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Shell Is ‘Welcome Barbarian’ in China’s Shale-Gas Development
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By Stanley Reed and Dexter Roberts

Nov. 17 (Bloomberg) -- The hilltop city of Yulin, about 500 miles (800 kilometers) southwest of Beijing, was once a strong point in the defensive wall that protected the Chinese heartland from the tribes to the north. An ancient fortress survives in the old part of the city, the Chinese characters for “Suppress the Barbarians” carved over its gate.

Today, Yulin’s a boomtown in the oil- and natural-gas rich Ordos Basin, Bloomberg Businessweek reports in its Nov. 21 issue. In the streets not far from the fortress walls, where men sell roasted goat heads from carts, young boys hand out brochures for apartment towers built for newly wealthy oil workers and coal miners.

If fresh characters were carved into the old fortress gates now, they might say “Resource Barbarians Welcome!” Or they might simply be a pair of corporate logos: one for PetroChina Co., the publicly traded wing of China National Petroleum Corp., the nation’s largest oil company, and a second for its foreign partner, Royal Dutch Shell Plc, the largest European oil company.

A half-hour drive from the city is a new, white building that stands out in the desert scrub land. Clean and bright, it has offices, conference rooms, and a big second-floor terrace overlooking acres of neatly arranged tanks and piping.

This is the Changbei gas field. An estimated $1.3 billion joint venture, the field is managed by The Hague-based Shell for PetroChina and produces more than 3 billion cubic meters of gas a year.

Over a lunch of stir-fried chicken and snow peas, tangy local peaches and green tea in the building’s high-ceilinged commissary, the plant’s two bosses, General Manager Xu Lin, a Shell man, and PetroChina veteran Xu Yanming, his deputy, banter about Changbei.

Shell Cost Controls

Xu Yanming, dressed more like a local merchant than an oil man -- in slacks and a dark windbreaker -- ribs Shell’s Xu, who has a degree from Oxford University and wears the standard blue, one-piece Changbei boiler suit.

“Shell has had four managers -- and the whole time it has just been me,” Xu Yanming says. An earlier Shell manager, whom he dubbed a yangren -- slang for Westerner -- assumed ridiculously high costs, including $20 per diem for Chinese staff. Shell had also factored in exorbitant costs for water.

“Some at Changbei think PetroChina had stronger cost controls than Shell,” Xu Yanming chuckles.

Changbei is the most visible playing field for a tricky high-stakes game Shell has entered into with the Chinese behemoth, an engagement that mirrors the larger global shift of power from the major oil companies to the state-owned crude producers.

Unlocking Resources

PetroChina wants Shell’s expertise to unlock the unconventional gas and oil resources, such as shale gas, that require new techniques to extract. Shell wants PetroChina’s help in gaining access to the mainland, China’s newly hot gas fields, and its energy-hungry consumers.

The U.S. Energy Information Administration said in April that Chinese shale may hold 1,275 trillion cubic feet of gas, 12 times the country’s conventional natural gas resource. The “technically recoverable” reserves are almost 50 percent greater than the 862 trillion cubic feet estimated for the U.S., the agency said.

Last year, China became the largest energy consumer in the world, surpassing the U.S., according to BP Plc’s Statistical Review of World Energy. China is expected to account for almost half the world’s growth in oil consumption in the next two decades, becoming the largest market for oil, and it’s trying to more than double the use of gas in its economy, to 8 percent of the energy mix, by 2015.

Flow to China

Shell isn’t just angling for the gas in China. As China and Asia surge in importance, the company wants to use its Chinese partnerships to help gain influence over the flow of all global resources destined for China, from the Middle East to Australia.

Shell executives think they’ve picked a winner in PetroChina and the company is going all out to please Beijing.
In June, company directors visited Changbei and the Iron Man Wang Jinxi Memorial Hall, a shrine to an iconic 1960s oil worker, at PetroChina’s largest field, Daqing.

