For the exclusive use of H. JU, 2018.

HKU183
02/15/02

PetroChina: International Corporate Governance with Chinese Characteristics

For its state-owned enterprises (SOEs) to float their shares on foreign exchanges in 2000, the Chinese government had to make a big show of seeking to improve the governance level of the SOEs, in order to attract investors in the global capital market. In April 2000, PetroChina was listed on the New York Stock Exchange (NYSE) and the Stock Exchange of Hong Kong (HKSE). In preparation for these listings, PetroChina underwent a dramatic corporate restructuring, including the establishment of a board of directors, the appointment of independent non-executive directors and improvements in its level of transparency. A year after its IPO, PetroChina had good news for its investors. Its 2001 interim profits surged 17 per cent to RMB 27.17 billion with earnings per share up seven per cent from the 2000 level.[1] PetroChina's impressive results were actually anticipated because the Chinese government wanted to use PetroChina to serve as the flagship of its state-sector reform and to help change investors' outlook towards mainland stocks. However, many analysts were still concerned about the investment risks associated with PetroChina's corporate governance model. Some felt that the state-owned company was not yet close to where it needed to be in terms of international governance standards.

The Oil and Gas Industry in China

The Chinese government regarded the oil and gas industry as one of China's "pillar" industries fuelling the country's economic development. With several major discoveries of crude oil and gas in northern China, China's oil and gas industry started its development in the 1950s. There was continuous growth in the production of crude oil throughout the late 1970s. As part of its economic reform process initiated in the early 1980s, the Chinese government undertook a series of restructuring moves in the oil and gas industry, including the separation of the government's roles as regulator and company operator. After the restructuring, the government was responsible for drafting laws and regulations, formulating polices, directing investments and overseeing reforms over the industry. Four central government authorities exercised control over many aspects of the oil and gas industry [see **Exhibit 1**].

China's oil and gas industry was dominated by three state-owned companies — China National Petroleum Corporation (CNPC), China Petroleum and Chemical Group (Sinopec)

[1] PetroChina, Interim Financial Statement, 30 June, 2001.

Sang Xu and Mary Ho prepared this case under the supervision of Prof. John Child for class discussion. This case is not intended to show effective or ineffective handling of decision or business processes.

This case is part of a project funded by a teaching development grant from the University Grants Committee (UGC) of Hong Kong.

© 2002 by Centre for Asian Business Cases, The University of Hong Kong. No part of this publication may be reproduced or transmitted in any form or by any means - electronic, mechanical, photocopying, recording, or otherwise (including the Internet) - without the permission of The University of Hong Kong.

Ref. 01/126C 15 February, 2002

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

and China National Offshore Oil Corporation (CNOOC). PetroChina Company Limited (PetroChina), a subsidiary of CNPC, was the largest oil and gas company in China in terms of reserve size and production capacity [see **Exhibit 2**]. Overshadowed by coal and oil production, natural gas accounted for only about two percent of China's domestic energy production and consumption. More than 60% of China's oil and gas companies were state-owned, accounting for about 55% of gross output value produced by the industry.[2]

Ranked as the world's fifth-largest producer of crude oil, China's average oil production was 3.2 million barrels per day in 2000.[3] However, China's crude oil demand, boosted by the country's rapid economic growth, exceeded its production, which grew slightly every year. In 1993, China turned from a net exporter to a net importer of crude oil. Such rising demand for oil and imports made China a significant player in global oil markets.

Since the early 1980s, China adopted a very limited form of privatisation, allowing fragments of its markets to develop in a move towards a market-driven economy. Much of China's economy remained under the control of large SOEs, many of which were inefficient and unprofitable. Restructuring of the SOE sector, including obtaining foreign capital to finance the restructuring, was a major priority of the government. In 2000, a total of 14 SOEs were listed on foreign exchanges. In addition to complying with China's regulations targeted specifically at them, these SOEs had to meet higher governance standards set by foreign exchanges. SOE reform strategies were clearly carried out for the oil and gas industry. The three industry leaders — PetroChina, Sinopec Corporation and CNOOC Limited — floated their minority shares overseas. Prior to these IPOs, the three companies had conducted substantial restructuring based on principles applicable to internationally listed companies, and implemented corporate governance standards to enhance foreign investors' confidence in them.

International Corporate Governance Strategy

Since the early 1980s, the world had witnessed significant developments in corporate governance. In the US, the UK and other developed countries, corporate governance was increasingly recognised as a strategy for governments to improve the legal, institutional and regulatory framework, and for corporations to ensure their operational performance and to attract international capital. In the US, the California Public Employees Retirement System (CalPERS) was a global leader in shareholder activism and produced the most comprehensive set of corporate governance guidelines in the world. The UK Cadbury Report was another influential set of corporate governance guidelines. Its requirements were not as aggressive as those outlined in the CalPERS guidelines, and were generally seen as more adaptable to developing economies. In Asia, the 1997 financial crisis focused the world's attention on the weak corporate governance practices of local companies. Since the crisis, many Asian governments have upgraded the corporate governance requirements of companies, although not to the point where any Asian market can claim to have achieved international standards of corporate governance.

> *"Corporate governance is defined as a system by which corporations are directed and controlled. Corporate governance structures specify the distribution of rights and responsibilities among different participants in a corporation, such as the board of directors, the managers, the shareholders and other stakeholders, and spell out the rules and procedures for making corporate decisions. By doing this, it also provides the structure through*

[2] Hong Kong Trade Development Council, URL: http://www.tdctrade.com/econforum/sc/001201.htm, 23 August, 2001.
[3] US Energy Information Administration, URL: http://www.eia.doe.gov/emeu/cabs/china.html, April 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

which the company objectives are set, and the means of attaining those objectives and monitoring performance."

- OECD Principles of Corporate Governance[4]

Generally, good corporate governance entailed three areas: shareholders' rights, independent non-executive directors and transparency. Corporate governance covered issues such as the role of the board of directors, the management structure, the committee system, the remuneration of directors and senior management, and the conduct of general shareholder meetings [see **Exhibit 3**].

