is, by necessity, provisional. First, the ramifications of the restructuring plan are still being worked out and implemented. The assignment of tasks and responsibilities is not yet completed. Second, the change itself results in

reliable information being more elusive than usual.

This paper comprises two main sections. The first, identifies certain key issues to be considered in the institutional reform of any country's energy sector, and provides the framework for the later analysis of the reforms announced for China's energy sector. The following section briefly examines recent development in each of the main energy industries and described the overall nature of the reforms as implemented to date. The focus is on the gross features of the emerging institutional structure, rather than on the details, for unless the overall structure is viable the details are irrelevant.

Issues which are extremely important in the context of effective government and the state sector, but which we do not address, include accounting standards, the fiscal system, the mounting bad debts of the state banks and the underdeveloped nature of the state social security provision. These problems have been analysed in depth by other writers (e.g. Rana and Hamid, 1996; World Bank, 1996; Lou, 1997; Lardy, 1998) and we do not repeat their arguments here except where essential to the flow of logic.

The aim of this paper is to assess the restructuring in terms of its potential benefits to the economy, other than through saving money on civil servants' salaries, and in the context of providing a firm basis for further reforms in the energy sector.

2. Key issues in the structure and regulation of the state sector

2.1 The changing responsibility of government

A challenge facing any government with a large state sector is to develop a framework to enhance the financial and technical performance of the state companies in order to increase the overall economic benefit to the nation.

In order to do this the government needs to be able to provide the chief executives of the companies with incentives, to measure reliably the performance of the company including its costs, and to be able to penalise poor performance, if necessary through bankruptcy.

The system of supervision and incentives in China has changed several times over the last twenty years in order to provide the basis for improved performance of state companies (Broadman, 1995). The failure of these attempts is evidenced by a large number of deficiencies in the state sector today: falling rates of return on capital investment, a rising proportion of loss-making companies, an increasing level of indebtedness to banks and a low level of central government tax revenue. These deficiencies in turn relate to: the failure of the government to remove social responsibilities from the state companies; the unwillingness to let state companies go bankrupt; excessive levels of investment; capture of profits by managers

and employees; and under-reporting of profits (e.g. Laffont and Senik-Leygonie, 1997; Lardy, 1998).

At the heart of the problem lies the institutional and legal framework of the country, and the relationship between the government and the state companies. No sustained progress can be made in state sector reform without addressing these issues, and the structure of government is the key. This issue has two dimensions: first the allocation of responsibilities amongst government agencies at the same level in the hierarchy; and, second, the division of responsibilities between central and local government.

2.2 The roles of government in the future

In the past the role of China's government was clear: to plan and direct investment, production and consumption, through the use of quotas and fixed prices. Though planning never permeated China's economy as thoroughly as it did in Russia (Nolan, 1995), it was the main task of government. Relationships between the different levels of government were based on the need to formulate and implement the plans.

Economic transition towards a market economy requires a different form of government, not necessarily less government, as the focus changes from vertical command and control to the regulation of horizontal contractual relationships (Penrose, 1993; Cameron, 1996; Shao et al, 1997; Waelde and Gunderson, 1997). Indeed, during the phase of transition an extremely high level of government involvement may be required in order to ensure the introduction of effective markets.

In a market economy, the government has four roles with respect to industrial enterprises, in addition to the need to collect taxes: policy formulation and regulation for the whole industrial sector, and ownership and management of state companies. Policy formulation involves the identification of priorities and the development of a coherent and integrated framework of laws, regulations and other instruments to supplement or regulate the market. Regulation in its broadest sense involves the implementation of policy through the instruments provided in order to encourage the required behaviour from the enterprises. In countries with state companies the government has two additional tasks. As owner it will appoint the chief executives of the state companies, and set their objectives and incentives. The role of company management may lie either in a government ministry or with the company itself. Where the responsibility for commercial management has been delegated to chief executives, the government should no longer have any part to play in this sphere other than through its roles as owner, policy maker and regulator.

China's reforms of 1998 have sought to achieve the removal of the commercial management of state enterprises from government. Even if fully implemented, this is not sufficient unless the remaining three roles are also separated from each other and clearly allocated to different organs

of government (Cho, 1996; Besant-Jones, 1996; Ronne, 1997). This further distinction of roles is necessary for three main reasons: to reduce the potential for conflicts of interest within government departments which combine two or more of these roles; to improve the transparency of government and reduce the arbitrariness of decision-making; and to prevent collusion between the industry and government agencies.

