

STATE-OWNED ENTERPRISES

POWERFUL: China's power-grid operator, State Grid Corp, is the world's biggest utility company.
REUTERS/PATTY CHEN



The Communist Party wants to break up the monopolies enjoyed by giant state-owned companies – but faces stiff resistance

China's other power struggle

BY CHARLIE ZHU AND DAVID LAGUE

HONG KONG, OCTOBER 17, 2012

As China's ruling Communist Party prepares for a once-in-a-decade leadership transition next month, it is planning a daunting step – breaking up the monopolies enjoyed by its gargantuan state-owned enterprises.

The monopolists have other ideas.

One of the most powerful of all Chinese state-owned giants is the power-grid operator, State Grid Corp, led by the politically savvy engineer Liu Zhenya. This summer, with blackouts paralysing neighbour India, he seized an opportunity.

Liu called his managers together for an urgent conference in Beijing to explore what lessons the world's biggest utility could learn from the Indian crisis. His conclusion: Beijing should preserve State Grid's monopoly over the transmission and distribution of power to 1.1 billion people across 90 percent of China.

"In light of the recent series of large-scale power cuts abroad, it is of crucial importance to stick to the right path of power industry reform," Liu told his team on the afternoon of July 31, as a swathe of India suffered blackouts for a second day running. Preserving State Grid and its 1.6 million employees as a single entity "will be conducive to supply security," Liu added, according to a State Grid official citing a company memo.

It is hardly surprising that the 61-year-old veteran engineer, who rose up through state-owned power units in his native Shandong Province, favours the status quo. What is remarkable is that he openly contradicts the views of his political masters.

China's outgoing Premier, Wen Jiabao, vowed in a speech earlier this year that Beijing would push ahead with monopoly-busting. "We must move ahead with reform of the railway, power and other industries, complete and implement policies and measures aimed at promoting the development of the non-state economy, break monop-



THE MONOPOLIST: State Grid CEO Liu Zhenya is a regular on the international conference circuit, advocating a new breed of ultra high-voltage lines to revolutionize long-distance electricity transmission. **REUTERS/HUGO CORREIA**

lies and lower industry thresholds for new entrants," Wen said.

All signs are that the next leaders of China – Xi Jinping, who is widely expected to replace Hu Jintao as paramount leader, and Li Keqiang, on tap to succeed Wen as premier – will generally stick to that script. Critics say the sheer size and market dominance of big state owned enterprises (SOEs) creates a drag on the economy through vast opportunity for corruption and waste, leading to higher costs for consumers.

In the leadup to the transition, Beijing has been engulfed in one of its biggest and most disruptive scandals in decades: The disgrace of party princeling and charismatic leadership contender, Bo Xilai, and the suspended death sentence handed down to his wife, Gu Kailai, for the murder of a British businessman.

The sensational implosion of Bo's po-

“We must move ahead with reform..., promoting the development of the non-state economy (and) break monopolies

Wen Jiabao

Premier of China

litical career and public revelations of greed and corruption exposed deep fault lines and bitter factionalism at the top at a time of slowing growth in the world's second-largest economy. When the new leadership is in place, it will be under immediate pressure to break the grip of inefficient SOEs and reinvigorate China's three-decade-long economic miracle. But on economic policy, too, there's division within the party.

PARTY'S MONSTERS

The increasingly powerful SOEs are a monster of the party's own creation.

After languishing through the 1990s, China's state sector came roaring back over the last decade to straddle vast swathes of the economy.

A catalyst for the resurgence of SOEs were decisions taken a decade ago to reaffirm the primacy of state ownership as a key plank in the party's authoritarian rule.

Dozens of industry heavyweights were carved out and nurtured and many smaller, inefficient SOEs were shut down or sold.

While private business expanded, many of these protected and privileged state companies also thrived through the ensuing period of torrid economic growth.

Today, SOEs and affiliated businesses account for more than half of Chinese economic output and employment. Of the 70 mainland companies on the 2012 Fortune Global 500 list, 65 are state-owned. State Grid is the world's seventh-biggest company. Oil giants Sinopec Group and China National Petroleum Corp, parent of PetroChina, rank fifth and sixth, respectively. The total profits of CNPC and state-owned China Mobile Ltd were higher than those of China's 500 largest private firms combined in 2010, according to government figures.

The SOEs have grown so dominant that economists accuse them of stifling innovation and restricting opportunities for private companies, which now account for almost all employment growth, according to government figures. "With export growth ex-

pected to slow in the coming years, China will need to break the monopolies of SOEs and unleash the growth potential of the private sector," says Zhu Jianfang, chief economist at Beijing-based Citic Securities.

The reforms sought by the Communist leadership are limited nonetheless.

The party isn't launching a fundamental attack on public ownership or pushing for widespread privatization of the state leviathans. It aims to split SOEs into smaller units or bring in more private investment to state-dominated sectors including energy, telecommunications, railways and banking, on the theory that doing so will reinvigorate the world's second-largest economy at a time of flagging growth. The state's dominance of strategic industries including banking, defence, resources, power, telecommunications and transportation will almost certainly remain firmly in place.