The Development of Corporate Governance in China

The Corporate Governance System of SOEs

Since the Communists took over power in 1949, China was structured as a state-owned economy. The corporate governance system of the SOEs experienced several significant changes, with different degrees of political interference in enterprise decision-making. Put simply, SOEs were instruments serving the political purposes of the government. Since the adoption of economic reform in 1978, China reduced the involvement of local party committees in enterprise management through a series of experiments.

The Enterprise Law, effective in 1988, formally approved a "factory director (manager) responsibility system", under which the factory director should assume overall responsibility and exercise leadership in the production, operation and management of the enterprise. The law, however, also provided local party committees sufficient legal grounds to play an active role in decision-making.

Unlike the Enterprise Law, the Company Law, promulgated in 1993, no longer gave local party committees overall supervisory power over incorporated SOEs. This law stipulated policies and procedures to establish a shareholder system and a governance structure characterised by a separation of ownership and control. Under a new strategy implemented in 1997, known as "grasping the large and freeing the small", many large SOEs were converted into shareholding companies in accordance with the Company Law, with the state retaining a controlling ownership, while small SOEs would become privately owned. As the legal and economic status of these private companies remained less clearly defined, they existed on the grey fringes of the economy. For example, they had less access to the capital markets than large SOEs, which received more favourable treatment from the government.

A shareholding company was required to set up a board of directors, a supervisory board and a management team [see **Exhibit 4**]. The distribution of power among shareholders, the board of directors, the supervisory board and management is outlined in **Exhibit 5**. The supervisory board, which was copied from German company law, acted as a second board to check the activities of the board and the managers.

The Company Law also allowed party committees to keep their organisational presence in incorporated SOEs. These internal committees were usually headed by a senior executive, often a board director. They generally had between 10 and 20 party members and had offices on the same floor as top management. A survey conducted by the Shanghai Stock Exchange in 2000 revealed that in listed companies, 99 per cent of the main business and staffing decisions, including board appointment and salaries, were made with the approval of these

[4] OECD, URL: http://www.oecd.org/daf/governance/Q&As.htm, September, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

party committees.[5] Given the important role played by the party in the everyday operations of state-owned companies, it was not surprising that party membership was still vital to an individual's appointment to a senior managerial position.[6] As managers were often appointed for political or other reasons, rather than their qualifications for the job, they might not be the best people to manage the company effectively.

Apart from party committees, it was also common for former or existing supervising government departments to continue to have an influence on the investment decisions of state-owned enterprises. The interference by these organisations was not necessarily bad. With nearly 65 million members nationwide, the party provided an indispensable network outside of which promotion was impossible, bank credit inaccessible and permission to list a company unattainable.[7] However, the huge overlapping network between the companies and these political organisations remained largely out of sight of investors and unsupervised by regulators. A potential clash might also exist between a board's duty to its shareholders and its obligations to the party and government departments.

Supervisory boards in China consisted of shareholders' and employees' representatives. But in many cases they were not effective. Most of them did not have the power to call extraordinary shareholders' general meetings, and some of them did not regularly inspect corporation activities and financial affairs. Lack of funding for supervisory board activities was a key factor in low motivation among supervisors. In addition, employees' representatives on the supervisory board could not carry out their role if that supervisory role involved confrontation with their supervisors.[8] The Company Law also required the board of directors to listen to the views of trade union members on major decisions. While this device allowed staff members to voice their opinions, there was no compulsory action prescribed for the board to do anything beyond this.

As of 2001, 204 listed companies in China had appointed 314 independent directors.[9] Many analysts had felt that the interests of minority shareholders were not protected, as a number of listed firms shared the same managers as their parent companies.

The Legal System

The concept of corporate governance was not well understood in China. For historic and cultural reasons, China had been ruled and continued to be ruled by "the rule of man" rather than "the rule of law".[10] Managers had wide discretion in running firms. Yet there were few mechanisms to ensure that they were acting in the best interests of the firms or the shareholders. China's legal framework was still at an early stage of development. Shareholders had limited legal remedies against exploitation by company management or a controlling shareholder. The Chinese judiciary, for example, was not fully independent. Corporate governance decisions were uncommon and even though they did exist, the decisions were considered only persuasive rather than controlling. The lack of developed legal precedent in China meant that it was very difficult for potential litigants to forecast legal outcomes.

[5] McGregor, R., "The little red book of business in China," *Financial Times (London)*, 2 July, 2001.
[6] Wong, G., Chan, S. and Ho, M., "Managing a State-owned Enterprise: A Daring Experiment by the Beijing Capital Group," Centre for Asian Business Cases, The University of Hong Kong.
[7] McGregor, R., (2001).
[8] Tam, K. O., "The Development of Corporate Governance in China", *Edward Elgar Publishing Limited*, 1999.
[9] Anonymous, "Directors in training as rules take effect", *South China Morning Post*, 18 July, 2001.
[10] Anonymous, "Of Laws and Men", *The Economist*, 7 April, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

The Enforcement Mechanism

The enforcement mechanism in China was rather weak. Low pay in governmental positions had facilitated the bending of rules and had resulted in widespread corruption and fraud. In some cases, the firm managers and state-appointed overseers could collude or tacitly agree to jointly expropriate wealth from the firm.[11] Abuses of accounting policies remained rampant. For instance, a Ministry of Finance survey found that 98.7 per cent of Chinese companies falsified their earnings in annual reports in 2000.[12]

The market for corporate control was virtually non-existent in China. Before 2001, Chinese laws made it illegal for the shares held by the state or corporate persons in a former state-owned enterprise to be traded on a secondary market. Thus spontaneous mergers and acquisitions were very rare. Even though many SOEs were insolvent, the rate of bankruptcy remained particularly low at 0.06%, compared with 1.1% in the United States.[13] In some countries, such as the United States and Britain, mutual or pension funds held a large number of shares in companies and could exercise influence through the board and challenge the power of management. In China, however, the state was the majority shareholder of all stated-owned companies. It also controlled the mutual funds and the Securities Regulatory Commission. Due to potential conflicts of interest, there was not enough leeway for one organisation to act as a check against the other.