Of the three main tasks of government, that of regulation is the most complex. Impartial decisions are required to be made within the framework of government policy which may have a profound impact on competing interests in the industry – state companies, private companies, government departments and end-users. Regulatory institutions have two types of responsibility. The first is largely routine and is relevant to almost any type of economy. This involves the tasks of granting licences for the exploration and production of natural resources and for the construction and operation of energy installations, and of inspecting and certifying such projects in the context of safety, environmental and other regulations. The second responsibility is more challenging and is particularly important during the early stage of the development of energy markets; that is the regulation of competition. In this case the regulator is acting to compensate for deficiencies in the market, in particular with respect to energy prices and access to energy transmission networks (Lock, 1995; Ingio, 1996; Ronne, 1997). As the market develops the role of this regulator diminishes, at least in principle.

This second type of regulatory agency faces a range of challenges:

- Obtaining technical, financial and management data from the companies it is regulating.
- Identifying collusion between enterprises.
- Resisting attempts by central and local governments and the enterprises to influence its decisions (which are made within the policy framework provided by the government).
- Acquiring the authority to enforce decisions against what is a very powerful industry.

One remaining issue to be addressed is whether the regulatory functions for a particular sector should be concentrated or dispersed. Three types of approach may be considered. The first is to have one major regulatory agency for each energy industry: one for electricity, one for gas etc). In the case that a range of energy services are provided by single companies, then creating a single energy regulator may be more appropriate. In developing and transition countries one of the key priorities is to enhance the transparency of decision-making and to find measures to reduce the probability of collusion between enterprises and government agencies. The dispersal of responsibilities among a number of agencies, even within a single industry, may be advisable (Laffont and Senik-Leygonie, 1997). If implemented, such a dispersal of regulatory tasks must be accompanied by clear and publicised allocations of responsibilities.

2.3 Division of responsibility between central and local government

In the past China's energy sector has been subject to a high degree of central control. During recent years evidence has been mounting that the effectiveness of this central control over activities at local level has been diminishing (Yang, 1995; Andrews-Speed et al, 1998a).

During the last twenty years the political, administrative and economic power of China's provinces has increased as the success of local enterprises has generated more revenue at local level (Solnick, 1996). In the financial sector, provincial governments succeeded in gaining an excessive level of control over fiscal revenues and the state banking system (Wong et al, 1995).

In the energy and natural resources sector, the provincial governments have slowly increased their influence over the relevant companies within their jurisdiction with the result that the central government has lost some of its ability to enforce its regulations and decisions. Two main causes may be identified. First, the central government has tried to control too much. Second, the staff at local level responsible for implementation are employed by local government rather than being seconded from the central government. Symptoms include the inadequate regulation of coal mining with respect to extraction licenses, safety and environmental protection, and vertical rivalry between different levels of hierarchy in both the government and the state companies as each seeks to protect its interests (Andrews-Speed et al., 1998a; Andrews-Speed and Dow, 1998).

Some reallocation of tasks and responsibilities is needed between central and local governments in China, and lessons may be drawn from federal market economies such as Canada and the U.S.A. (Fox, 1983; Farrell and Forshay, 1994; Hancher, 1997). Central governments tend to retain powers over issues which are of truly national importance, and to delegate other powers. For example the production and processing of energy may be regulated mainly at provincial level, with the exception of offshore areas and special federal lands such as national parks or ethnic minority regions. However the central government may draw up guidelines or minimum standards, as it does in India for the power industry for example (Bath, 1997). The regulation of interprovincial energy transport networks and international sales may also lie with the central government, as may the regulation of wholesale prices. Environmental protection should lie firmly in the remit of the federal government because of the long-term and widespread environmental impact of the energy industries. As a result of such a reallocation of responsibilities the central government is able to focus its attention on and provide resources for a more tightly defined list of priorities in the energy sector.