"The new leaders may introduce more competition to some industries now monopolised by SOEs," said Qiu Xiaohua, former chief of China's National Bureau of Statistics. "But, they will definitely abide by the basic principle – which is keeping public ownership as the backbone of the economy."

Debate over the future role of big SOEs in China's economy has been heating up in the run-up to the leadership change, expected to be formalized at the 18th party Congress scheduled to start in Beijing on November 8.

It is too early to tell if the incoming team will have the stomach for battle with the biggest SOEs such as State Grid. But regulatory sources told Reuters they expect the new leadership to widen the private sector's role in the economy, citing the background of some top incoming officials and their work experience in provinces where entrepreneurs play a key role.

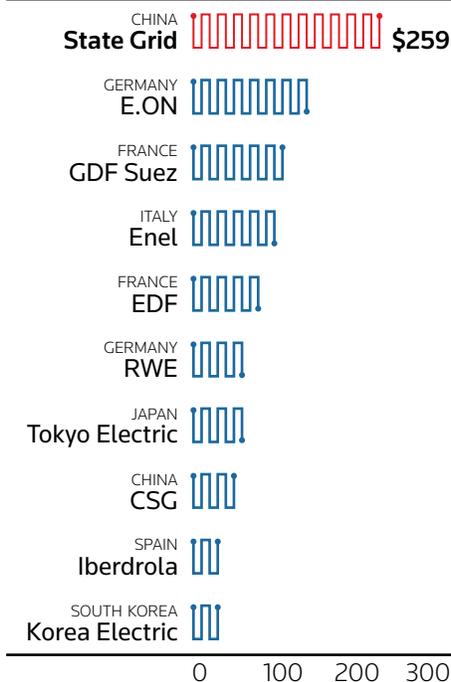
They note that Xi Jinping, widely expected to succeed Hu Jintao as China's top leader, held top posts in Fujian and Zhejiang provinces along with a stint in Shang-

Power pack

State Grid, China's third largest state-owned enterprise, is the biggest utility company in the world.

TOP UTILITY COMPANIES

2011 revenues – billions of dollars



Note: EDF = Electricité de France; CSG = China Southern Power Grid.

Source: 2012 Fortune Global 500.

hai – all at the forefront of China's vibrant market economy.

In resisting change, Liu and other big SOE bosses fight from a position of strength: They dominate key strategic industries with almost unlimited access to finance from state-owned banks, and enjoy strong political connections. They are all appointed by the party and many are political heavyweights in their own right. Liu is an alternate member of the party's 204-member central committee, China's top ruling body.

These defenders of the SOEs are not going easily. Their argument is that state-run

leviathans have been a key driver of China's economic success, as the dominant players in the infrastructure and industrial boom that laid a solid foundation for long-term economic growth.

In a lengthy article last month, *Qiushi* magazine, the party's top journal of Marxist theory, said state monopolies were serving the country well. The article warned that criticism of SOEs was linked to a Western conspiracy to undermine China's economic system and the competitiveness of these companies overseas.

"Don't fantasize that privatisation can resolve all the problems existing in industry monopolies," said *Qiushi*, which means "seeking truth" in Chinese.

BANK COMPETITION

Reformers made some progress in June, when state-owned banks were given more flexibility in setting interest rates for deposits and loans, increasing the scope for competition for deposits and clients. Chinese interest rate spreads – the gap between lending and deposit rates – are among the fatter in the world.

Again, it was Premier Wen Jiabao leading calls for change when in April he criticised the banks for "making money far too easily." However, days before the decision was announced on June 7, the move faced strong resistance.

Regulators advocating the change, including central bank governor Zhou Xiaochuan, and senior executives of major state-run commercial banks were locked in a heated debate at a closed-door meeting in Beijing. Xiao Gang, chairman of the giant state-owned lender Bank of China and a former deputy governor of the central bank, was among those who fought the proposal. He argued it would jeopardise China's banking sector, a person with knowledge of the matter told Reuters.

"Xiao Gang expressed strong opposition to the proposal. He became emotional during his speech, banging his hand on the

table constantly,” the source said.

China's major state commercial banks, which the government rescued in a series of bailouts starting in 1998, are again facing a surge in bad loans that resulted from massive, government-directed lending to support Beijing's 4 trillion yuan (\$638 billion) economic stimulus launched in 2008.

Critics of the SOEs are also pointing to scandal and graft in China's vast but debt-laden rail monopoly as an example of the abuses that accompany unbridled size and power.

Beijing in May accused a former railways minister, Liu Zhijun, of economic crimes and expelled him from the party. Liu (no relation to the State Grid chief) allegedly took huge bribes and misused his position to help the chairman of an investment company get “an enormous illegal profit,” the official Xinhua news agency reported.

Reports in the official media have suggested Liu will soon face charges.

“We are marching back towards the planned economy and crony capitalism,” said Xu Xiaonian, a professor at Shanghai's China Europe International Business School, who is a vocal critic of China's state sector.