The banking system in China was unable to play the role it would have to play in a developing or developed country. Many banks were state-owned and did not provide sufficient oversight of the governance of corporate creditors. Loans were often guided by politics or policies of the past or the "soft budget" constraints of SOEs. To a certain extent, these policy loans had replaced state subsidies. The banking system also lacked well-trained personnel capable of implementing a genuine credit risk policy towards enterprises.

Reforms

As China moved to expand its capital markets and exposed itself to international capital market disciplines, it began to recognise the importance of corporate governance. In 2000, four giant Chinese companies — PetroChina, China Mobile, China Unicom and Sinopec — raised more than US$20 billion through international share offerings, a staggering sum for any emerging market. Given the low cost of capital in China's booming domestic markets, it appeared that there was little sense in these companies raising money abroad. However, industry experts felt that the Chinese government was using this group of companies to discipline managers and to drive change through the rest of the corporate system. China desperately needed to do so as it opened up the economy to foreign companies under the strictures of the World Trade Organisation.

The China Securities Regulatory Commission (CSRC), the national securities regulator, was leading the charge to spread the concept of corporate governance in China. In April 2001, the CSRC announced that listed companies would need to make quarterly financial reports starting from 2002. Around the same time, the CSRC ordered a delisting of a Shanghai-listed company that had suffered four consecutive years of losses. This company became the first to be delisted from a mainland stock exchange. In June 2001, another 12 companies were selected for delisting because of poor performance and a lack of transparency. In mid-2001, the CSRC also announced that it was drafting a new set of corporate governance standards applicable to listed companies. A former Hong Kong securities regulator was hired by the

[11] Hodges, J., "China Securities Regulatory Commission issued rules to improve corporate governance in the country's public firms", *Institute of Internal Auditors*, 16 October, 2001.
[12] Brooker, M., "Reining in the China Bulls", *South China Morning Post*, 5 June, 2001.
[13] O"Neill, M., "Reformist calls for break-up of big four", *South China Morning Post*, 6 February, 1998.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

CSRC to oversee the introduction of the new standards expected, for release at the end of 2001.

In June of the same year, China announced a series of long-awaited rules about how it planned to allow state-owned shares to be sold on the stock market. The new rules permitted the sale of such shares and stipulated that 10 per cent of state companies' IPOs should consist of state-owned shares. The proceeds from their sale would go into a national social security fund. Though it was unlikely that the state would cede the controlling stake in most listed companies, the new rules were expected to help improve corporate governance.

Another indication of the improvement in China's corporate governance standards was the waning influence of the party. While party committees remained active in listed and large state-owned and private companies, there were signs that indicated the party's declining influence in small companies. A survey conducted in Shenzhen, for example, found that fewer than one per cent of the new, small private companies had a party committee in 2001.

In spite of the above improvements in corporate governance standards, it was not expected that the Chinese government would be able to introduce the international corporate governance regime to China within a short period of time. In 2000, the Shanghai Stock Exchange (SSE) identified seven weaknesses characterising China's corporate governance environment[14]:

1. Banks did not provide sufficient oversight of the governance of corporate creditors.
2. A keyman, or a single decision-maker, often dominated companies.
3. Supervisory boards lacked the power to appoint or dismiss directors and managers.
4. Shareholders' participation was low and a corporate governance culture was absent.
5. Directors did not understand their duties.
6. Ownership concentration in most companies was high.
7. Because of state ownership, insider trading and other factors, no significant correlation existed between the market value of a company, its intrinsic value and governance.

PetroChina

In November 1999, PetroChina was incorporated as a result of a comprehensive restructuring of CNPC, in preparation for the listing of PetroChina on foreign exchanges. Under the restructuring, CNPC transferred to PetroChina a workforce of 480,000, most of its assets and liabilities, and interests relating to its main domestic oil and gas businesses. Meanwhile, CNPC retained the international oil businesses and the group's domestic non-oil businesses. The restructuring, considered as China's most ambitious privatisation project as of February 2001, was the government's plan to lay the groundwork for other capital-starved SOEs on the global capital market. At the time of its IPO, PetroChina was the first IPO in a series of planned public offerings of SOEs looking to privatise on the NYSE. The restructuring followed advice from China International Capital Corporation (CICC) and Goldman Sachs. Every single asset was inspected, and the accounting and management systems were reorganised.

Focused on upstream operations, PetroChina's business covered a broad range of petroleum-related activities, including:

- exploration, development and production of crude oil and natural gas;

[14] Allen, J. and Francois, R., "Corporate Governance in Greater China: A Comparison Between China, Hong Kong and Taiwan", *Asia Law & Practice*, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

- refining, transportation, storage and marketing, including import and export, of crude oil and petroleum products;
- production and sale of chemicals;
- transmission, marketing and sale of natural gas.

PetroChina was established as a joint stock company with limited liability in accordance with the Company Law.[15] Thus, its management structure consisted of a board of directors, a supervisory board and a senior management team in charge of all different segments of the business. It also set up four committees, including an Audit Committee and a Personnel Development & Compensation Committee, to monitor the management and business operations [see **Exhibit 6**].

Initial Public Offering (IPO)

In April 2000, five months after its establishment, PetroChina went public at HK$1.27 per share with 17.58 billion shares in the global offering and 160 billion shares outstanding. The ADSs and H shares of the Company were listed on the New York Stock Exchange and the Hong Kong Stock Exchange Limited on 6 April, 2000, and 7 April, 2000, respectively. BP plc, the world's third largest oil company, took 20% of the global offering to develop a PRC retail network and sell natural gas to power stations. Various Hong Kong listed companies, including Cheung Kong (Holdings) Limited, Hutchison Whampoa Limited, Sun Hung Kai Properties, and New World Development Company Limited, also invested a total of US$350 million. The shares issued to the public represented 10 per cent of the total capital of the company.