3. Context and nature of the reforms to China's energy sector

3.1 Government structure

Previous structure

In the first half of the 1990s the structure of government for the energy sector, and indeed for many other industrial sectors, was very simple. The State Planning Commission (SPC), reporting to the State Council, stood at the pinnacle of the hierarchy. The other two relevant Commissions, the State Economic and Trade Commission (SETC) and State Science and Technology Commission (SSTC), though nominally equal with the SPC, played relatively minor and subordinate roles in the energy sector.

Each of the main energy industries was dominated by a single institution, which was either a state corporation or a Ministry: CNPC for petroleum exploration and production; Sinopec for oil refining and distribution; the Ministry of Electric Power; and the Ministry of Coal Industries. These large institutions dominated their respective industries for two reasons: first, their sheer size; and second their dual role as government organ and commercial enterprise. They were involved in policy formulation, regulation and enterprise management, though certain regulatory tasks such as investment approval and pricing were retained by the SPC. Only the role of owner would have appeared to have been retained by the government, separately from these industrial institutions; that responsibility lay and still remains with the State Council.

New structure

The reforms of 1998 resulted in three major changes to the government structure in the energy sector. First, the function of enterprise management was nominally removed from the government and assigned to the energy companies themselves. How they were structured is discussed below. Second, the SETC, for the first time, was given an apparently important position in the energy sector. The previous Chief Executive of Sinopec was appointed as State Commissioner. Third, a new ministry was created, the Ministry of Land and Natural Resources (MLNR), to administer land use. The previous Chief Executive of CNPC was appointed Minister.

The key, and apparently as yet unresolved, question is the future function of the SETC. Two new bureaus were created within the SETC, for petroleum and petrochemicals and for coal, and a new department for the power industry was set up. Each of these offices is to take responsibility for its particular industry. At present the nature of these responsibilities is not clear, though they appear to include policy and regulatory tasks, as well as, possibly, enterprise management.

Though the details of the reorganisation are far from clear and are still being resolved, a number of general points can be made.

The SPC (now renamed the State Development Planning Commission, SDPC) is clearly reluctant to relinquish some of its long held responsibilities. It is therefore likely that the final allocation of tasks between the SDPC, the SETC and the MLNR will be the result of

negotiation and compromise rather than following from a vision of what may lead to the most effective form of government.

Though a multiplicity of regulatory agencies in itself may not be harmful (as discussed above), there is yet no clear evidence that the government wishes to separate policy and regulatory functions.

One of the key elements of the reforms was to separate the government and enterprise functions. This ambition may yet be thwarted by two factors. First, the staff in the relevant SETC bureaus and departments are drawn from the state energy industries. Even the heads of the SETC and MLNR are past industry executives. As a result these government institutions may be unable to resist the temptation either to meddle in enterprise management or to collude with the industries against the best interests of the country as a whole. Second, the SETC teams may be understaffed, certainly the power department is with just sixteen professionals. When they need additional help they call on the state companies, thus giving these companies undue influence over policy and regulation. Not only must the government be removed from enterprise management, the companies should be removed from government policy-making and regulation.

Whatever responsibilities the SETC is assigned, its major challenge will be to exert its authority over the state energy companies which hold a great deal of economic and political power. The extent to which the power of the companies may have been enhanced by the reform is discussed below.

The reforms announced at national level are expected to be mirrored at provincial and lower levels of government. To date there does not seem to have been a concerted and considered attempt to reallocate responsibilities between central and local governments in the energy sector.

3.2 Petroleum industry

Previous structure and performance

China's petroleum industry has been dominated in recent years by two state companies: CNPC which was responsible for onshore oil and gas exploration and production; and Sinopec which undertook much of the oil refining and distribution. Both organisations combined the roles of government and enterprise management. Other Chinese players have included: the Ministry of Chemical Industries; China National Offshore Oil Corporation (CNOOC); Sinochem the official international oil trader; two joint-venture trading companies, Unipecc and China Oil; and the newly created China National Star Petroleum Corporation (CNSPC).

The financial performance of China's oil companies depended to a great extent on the domestic price of oil which was set at irregular intervals by the SPC. In the late 1980s and early 1990s the domestic prices for crude

oil and oil products were raised from very low levels to rough equivalence to international prices. As a result the profits of the upstream operator, CNPC, rose dramatically, while those of the downstream operator, Sinopec, stagnated (Andrews-Speed, 1998).

