

client alert

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CHINA'S MARCH TOWARDS SHALE GAS

On 30 October 2013, the National Energy Administration ("NEA") released the *Shale Gas Industrial Policy*¹ (the "**New Shale Gas Policy**").

The policy officially makes the exploitation of shale gas a strategic emerging industry and provides supportive and incentive measures for shale gas development in China. It also contains provisions that encourage investment in infrastructure and construction of demonstration sites, and clarifies industrial standards and environmental protection guidelines for shale gas production.

With a third round of bidding for exploration rights anticipated in the near future, the New Shale Gas Policy is seen as another push for the industry's expansion and an attempt to address "market glitches" encountered by this sector to date.

Although welcome, the New Shale Gas Policy continues to lack concrete measures for the shale gas industry to advance, and the abstract guidelines it contains are often copied and pasted from previous regulations.

PREVIOUS DEVELOPMENT OF CHINA'S SHALE GAS POLICIES

March 2011	China announced 12 th Five Year Plan (2011 – 2015) ² , seeking development of shale gas.
June 2011	The first round of bidding for exploration rights was held, only six companies - all state-owned enterprises ("SOE") - participated, and only two of those SOEs ended up being granted rights.
Dec. 2011	The Ministry of Land and Resources ("MLR") reclassifies the shale gas as an independent mining resource ³ .
March 2012	The Development Plan ⁴ was issued. Specifically calling for cooperation with foreign companies and technology imports so that China can improve its ability to innovate.
Sept. 2012	The second round of bidding for shale gas exploration rights was held and considerably more successful. 83 companies put forward bids, of which 16 (6 central SOEs, 8 local SOEs and 2 private companies) were finally granted 19 of the 20 blocks up for auction.

¹ *Shale Gas Industrial Policy* (Announcement [2013] No. 5), promulgated by NEA on 22 October 2013 and effective from the same day

² *12th Five Year Plan*, promulgated by the National People's Congress on 16 March 2011 and effective from the same day

³ *Announcement No. 30 on a Newly Discovered Mining Resource*, issued by MLR on 3 December 2011 and effective from the same day

⁴ *Development Plan for Shale Gas (2011 – 2015)* (the "**Development Plan**"), jointly issued by the NEA, MLR, NDRC and MOF on 13 March 2012 and effective from the same day

Oct. 2012 Circular 159⁵ firstly details the conditions for being granted exploration and exploitation rights for shale gas. Foreign companies with experience in shale gas exploration and exploitation are welcome to participate in China's shale gas industry by forming an equity or cooperative JV with qualified Chinese companies.

Oct. 2013 The NEA published the New Shale Gas Policy.

MARKET GLITCHES

While the second round of bidding caught many spotlights and made shale gas become a headline commodity, the market has now cooled. Subsequently bid-winners are becoming aware of inherent problems associated with this new industry as they gradually become exposed to realistic daily problems, notably:

Lack of experience and technology Chinese companies, regardless of whether they are central SOEs or private companies, presently do not have enough experience and/or technology (including the core equipment) needed to explore and exploit shale gas. Current projects rely on transferable techniques used in the oil & gas industry, and specialist equipment required to explore and drill for shale gas continues to be imported as it is not available domestically.

Limited funding and subsidies The exploration and exploitation of shale gas require a large capital investment up front and has slow returns. Although MOF and NEA offer a subsidy for shale gas exploitation⁶ (the "**Shale Gas Subsidy**"), many bid-winners, especially private companies and local SOEs, are still short on funds to make a sizable investment.

Obstacles in transport and sale Existing pipe networks rarely extend to shale gas drill sites which forces many exploitation companies to rely on road transport. This mode of transportation is expensive and only capable of delivering small volumes to market.

Lack of industrial standards and environmental guidelines Due to its infancy, China's shale gas industry continues to lack detailed industrial standards and environmental protection policies.

These obstacles are severely limiting the development of the shale gas industry. For example, it is reported that at one exploitation site in Chongqing, Sinopec had originally planned to drill 24 gas wells with an output of 822,000 cubic meters per day. However, as of June 2013, only one gas well has been completed, producing 60,000 cubic meters per day⁷.

⁵ *Circular on Exploration, Exploitation and Administration of Shale Gas* (Guo Tu Zi Fa [2012] No. 159) ("**Circular 159**"), issued by MLR on 26 October 2012 and effective from the same day

⁶ *Subsidy Policy for Shale Gas Exploitation and Use* (Cai Jian [2012] No. 847), jointly issued by MOF and the NEA on 1 November 2012 and effective from the same day, provides that from 2012 to 2015, the central budget will offer RMB 0.4 per cubic meter of shale gas produced.