Prior to the IPO, PetroChina had gone through a difficult time gaining the confidence of foreign institutional investors. Human rights groups criticised PetroChina's projected expansion of oil and gas production in Tibet and the involvement of CNPC, PetroChina's parent company, in oil development projects in Sudan. Environmentalists accused PetroChina of operating in an environmentally irresponsible manner. As the state remained the controlling owner of PetroChina's parent, investors were also concerned about corporate governance issues in China, including minority shareholders' rights, the transparency of information and political interference in enterprise decision-making. An American labour union organised a boycott campaign against the PetroChina IPO. Some institutional investors responded to the boycott by vowing not to invest in PetroChina. Although the listing eventually went through, the capital raised was only around US$3.4 billion, far less than the US$10 billion originally expected. However, PetroChina's IPO opened the market for other large SOE listings, including Sinopec and CNOOC.

PetroChina's Corporate Governance Model

In its prospectus and other IPO documents, PetroChina promised many changes in corporate governance. However, the prospectus also revealed a number of inherent risks.

Dividend and Capital Investment Policy

Although the IPO seemed to distance PetroChina from its parent's activities, many analysts had felt that the firewall was illusory. For the purpose of the IPO, CNPC had retained most of the liabilities such as those associated with massive layoffs. Nevertheless, it continued to hold as much as 90% of PetroChina. Given that CNPC was a "classic state-owned enterprise", with the burden of a bloated payroll and a vast network of hospitals and schools, any income earned by PetroChina might find its way back to the parent company.

[15] A joint stock company with limited liability referred to a company where the total capital had to be divided into equal shares; where shareholders assumed liabilities towards the company to the extent of their respective shareholdings, and where the company was liable for its debts to the extent of all its assets.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

CNPC's control created a danger that any cash raised or income earned by PetroChina might not be used in the best interests of the company's shareholders. In fact, according to PetroChina's prospectus, 10 per cent of the IPO proceeds would go to CNPC to reduce debt and pay for employee severance and retraining. Since the state was also the owner of CNPC, this raised concerns related to both PetroChina's dividend policy and business strategy. As the majority shareholder, CNPC would get a substantial share of dividend payments. Due to future losses that CNPC might incur because of the restructuring, investors were concerned that CNPC might seek to influence PetroChina's dividend policy with a view of satisfying its cashflow requirements. At the same time, PetroChina seemed to have very little bargaining power in potential negotiations with CNPC. In its prospectus, PetroChina admitted that its business was substantially dependent on the provision by CNPC of services and products for which the company had limited alternative sources of supply. Thus many feared that PetroChina's management might not be able to prevent the looting of its resources on the instructions of its parent or even the government.[16]

Appointment of Directors and Corporate Officers

As at 31 December, 2000, there were 13 directors on the board of PetroChina, three of whom were independent non-executive directors. However, the board did not seem to be structured in such a way that it could act as a check on the power and interests of the controlling shareholder and the Chinese government. Out of the three outsiders, two appeared to have close ties with the Chinese government. Mr. Tung Chee-chen was the brother of Mr. Tung Chee-wah, the Chief Executive Officer of Hong Kong Special Administrative Region. Mr. Wu Jinglian, a leading mainland economist, was an adviser to Chinese Premier Zhu Rongji. Mr. Franco Bernabe, former head of Italian oil conglomerate ENI, was the only independent non-executive director who did not appear to have close connections with the Chinese Government.

Many observers viewed PetroChina as being one with CNPC, even though it was a separate entity owning domestic assets only. Such views were certainly not groundless. Mr Ma Fucai, for example, was both PetroChina's chairman and president of CNPC. A number of PetroChina's senior management personnel also served on the board of CNPC [see **Exhibit 7**].

In its prospectus, PetroChina highlighted a number of structural constraints set by the state:

> *CNPC will be able to elect all of our directors and otherwise control us…We will be controlled by CNPC, whose interests may differ from those of our other shareholders…Our operations, like those of other PRC oil and gas companies, are subject to extensive regulation by the PRC government…As a result we may face significant constraints on our ability to implement our business strategies, to develop or expand our business operations or maximise our profitability.*[17]

Since the corporate officers of both PetroChina and CNPC were appointed by and could be dismissed by the Chinese Government, many feared that PetronChina's management appointments or changes could be determined by political considerations.

Legal Protection for Outside Investors

To outside investors, PetroChina seemed to offer some meaningful legal protection. The company's articles of association required shareholders to submit any disputes with the company to arbitration in Mainland China or in Hong Kong. However, some shareholders

---

[16] AFL-CIO's Office of Investment, PetroChina Watch, URL: http://www.petrochinawatch.com/ipo/, 13 November, 2001.
[17] AFL-CIO's Office of Investment, (2001).

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

were concerned that it might be difficult, if not impossible, to find an independent arbitrator. Another issue that troubled shareholders was that they might not be able to enforce legal judgements against the company or its officers, especially judgements determined by the securities laws of the United States or other countries. Indeed, PetroChina's prospectus stated that China did not have treaties or arrangements providing for the recognition and enforcement of judgements of the courts of Western countries or even Hong Kong, and therefore judgements obtained in those jurisdictions might not be enforceable in China.

Moving Towards International Corporate Governance Standards

While investors remained cynical about the minimal corporate governance protection that PetroChina offered, the company had tried hard to shed its image as a typical Chinese state-owned company by initiating a number of changes.

Management Incentive Programme

To align the management's interests with those of shareholders, PetroChina adopted a new management incentive programme, in which managers' compensation was linked to their performance. The managers' compensation package was made up of basic salaries and bonuses that accounted for 30% and up to 70% respectively of total compensation. In addition, PetroChina granted share options to directors, supervisors and members of the management team. In 2000, a total of 122 million share rights were granted to officers and directors of the company. PetroChina also promised that it would extend such share option plans to its remaining employees.[18]

Information Disclosure

PetroChina was viewed by some international observers as one of the few companies in China that had ensured a relatively high level of transparency. PetroChina delivered financial reports to the public every quarter. An audit for the fiscal year 2000 was conducted in accordance with International Auditing Standards (IAS), and a clean auditor's report was issued by PricewaterhouseCoopers. It also had a Website that disclosed much of the important information regarding the company, such as:

- Executive profiles
- Operating statistics / highlights
- Quarterly reports / interim results / financial reports
- Stock information
- General meetings
- Rights and obligations of shareholders [see **Exhibit 8**]

Supervisory Board

The supervisory board of PetroChina consisted of seven members, including two independent supervisors. As stated in the "Reports of the Supervisory Committee" of PetroChina's 2000 annual report, the supervisory board carried out the following duties:

- meetings of the supervisory committee
- inspection of the company's financial position
- operation of the company in compliance with the law
- fulfilment of duties by directors and senior management of the company

Policies and Procedures

In 2000, PetroChina complied with the Code of Best Practice governing companies listed on the HKSE. Moreover, it formulated a set of policies and procedures regarding shareholders' general and extraordinary meetings [see **Exhibit 9**].