By the mid 1990s China had become a net importer of oil, and the import requirement was set to rise indefinitely. The dramatic fall in the international price of oil in late 1997 caught the Chinese industry unawares. Legal and illegal imports soared during the first half of 1998 as customers sought cheap foreign oil rather than expensive domestic oil. At the Chinese oil fields stocks rose, production in some fields was cut back and financial losses mounted. The government responded with a crackdown on smuggling and a temporary ban on the import of oil products. This was the setting of the reforms announced in the spring of 1998.

The new structure

For the petroleum sector the restructuring involved two key components. First, as discussed above, the government functions were removed from the state companies and placed with the SETC. Second, the assets of CNPC and Sinopec were redistributed to create two vertically-integrated companies which spanned the full range of activities from exploration through refining to marketing. CNPC's assets now lay in the north and west of the country; Sinopec's in the south and east.

A further innovation was in the field of pricing. From now on domestic oil prices would be linked directly to international prices through a formula set by the SDPC. As international prices fluctuated, domestic prices would follow automatically. From the summer of 1998 domestic prices were only marginally above international levels.

The petroleum industry would now be regulated by up to four bodies: the Price Administrative Department of the SDPC; the Transport and Energy Department of the SDPC; the SETC; and the new Ministry of Land and Natural Resources.

Evaluation

The nature of this restructuring appears to be based on three objectives specific to the oil industry: to remove the need for incessant lobbying by the upstream and downstream companies concerning the level of domestic oil price; to provide a stronger basis for China's oil companies to compete internationally; and to encourage competition within China.

The first of these objectives has clearly been achieved. Both CNPC and Sinopec now have upstream and downstream assets and are more able to cope with fluctuations in the international and domestic prices of oil (Fesharaki and Wu, 1998).

The ambition for China's two largest oil companies to become major players on the international stage is potentially realisable. But size alone is not sufficient. The present low level of oil prices looks set to remain for some years, barring international crises. Only the most competitive oil companies will survive.

In this respect, the government's desire to develop a framework for domestic competition in the petroleum sector is laudable. Only with competition at home will CNPC and Sinopec develop the skills to compete overseas without subsidy. However the government's vision of the nature of domestic competition is far from clear. Certainly the two oil companies will have to trade crude oil and oil products because of the geographical imbalance of oil reserves, refining capacity and markets in the country. The issue which does not seem to have been addressed is whether one oil company may invest and conduct exploration, production, refining or distribution in the other's territory. Unless the government takes steps to promote such competition, also involving other oil companies, one possible outcome is that the two large oil companies collude as a cartel rather than compete.

Collusion can only be prevented and competition encouraged if the government has a well-defined vision of what it wants to achieve and allocates clearly the required regulatory tasks to the designated agencies as soon as possible. The longer the period of ambiguity, the stronger the position of the companies. In this respect one glaring deficiency in the legal framework is the absence of a petroleum law (Gao, 1997).

3.3 Electrical power industry

Previous structure and performance

Before 1997 the Ministry of Electric Power (MOEP) acted as policy-maker, regulator and enterprise manager for most of China's power industry. Under the MOEP the provincial power bureaus were monopolies within their respective areas. Some of these bureaus were consolidated into regional Power Groups for the purpose of inter-province transmission of power. In 1997, the State Power Corporation of China (SPCC) was established to take over the enterprise management functions from the MOEP. The provincial and lower level bureaus were renamed companies.

During the late 1980s and 1990s China's power industry faced two major challenges. First, a major increase of generating capacity was required in order to satisfy the growing demand. A massive and sustained programme of investment was implemented which resulted in a 200% increase in generating capacity from 1985 to 1998. The second challenge was to compensate for the geographic mismatch between the location of fuel sources and demand. Coal is concentrated in the north of the country and hydro-electric potential in the south-west (State Planning Commission, 1997), whereas demand is growing most rapidly along the coast. Rather belatedly efforts are being made to direct the construction of power plants

near coal mines and to upgrade the power transmission infrastructure.

The producer and consumer prices for electricity are fixed by central and local governments with a complex system which involves high levels of subsidies and cross-subsidies (Andrews-Speed et al., 1998b). Though prices have risen significantly in recent years, they have failed to keep pace with inflation. Rising feedstock prices combined with constraints on producer and consumer prices have led to a static level of profits for the power industry (Andrews-Speed, 1998). No price rises have been announced in 1998. Indeed some provinces have ordered a reduction in consumer tariffs to prevent hardship as a result of growing unemployment.