“This is the most advanced Chinese alliance; this is about the future,” says Jerry Kepes, a partner at the Washington energy consultant PFC Energy. “Shell gets it. But Shell has to deliver.”

The relationship carries plenty of risk. For Shell, the risk is that once PetroChina has absorbed its know-how, it will become a competitor that not only will take Shell’s share of the business but also will one day attempt to swallow the Anglo- Dutch giant whole.

Courting CNPC

The Chinese have long known there was gas in Changbei, without having the skills or technology to extract it. So they went looking for a partner that did. Even though the pair seemed to be made for each other -- both are gigantic, bureaucratic, and eager to be top players -- CNPC, as PetroChina’s parent company is known, and Shell courted for more than a decade before getting serious in the late 1990s.

The two companies signed a production-sharing agreement in 1999. Shell’s bosses dithered on giving the final go-ahead for investment when China raised gas prices and the market outlook improved.

At about the same time, the company spurned an invitation to participate in the $12 billion West-East Gas Pipeline that China wanted to build to bring gas to its major cities. Shell’s management did not think the terms were adequate.

Sharing Priorities

"It became clear that we did not share the same priorities and expectations," said Shell Chief Financial Officer Simon Henry.

Shell's top managers didn't give the green light on Changbei until 2005, after lower-level executives warned it was on the verge of losing the deal and another great opportunity.

Since then, Shell's expertise, coupled with PetroChina labor, has made Changbei work.

The field's gas is "tight," meaning it's trapped in rocks that don't easily give up their treasure. Shell solved the problem with horizontal wells that level off when they reach the gas, which is in layers about 10,000 feet (3,000 meters) below the surface.

A two-pronged pipeline is then drilled out from the bottom of the well horizontally for about 6,000 feet so that the well can suck gas from a huge expanse of rock. So much gas flows into these pipes that Changbei's fields are highly prolific.

Slashing Well Costs

Before teaming up with Shell, PetroChina used to take more than 250 days to drill a well like this. Now it takes about 130 days, slashing costs on the 25 wells that have been drilled so far to $10 million from about $17 million each.

Xu Lin said development costs at the equivalent of less than $1 a barrel of oil make Changbei highly profitable. Shell won't disclose the project's profit margin.

While noteworthy, Changbei is the first step of a much larger plan. Shell, which has about $4 billion invested in China wants to be that nation's energy concierge, catering to the oil and gas industry's needs. CNPC is the only avenue available to fulfill such ambitions.

The breakthrough in Shell's China strategy occurred in August 2009 at a meeting held in The Hague. Peter Voser had recently become Shell's chief executive officer and had cut short his vacation to meet with a delegation led by CNPC Chairman Jiang Jiemin.

Diplomatic Summits

The chemistry was good between Jiang and Voser, a Swiss national who has instilled more financial discipline at the conglomerate. Since then, meetings have occurred every few months, either in the Hague or at CNPC's 25-story headquarters in Beijing's Dongcheng district.

These meetings resemble high-level diplomatic summits more than business negotiations -- not surprising, perhaps, given the size of the respective companies. The chairman of CNPC, which has more than 1.5 million people on the payroll and revenue of $271 billion, is more like the governor of a major province than a CEO of a company.

Each session follows the same format. The CEOs sit at the top end of a horseshoe-shaped table and converse through an interpreter hidden by a huge arrangement of flowers. Aides sit along the sides of the horseshoe.

The CEOs reach agreements in principle on ideas to pursue and signal to aides to work out the details before the next meeting three or four months later. Invariably there are lunches and dinners and drinks. The talks recently have been enlivened by the Chinese liquor Maotai. Every executive is expected to drain a toast to each person present, with no half measures tolerated.

‘Government Functionaries’

Shell executives have warmed to Jiang because he appears to be receptive to their ideas, unlike some of his counterparts at state companies. CEOs of Chinese state companies are political animals whose decisions aren’t driven strictly by profit motive.