State Grid's Liu has seen at close hand the impact of high-level corruption.

In 2002, when he was deputy chief of State Grid's predecessor, State Power Corporation, his boss, company president Gao Yan, fled overseas in the midst of a graft scandal that Beijing said involved losses of almost \$1 billion.

Dozens of State Power officials were later arrested after authorities said investigations revealed the company had cooked its books, hidden revenue and exaggerated costs. Gao, a former provincial governor and protege of retired premier Li Peng, remains a fugitive.

Within months of Gao's flight, Beijing moved to implement a blueprint for sweeping power sector reform. It split the vast State Power Corporation, then owner of most of the country's transmission networks



BREAKUP: Beijing wants either to split State Grid into a transmission company and a distribution company, or divide it into several units along geographic lines. **REUTERS/PATTY CHEN**

and half of its power plants, into generators and grid corporations. State Grid emerged as the dominant transmission operator, and Liu took the helm in 2004.

Since then, the company has staunchly resisted pressure for further change. Until last year, it retained control over non-core businesses including engineering and construction. It only agreed earlier this year to cede its remaining power-generating businesses, worth about \$7.9 billion, to state coal giant Shenhua Group.

FORCEFUL CHARACTER

A strongly built and forceful character, Liu cultivates an image as a leading thinker on the future of power transmission for China and the global economy. He is a regular on the international conference circuit with detailed presentations on his plans for a new breed of high-voltage lines and

“We are marching back towards the planned economy and crony capitalism

Xu Xiaonian

professor, China Europe International Business School

the importance of “smart grids”.

In an echo of earlier Maoist times, when urban students were sent to the countryside to learn from farmers, Liu likes to post young engineers to remote and difficult regions so they get grounded in the realities of China's power industry, according to people familiar with his leadership style.

State Grid did not respond to requests for an interview with Liu for this article.

Industry experts expect Liu to fight even harder to frustrate a breakup of State Grid itself.

The network has total assets worth 2.21 trillion yuan (\$350 billion) and reported a profit of 53.4 billion yuan last year. Reformists say that splitting it into smaller SOEs would make their books more transparent and allow greater scrutiny of its operating costs – the basis for setting China's electricity prices – and possibly lead to lower power tariffs.

Electricity prices for industrial users, by some estimates, are about 75 percent of average tariffs in the West. But, taking into account China's much lower per capita income, power bills are more onerous.

Beijing wants either to split State Grid

into a transmission company and a distribution company, or divide it into several units along geographic lines. China's cabinet, the State Council, earlier this year called for trials with transmission and distribution businesses separated but it is not clear if and when they will start.

BIGGER IS BETTER

Liu's counter-proposal is boldly defiant: State Grid actually should become even bigger.

In speeches and presentations at home and abroad, he champions the adoption of ultra high-voltage (UHV) lines to revolutionise long distance electricity transmission.

This controversial, technically challenging and expensive technology is untested in large-scale networks, but it holds out the prospect of dramatically lower energy losses over long-distance transmission lines.

Liu believes these lines are the answer to China's geographic energy imbalance: most of the country's coal and renewable energy resources are located in the northeast, northwest and west, while most demand is in the east and south.

He has been lobbying Beijing for approval to build up to 20 cross-country UHV lines, dubbed power corridors, by 2020. Industry experts say this would cost up to \$250 billion.

This would allow power stations to operate close to coal mining centres, reducing the need to ship billions of tonnes of the fuel each year across the country by rail. It would also allow China to efficiently transmit power from distant renewable sources such as solar-panel arrays.

"Building UHV grids will provide a platform for the development of large-scale



MARKET MAN: Xi Jinping, set to succeed Hu Jintao as president, is expected to continue China's economic reforms. **REUTERS/ADRIAN BRADSHAW**

energy centres and optimize allocation of massive energy resources," Liu said at a June ceremony when the party mouthpiece newspaper, the People's Daily, named him China's "Energy Man of the Year".

Some industry experts say this vast new network would also entrench State Grid's transmission monopoly. There are signs, however, that Liu faces a bureaucratic backlash.

"The UHV technology is not widely used in the world, so it does not make sense for him to propose so many projects in one go," says Yan Shi, a Shanghai-based energy analyst at securities house UOB Kay Hian. "It makes sense if you just propose to experiment with the technology in a small place first."

The National Development and Reform Commission, the country's top economic planning agency, has so far only approved five of the UHV lines proposed by State Grid. It wants more time to assess the economics, technical details and environmental impact of the multi-billion dollar projects.

"There is a huge conflict going on here," says Adam Worthington, head of regional utilities, renewables and coal research at Macquarie Securities.

While the debate continues, State Grid's Liu continues to push his view that what's good for his company is good for China. Keeping State Grid whole, he is telling other Chinese officials, will help avert blackouts like those that hit India, where there was a lack of coordination among its fragmented grid networks and distributors.

"Whether we are big or not does not really matter," says an official at State Grid, describing the president's views. "The key is whether we are healthy."

(\$1 = 6.3145 Chinese yuan)

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