---

[18] Clifford, M., "An Oil Giant Stirs", *Business Week*, 7 May, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

The Challenges Ahead

PetroChina, a showcase for sound corporate governance in China, had a board structure that in certain respects exceeded requirements in Hong Kong, which had the highest standards of governance in Asia. Three members of PetroChina's board of directors were independent non-executives, while only two independent non-executive directors were required in Hong Kong. One year after its global listing, PetroChina recorded impressive financial results. The government went to a great deal of trouble to make PetroChina a showcase, because it wanted to boost the confidence of investors in its SOEs.

In spite of the Company's robust earnings, however, investors still had doubts about the independence of its management and its freedom to make business decisions. In 2000, for example, many had suspected that the Company's decision to build a natural gas pipeline from Qinghai province in West China to Lanzhou city was in response to Chinese premier Zhu Rongji's comments that Lanzhou badly needed to use cleaner fuel to solve its pollution problems.

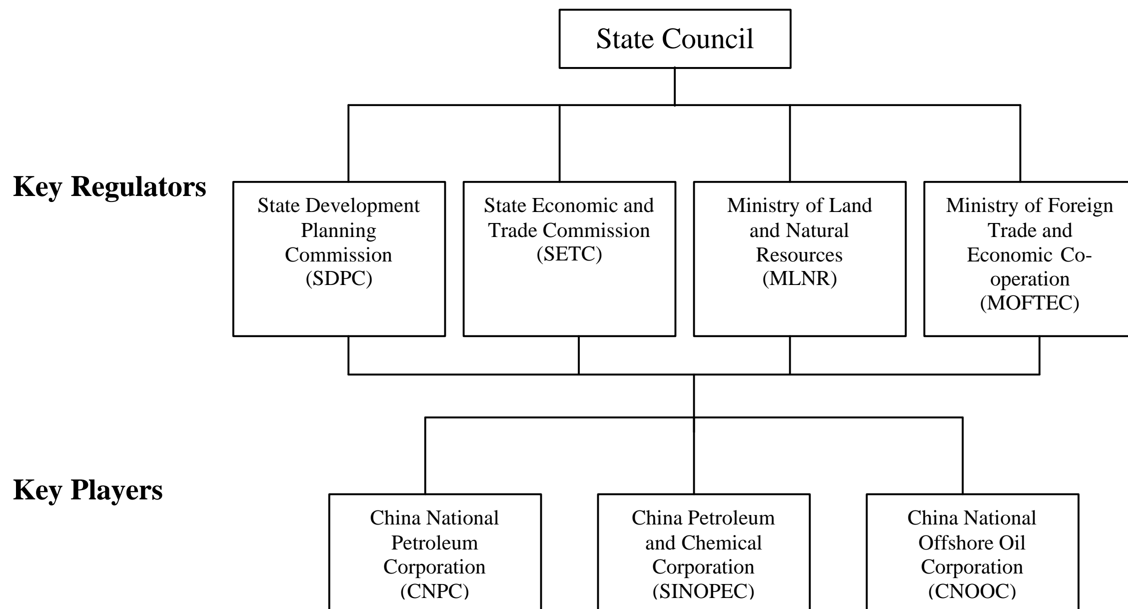
The investors' doubts about PetroChina's credibility and accountability had placed considerable pressure on the company's share price during the first few months of its global listings. On the first day of its trading in Hong Kong, the stock fell below its issue price of HK$1.27. As at 15 November, 2001, the stock was priced at HK$1.38, against its lowest level of HK$ 1.11.

As of November 2001, PetroChina's corporate governance system still had some space for state and management manipulation. Questions had been asked about whether the Company, which was one of the five biggest oil producers in the world, could someday be like BP plc, Royal Dutch, Shell or Exxon Mobil in terms of corporate governance standards.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 1
CHINA'S OIL AND GAS INDUSTRY STRUCTURE



Responsibilities of Key Regulators:

SDPC - (responsible for long-term development issues including approval of large projects and joint ventures)

- determines mandatory minimum volumes and applicable prices of natural gas to be supplied to certain fertiliser producers;
- publishes benchmark prices for crude oil and guidance prices for natural gas and certain refined products, including gasoline and diesel;
- approves investment and finance projects exceeding certain capital expenditure amounts;
- approves Sino-foreign equity and co-operative projects exceeding certain capital amounts.

SETC - (responsible for short-term operating and reform issues)

- engages in industry administration and policy co-ordination;
- sets import and export quotas for crude oil and refined products.

MLNR - (responsible for oil and gas resources issues)

- grants, examines and approves oil and gas exploration and production licences;
- administrates the registration and transfer of exploration and production licences.

MOFTEC - (responsible for foreign trade issues)

- examines and approves production sharing contracts and Sino-foreign equity and co-operative joint venture contracts;
- issues import and export licences for crude oil and refined products.

Source: Hong Kong Trade Development Council, URL: http://www.tdctrade.com/econforum, August 2001, and PetroChina Prospectus, March 2000.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 2
DOMESTIC COMPETITORS

	PetroChina	**Sinopec Corp.**	**CNOOC Ltd.**
Date of Establishment	Nov. 1999	Feb. 2000	Oct. 1999
Production Location	onshore	onshore	offshore
Parent Company	CNPC	Sinopec Group	CNOOC Corp.
Employees as at 31/12/2000	441,000	508,168	1,007
Date of IPO	April 2000	Oct. 2000	Feb. 2001
Capital Raise at IPO[19]	US$3.4 billion	US$2.9 billion	US$1.26 billion
State Ownership	90%	80%	72.5%
Total Revenue as at 31/12/2000	RMB241,992 million	RMB328,901 million	RMB24,224 million
Net Profit as at 31/12/2000	RMB55,231 million	RMB20,797 million	RMB10,297 million
Board of Directors as at 31/12/2000	13 members including 3 independent non-executive directors	10 members including 3 independent non-executive directors	9 members including 2 independent non-executive directors
Senior Management Compensation System	▪ Basic salaries ▪ Performance bonuses ▪ Share appreciation rights	▪ Basic salaries ▪ Performance bonuses ▪ Share appreciation rights	▪ Annual salaries ▪ Discretionary bonuses ▪ Share option scheme

Source: PetroChina, Sinopect Corp. and CNOOC Ltd.'s homepages and their 2000 Annual Reports.