“These are talented, tenacious people that should not be underestimated,” said Jeff Layman, a partner at law firm Baker Botts LLP in Beijing. “But at the end of the day, they are still government functionaries. They may be looking at their futures beyond the companies they are managing.”

The powwows between the two companies have produced a list of projects, some of which are already under way. If they all come to fruition, they could be investing $50 billion together, not only in China but also in Qatar, Australia, and elsewhere over the next decade or so.

Syrian Joint Venture

Shell also let CNPC into a joint venture in Syria that might have been an entrée into the Arab world. The deal has fizzled, and Shell is no longer lifting crude since the Syrian regime was hit with international sanctions following its crackdown on dissidents.

For Shell executives, this elaborate courting of the Chinese reflects a growing awareness of the energy market’s new realities.

Forty years ago major Western oil companies such as Shell controlled more than 60 percent of the world’s oil reserves. Thanks to waves of nationalizations and depletion of oil fields in the West, the producing countries now control the bulk of that oil.

With few exceptions, the only way to make an impact in such places -- whether Venezuela, Russia, or Abu Dhabi -- is through partnerships with the national oil companies. China is the biggest of these.

Global Player

According to Xinhua, China’s official news agency, China plans to invest $828 billion in its power industry by 2015, developing oil and gas fields, building refineries and pipelines across the country and adding power plants, wind farms and nuclear reactors. Green energy production is a priority because China also wants to cut carbon emissions and reduce the energy intensity of its economy by 2015.

PetroChina’s plans are ambitious, too, and its objective is clear: It wants to be on the level of Shell someday and is pushing its partner to help it become a global player.

For instance, Shell sponsors a leadership development program for senior Chinese executives run by Peter Nolan, a professor at the Judge Business School at the University of Cambridge.

The company supplies materials and speakers for the program to build relationships with the Chinese executives and prepare them to work on joint ventures. PetroChina executives have even visited the Hague to learn how Shell complies with U.S. Securities and Exchange Commission regulations.

Riding the Tiger

The big question is: Can Shell keep riding this tiger? What prevents PetroChina’s parent, CNPC, from exploiting the Western

producer for what it wants and then tossing it aside or perhaps even taking it over?

For now, CNPC appears content to see what it can gain through the partnership. Shell CFO Henry, who manages the PetroChina relationship, said in an interview that there is a quid pro quo for being permitted to work in China: helping the Chinese company acquire oil and gas resources outside of China.

Qatar, the emirate that is the world's leading gas exporter, is a place where Shell is playing the energy concierge with considerable skill. In 2008, the company sold more than one- third of the output of its Qatargas 4 plant in Qatar to PetroChina in long-term contracts.

That deal impressed Shell's majority partner in the project, Qatar Petroleum, and has led to two others: Shell, Qatar Petroleum and PetroChina are planning a refinery and petrochemical complex in China's southeastern Zhejiang province.

Tripartite Relationship

Shell has also brought in PetroChina as a 25 percent partner to explore for more gas in Qatar. If that arrangement yields a big find, it could lead to a new $10 billion to $15 billion liquefied natural gas plant.

"This tripartite relationship is important to us," said Andy Brown, Shell's Qatar chief. "We can play a role between a major energy-producing country and a major energy-consuming one."

Shell is delivering not only in Qatar but also on Curtis Island, a 30-by-15-mile strip of land within Australia's Great Barrier Reef World Heritage area.

In 2010, it joined forces with PetroChina to buy Arrow Energy for A$3.6 billion ($3.6 billion). Arrow has plans to build a $20 billion liquefied natural gas plant to feed the fuel to China. Henry says being able to buy an energy company in a developed country such as Australia earned Shell "huge Brownie points."

Still, the long-term risk remains that PetroChina will learn to develop even difficult oil and gas fields with the aid of technology-rich service companies such as Schlumberger Ltd.
and Halliburton Co., then kiss Shell goodbye.

That's the thing about the energy game in China: Sooner or later, someone has to lose.

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