The first half of 1998 saw a dramatic reduction in demand for energy, especially for coal. Electricity demand grew at an annual rate of only 2% in the first eight months, compared to 5-10% over the previous fifteen years (State Planning Commission, 1997). The precise causes are a topic of debate. Suspension of production in state factories triggered by the Asian recession and limitations in the electricity transmission network are the most likely to create a sudden stagnation of demand. As a result of the flattening of demand, there is a temporary surplus of generating capacity in some regions for the first time. Partly in response to this surplus, the State Power Corporation is increasing its efforts to close down old power stations. Officially this is on the grounds that they are inefficient and dirty. These small plants tend to be owned by county and city level companies and, being old, are able to sell power at a lower price than the newer power stations owned by the provincial companies.

The surplus of power and the desire to restrain tariff increases has led to a sudden interest in introducing competition. To date most new power stations have been built on the basis of Power Purchase Agreements (PPAs) in which the offtaker, usually the Provincial Power Company, agrees to take a minimum quantity of power each year at an agreed price from the generator which may be partly or wholly separate from the Provincial Power Company. During 1997 localised surpluses of power, especially in the north and north-east of China, caused provincial power companies to renege on these agreements. There now appears to be a general move to cancel all PPAs except for those held by foreign companies under the Build-operate-transfer (B.O.T.) draft regulations. The intention has been declared to introduce competition in power generation in a number of provinces in the near future.

The new structure

In outward form the power industry changed little in 1998, except for the abolition of the Ministry of Electric Power and the transfer of its government functions to the SETC. The Electric Power department of the SETC has a staff of less than twenty people, which is quite inadequate for the challenge of regulating the nations power industry. It is understood that the SETC goes to the State Power Corporation when it wants

additional staff.

Within the Power Corporation plans are being developed to separate the function of generation from transmission and distribution in order to provide the basis for competition in power generation. For example, in Shandong Province it is envisaged that four or five generating companies might be created from the existing plants and those under construction. These companies would compete to sell power into a 'pool'.

Evaluation

The power industry is the most difficult of the energy industries to reform and to move towards a competitive market, for two reasons. First, electricity cannot be stored. Second, the transmission and distribution functions are natural monopolies. Competition can only be introduced easily in power generation and supply. Now that a surplus of power generation capacity exists in some provinces, it is possible to introduce competition in generation. So the government's desire to move in this direction is to be commended; its haste is not.

The introduction of an effective market in the power sector in any country has many requirements. Three which are relevant to this discussion are: a strong institutional framework; a clear strategic vision for the sector; and well-defined ownership rights. China lacks all three at present, and the government restructuring has not yet appeared to have strengthened the first of these. The functions of policy-making and regulation are still mixed together in the SETC. The SDPC still retains some influence of pricing and investment policy. Of greater concern, the State Power Corporation itself seems to be driving the reform policy. If the corporation is driving the reforms and the corporation itself does not withdraw from power generation, a severe conflict of interests exists. This is illustrated by the suggestion that the Provincial Power Company of Shandong might retain shares, even a majority holding, in the generating companies which are created for the purposes of competition. If such a situation materialises, meaningful competition cannot develop and incentives for improved performance will prove to be illusory.

As in the petroleum industry, the government faces the danger that the state company gains excessive power and is able to manipulate the reforms to satisfy its own interests rather than those of the country as a whole.

3.4 Coal Industry

Previous structure and performance

Unusually for China's energy sector, the coal industry in recent years has not been dominated by a single corporation. The output of township and village enterprises (TVE) and private mines has risen to more than 40% of the country's annual production. In 1996 the production from these mines

reached 640 million tonnes (State Planning Commission, 1997), equivalent to the entire production of western and eastern Europe (British Petroleum, 1997).

In the same year about 38% of production came from the state mines owned and managed by the Ministry of Coal Industries. These mines tend to be the largest, most modern and most highly mechanised of China's mines. The remaining output comes from mines owned by various levels of local government.