[19] Anonymous, "CNOOC Hits Paydirt on Debut", *The Asset*, 8 March, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 3
KEY AREAS OF CORPORATE GOVERNANCE

Shareholders' Rights

In modern corporations with diversified activities, separation of ownership and management is an inevitable outcome. Shareholders are made up of individuals and institutions whose goals, interests and capabilities vary. Moreover, professionalism is needed to make effective business decisions and cope with the fast-changing markets. Typically, the corporate management is placed in the hands of the board of directors and a management team with industry expertise. Thus, good corporate governance, which focuses on management accountability and transparency of information, is required to ensure that the board and the management team act in the best interests of ALL shareholders.

Independent Non-executive Directors

Independent non-executive directors on the board of directors provide an objective evaluation of management operations. They serve as internal regulators or controllers. They can also prevent individuals or small group of individuals from dominating the board's decision making, and bring additional assurance to shareholders that their interests are defended. Where there is a potential for conflict of interest among management and shareholders, such as executive remuneration and succession planning, independent non-executive directors will play an important role in helping the company move on to the protection of shareholders' rights. Non-executive directors are usually those who can contribute industry expertise and experience to the board. In addition, the US and UK legislation require an audit committee be composed of a majority of independent directors.

Transparency

In light of very limited participation of shareholders in business operation, shareholders should be given access to timely, relevant and accurate information regarding the corporation, including information on the financial situation and performance of the corporation. Regular financial and operational reporting and external audits by independent accounting firms will naturally enhance the protection of shareholders' rights.

Roles of board of directors - A board is to set the strategic direction and planning of a corporation, and to make decisions on major transactions.[20] An effective board should create competitive advantage and achieve adequate returns for shareholders.

Management structure - a corporation's daily operation is delegated to a management team. Responsibilities of senior managers should be clearly defined, and a set of policies and procedures should supplement existing management structure.

Committee system - Independent committees should be established to enhance internal control. Such committees should include non-executive directors.

Remuneration of directors and senior management - A well-established remuneration practice helps retain talented directors and senior managers and encourages them to work with shareholders' best interests at heart. A level of transparency should be implemented in disclosing such remuneration.

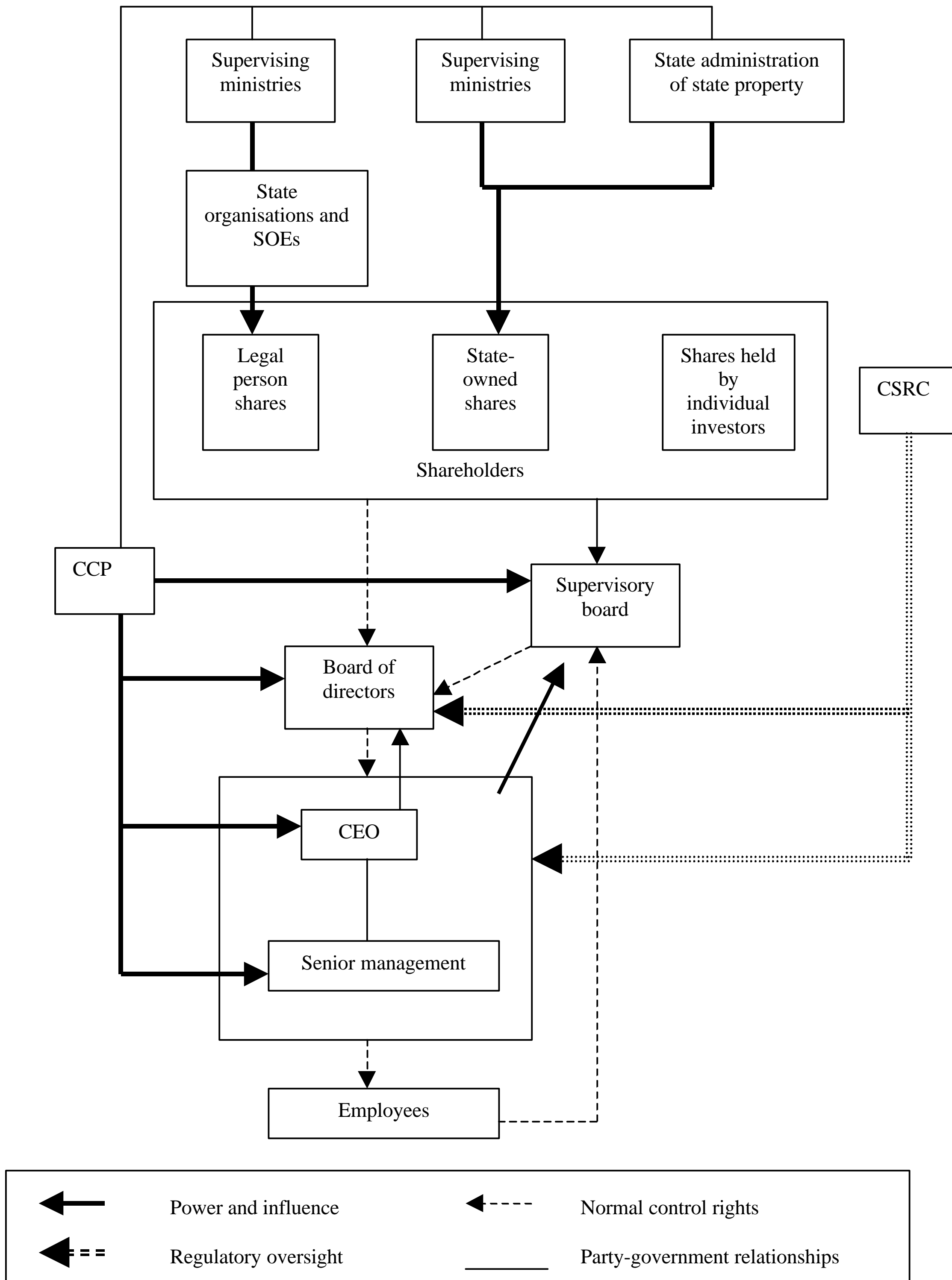
General shareholder meetings - Shareholders have the right to influence the corporation, primarily by voting at general shareholder meetings.