⁷ "页岩气第三轮招标不容乐观", China United Business News, 24 June 2013 (available at http://www.cubn.com.cn/News3/news_detail.asp?id=12705)

NEW SHALE GAS POLICY

In response to these problems, NEA has issued the New Shale Gas Policy to provide more support and incentives. The main topics covered by the New Shale Gas Policy are:

Making shale gas exploitation a strategic emerging industry⁸	<ul style="list-style-type: none"> • Emphasise further cooperation with foreign companies or institutions to introduce technologies and experience on shale gas. • Encourage R&D on core-equipment with a view to developing Chinese shale gas equipment technology. <p>⇒ No concrete measure at this stage</p>
Proposing demonstration sites	<ul style="list-style-type: none"> • Set up “demonstration sites” to display and apply cutting-edge equipment and methods for shale gas exploration and exploitation. <p>⇒ No concrete measure at this stage</p>
Offering more financial support	<ul style="list-style-type: none"> • Special Funds for the Development of Strategic Emerging Industries⁹ could be available to shale gas companies. • Other benefits: i) Shale Gas Subsidy (see above); ii) total or partial exploitation royalties exemption, and exemption from import duties on equipment and related technology that are imported for self-use and cannot be sourced domestically. • Encourage local government financial support and additional tax benefits (stemming from resource tax, value-added tax and income tax). <p>⇒ No precise new funding sources/subsidies at this stage</p>
Encouraging infrastructure development	<ul style="list-style-type: none"> • Encourage companies to establish transmission pipelines, compressed natural gas (CNG) and liquefied natural gas (LNG) facilities in remote areas lacking in infrastructure. • Existing transmission facilities are to be made available to all shale gas producers and traders without discrimination. • Encourage all types of companies to enter the shale gas market. Furthermore, shale gas prices are to be freely determined by the market without government pricing guidance. <p>⇒ The practical reach and consequences of these principles are not defined</p>
Clarifying industrial standards and environmental protection policies	<ul style="list-style-type: none"> • Industrial standard: Comply with the current technical standards and protocols for shale gas¹⁰. Where there is no specific standard, the corresponding standards for natural gas and oil will apply. • Environmental protection: i) An environmental impact assessment is necessary before initiating the project; ii) Anti-pollution facilities must be designed, built and commissioned simultaneously with the main part of the shale gas project; iii) Prohibits exploitation in natural reserves and scenic areas, drinking water conservation areas and areas with geological hazards.

⁸ The State Council introduced the concept of “strategic emerging industry” in 2010 to categorise certain industries that will be rewarded with most policy support. The shale gas exploitation is now a strategic emerging industry.

⁹ Which is financed by the central budget to support venture capital plans, collaboration between industry and academics, technological development, and regional cluster development of strategic emerging industries, provided in the *Tentative Measures for the Management of Special Funds for the Development of Strategic Emerging Industries* (Cai Jian [2012] No. 1111), jointly issued by MOF and the NDRC on 31 December 2012 and effective from the same day

¹⁰ The NEA has already set up a standardisation committee for shale gas and listed 81 standards that will be formulated. *Reply on the Establishment of a Technical Committee for Standardisation of the Shale Gas Industry* (Guo Neng Ke Ji [2013] No. 257), issued by the NEA on 5 July 2013 and effective from the same day

GIDE COMMENTS

Issued in response to the identified issues, the promulgation of the New Shale Gas Policy reveals the Chinese government's desire to continue developing the shale gas industry. The real breakthrough is quite limited, though, and further implementing rules are still awaited. Most of the incentives in the New Shale Gas Policy have already been mentioned in previous regulations.

Moreover, the policy framework for the shale gas industry is still far from adequate. For instance, while the New Shale Gas Policy calls for more foreign cooperation and investment, foreign participation is still limited to Joint Ventures¹¹, and in practice direct foreign investment in the Chinese shale gas exploration sector is non-existent.

At present news reports are circulating that a third and much larger round of exploration rights are to be offered before years end. These reports and the absence of new standards or measures to address current issues by the New Shale Gas Policy gives rise to the question of whether the new policy is merely an attempt by the state to preheat the market again.

The contents of the tenders for bids for the third round, and in particular the conditions to foreign participation, should reveal more about the strategy followed by Chinese authorities than the New Shale Gas Policy.

As always, Gide will closely follow any legal and practical developments in the shale gas industry. Please contact us should you have any questions regarding this or other energy issues in China.

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¹¹ *Catalogue of Industries for Guiding Foreign Investment*, revised by the Ministry of Commerce and NDRC on 24 December 2011 and effective from 30 January 2012