The development of China's coal industry is constrained by two natural features. First, most of the coal reserves are in the north of the country, far from the booming coastal regions. Improving the transport network has thus been a high priority for government. Second, the main area of coal production receives very little rainfall. Thus the mines are only able to wash a limited proportion of the coal output. This in turn raises the requirement for transport capacity and renders the coal more polluting when burnt.

From the mid-1980s the government has taken steps to introduce market mechanisms to the sale of coal. As a result the price has risen throughout the country, and more so in areas remote from production. Subsidies still exist for household consumers and for some power stations. The rising prices allowed the state-owned coal mines at all levels to reduce their financial losses and move into profit (Andrews-Speed, 1998).

In response to the rising stock piles resulting from the falling demand for energy in 1998, the government had to order the temporary suspension of production from some state mines. Low international coal prices and the unreliable quality of China's coal prevented the situation being alleviated through raising the level of exports.

An additional measure has been to intensify the process of closing down 'illegal' coal mines. These are mainly TVE and private mines. Many operate without licenses, and in a manner which is unsafe, polluting and detrimental to the effective use of resources (Yang, 1995). However, a further reason for closing these mines is to reduce the competition facing the state-owned mines in a time of reduced demand. The costs of the state mines are still high, partly as a result of their social obligations, whilst the small mines can reduce their costs through avoiding tax and royalty payments.

The new structure

The reforms to the coal industry took quite a different form from that in the oil and power industries. A firm step was taken towards decentralisation and disaggregation. The Ministry of Coal Industry was abolished and its government functions were assigned to the State Administration for Coal Industries (SACI), newly created within the SETC. This agency and its provincial equivalents would appear to have

responsibility for both policy and regulation. The SDPC is likely to retain some control over major investment decisions and the Ministry of Land and Natural Resources should take over responsibility for licensing.

The ownership and operation of the state mines are to be transferred to the provinces, as is much of the regulatory responsibility. Though the process of restructuring is still in progress, it is evident that no single model is being imposed on the provinces. Some provinces are creating a single coal mining group to incorporate all the state-owned mines in the province. Others are allowing each of the major mines to be a company in their own right or creating a number of groups. Following the general government policy of encouraging mergers between state companies, a small number of large coal companies are to take over smaller companies in other provinces. In addition most provinces with coal mines have set up provincial coal transport and trading companies with monopsony and monopoly powers.

Evaluation

The transfer of ownership of the state mines to the provinces may relieve the central government of a major financial and administrative burden, but it is far from clear that this restructuring will lead to improved performance of the coal industry. By relinquishing, in one step, the enterprise ownership and management functions and much of the responsibility for policy and regulation, the central government runs the risk of losing control over the reform process.

Clear separation of the functions of policy-making, regulation, ownership and management are required at provincial level. Failing this, a probable outcome is the local monopolies companies emerge which have a close relationship with local government. Incentives for improved performance and transparent competition will be difficult to develop. The steps taken to liberalise the domestic market for coal products may even be reversed.

The central government faces a major challenge to ensure that the reforms of 1998 lead to enhanced technical and financial performance of the coal industry and the continued development of an internal market for coal. Measures are required to ensure that provincial governments do not take advantage of their newly acquired assets, to the detriment of the nation's interests. These measures should include a diversification of ownership, a clear policy for competition and strong regulation.

4. Conclusions

The reform of the energy sector in any country requires a strong and appropriate institutional framework in order to minimise conflicts of interest, to promote transparency of decision-making, to reduce the chances for collusion and to prevent the abuse of monopoly power. A strong institutional structure not only provides a basis for industrial reform, it also provides a greater chance that any mistakes made during

the restructuring of the state companies may be corrected.

The reforms announced by the Chinese government in 1998 were intended to reduce the cost of government, separate the functions of government and industry, and, ultimately, to increase the effectiveness of government. This analysis suggests that though the first two may have been achieved, little contribution has been made to the third objective.

The restructuring of a state-dominated energy industry and the introduction of market principles requires a well-defined vision, decisive government and a clear allocation of government tasks. Eight months after the reforms were announced, all these features seem to be absent. The danger facing the government is that its moves to introduce competition and to enhance the performance of the energy industries in the absence of a suitable institutional framework will allow the state companies to increase their power and abuse their monopoly position. Without decisive action by the government, these reforms may not just fail in their objectives, they may make further reforms more difficult.

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