[20] Lyn , F. and Dou, A., "Corporate Governance", *Asia Law & Practice*, 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 4
CORPORATE GOVERNANCE STRUCTURE IN CHINA



Source: Tam, K. O., "The Development of Corporate Governance in China", Edward Elgar Publishing Limited, 1999.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 5
POWER DISTRIBUTION IN CHINA'S SHAREHOLDING SYSTEM

Roles of Shareholders' General Meeting:

1. to decide upon policies on business operation and investment plans of the company;
2. to elect and replace members of the board of directors and to decide upon matters concerning the remuneration of the directors;
3. to elect and replace the supervisors who are representatives of the shareholders and to decide upon matters concerning the remuneration of the supervisors;
4. to examine and approve reports of the board of directors;
5. to examine and approve reports of the supervisory board;
6. to examine and approve plans of the companies' fiscal financial budget and final accounts;
7. to examine and approve plans for companies' profit distribution and making up losses;
8. to make resolutions on the increase or reduction of the registered capital of the company;
9. to adopt resolutions on the issuance of company bonds;
10. to adopt resolutions on matters such as the merger, division, dissolution and liquidation of the company; and
11. to amend the articles of association of the company.

Roles of the Board of Directors:

1. to convene the shareholders general meeting and to report on its work to the shareholders general meeting;
2. to implement resolutions passed at the shareholders general meetings;
3. to decide on the business operation plans and the investment plans of the company;
4. to formulate the fiscal financial budgets and the final accounts of the company;
5. to formulate plans for the profit distribution and making up losses of the company;
6. to formulate plans for increasing or reducing the registered capital of the company and plans for the issue of company bonds;
7. to formulate plans for the merger, division and dissolution of the company;
8. to decide on the establishment of the internal management organs of the company;
9. to engage or dismiss the manager and, upon recommendation of the manager, to engage or dismiss the deputy manager(s) and responsible persons in charge of the financial affairs of the company, and to decide on matters concerning their remuneration; and
10. to formulate the basic management system of the company.

Roles of the Supervisory Board:

1. to examine the financial affairs of the company;
2. to supervise the acts of the directors and the manager violating the laws, the administrative rules and regulations or the articles of association of the company during the performance of their functions;
3. to demand directors or the manager to make corrections if any of their acts is found to have damaged the interests of the company;
4. to propose the convening of interim shareholders' general meetings; and
5. other functions and powers provided for in the articles of association of the company.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 5
POWER DISTRIBUTION IN CHINA'S SHAREHOLDING SYSTEM (CONTINUED)

Roles of Managers:

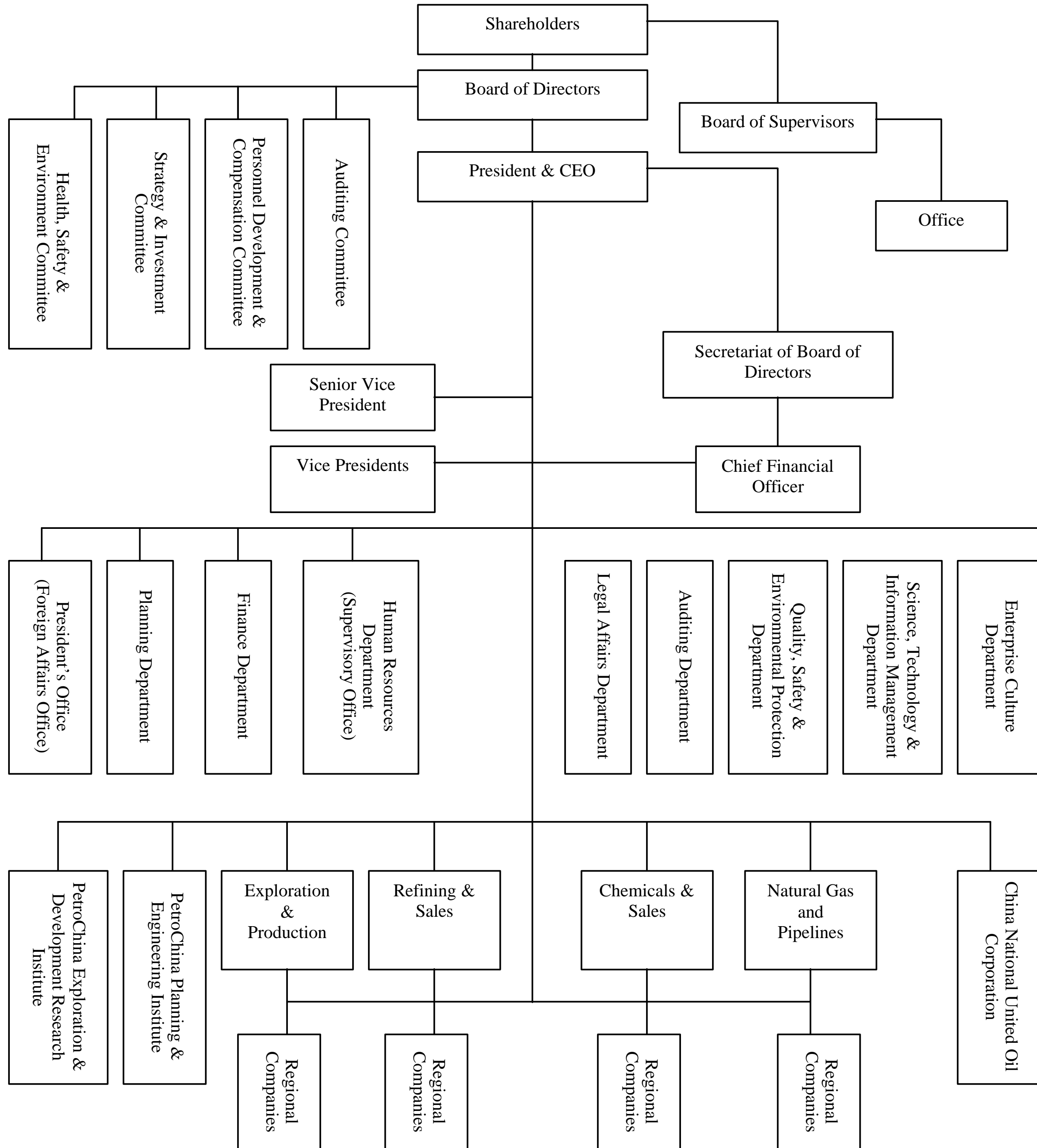
1. to be in charge of the production, operation and management of the company, and to organize the implementation of the resolutions of the board of directors;
2. to organize the implementation of the annual business plans and investment plans of the company;
3. to draw up plans on the establishment of the internal management organs of the company;
4. to draw up the basic management system of the company;
5. to formulate specific rules and regulations of the company;
6. to recommend the appointment or dismissal of the deputy manager(s) and of persons in charge of the financial affairs of the company;
7. to appoint or dismiss management personnel other than those to be appointed or dismissed by the board of directors; and
8. other functions and powers granted by the articles of association of the company and the board of directors.

Source: The Company Law of China, MOFTEC, URL: http://www.moftec.gov.cn, August 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 6
ORGANISATIONAL STRUCTURE OF PETROCHINA



Source: PetroChina, URL: http://www.petrochina.com.cn, July 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 7
SENIOR MANGAGEMENT PROFILE: PETROCHINA

Senior Management Personnel	Position with PetroChina	Position with CNPC
Director		
Ma Fucai	Chairman	President
Yan Sanzhong	Vice Chairman	Vice President
Huang Yan	Vice Chairman and President	Vice President
Wu Yaowen	Director	Vice President
Ren Chuanjun	Director and Senior Vice President	Vice President
Jiang Jinchu	Director	
Zheng Hu	Director	Vice President
Gong Huazhang	Director	General Accountant
Wang Fucheng	Director and Vice President	
Zou Haifeng	Director	
Franco Bernabe	Independent Non-executive Director	
Chee-chen Tung	Independent Non-executive Director	
Wu Jinglian	Independent Non-executive Director	
Supervisors		
Li Kecheng	Chairman of the Supervisory Committee	Other Members of Leadership
Lin Jingao	Supervisor	
Chen Eizhong	Supervisor	
Bai Xinhe	Supervisor	
Sun Chongren	Supervisor	
Liu Hongru	Independent Supervisor	
Wu Zhipan	Independent Supervisor	

Source: PetroChina, URL: http://www.petrochina.com.cn and CNPC, URL: http://www.cnpc.com.cn

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 8
PETROCHINA'S VIEW ON THE RIGHTS OF A SHAREHOLDER

The rights of a shareholder include:

- to attend in person or appoint a proxy to attend shareholders' general meetings, and to vote in respect of the number of shares held;
- to transfer his shares at a legally established stock exchange in accordance with the Company Law and the articles of association of the company;
- to inspect the company's articles of association, minutes of shareholders' general meetings and financial and accounting reports and to make proposals or enquiries in respect of the company's operations;
- if a resolution adopted by a shareholders' general meeting or the board of directors violates any law or administrative regulation or infringes the lawful rights and interests of shareholders, to institute an action in People's Court demanding that the illegal infringing action be stopped;
- to receive dividends in respect of the number of shares held;
- to receive surplus assets of the company upon its termination in proportion to his shareholding; and
- any other rights specified in the company's articles of association.

Source: PetroChina, URL: http://www.petrochina.com.cn**, September 2001.**

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.

For the exclusive use of H. JU, 2018.

EXHIBIT 9
POLICIES & PROCEDURES RELATED TO SHAREHOLDERS' MEETINGS OF PETROCHINA

1. Shareholders' general meetings can be annual general meetings or extraordinary general meetings. Shareholders' meetings shall be convened by the Board.

2. The Board shall convene an extraordinary general meeting within two months of the occurrence of any one of the following circumstances:

   - where the number of Directors is less than the number stipulated in the Company Law or two-thirds of the number specified in the Articles of Association;

   - where the unrecovered losses of the Company amount to one-third of the total amount of its share capital;

   - where shareholder(s) holding 10 per cent. or more of the Company's issued and outstanding shares carrying voting rights request(s) in writing for the convening of an extraordinary general meeting;

   - whenever the Board deems necessary or the supervisory committee so requests.

3. The following matters shall be resolved by way of ordinary resolution of the shareholders' general meeting:

   - work reports of the Board and the supervisory committee;

   - profit distribution plans and loss recovery plans formulated by the Board of Directors;

   - removal of the members of the Board and members of the supervisory committee, their remuneration and manner of payment;

   - annual preliminary and final budgets, balance sheets and profit and loss accounts and other financial statements of the Company;

   - matters other than those which are required by the laws and administrative regulations or by the Articles of Association to be adopted by special resolution.

4. The following matters shall be resolved by way of special resolution of the shareholders' general meeting:

   - increase or reduction in share capital and the issuance of shares of any class, warrants and other similar securities;

   - issuance of debentures by the Company;

   - division, merger, dissolution and liquidation of the Company;

   - amendment of the Articles of Association; and

   - any other matters considered by the shareholders in general meeting, resolved by way of an ordinary resolution, to be of a nature which may have a material impact on the Company and should be adopted by a special resolution.

Source: PetroChina, URL: http://www.petrochina.com.cn, September 2001.

This document is authorized for use only by HU JU in International Corporate Governance Fall 2018 taught by John Byrd, University of Colorado - Denver from Aug 2018 to Feb 2019.