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THE UNIVERSITY OF SYDNEY
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Demystifying Chinese Investment in Australia

The Energy Imperative:

Australia-China Opportunities

Preliminary Brief 25 September 2012

What does the future hold for Chinese energy and energy infrastructure investors in Australia? Will there be strong and diversified investment into these sectors for the long haul? Or will Chinese interest be drawn to other increasingly competitive and attractive global market opportunities as a result of our failure to address present, wide-ranging concerns in Australia?

China's largest energy companies have rapidly increased their stakes in Australia's energy sectors in recent years, motivated by the same factors that have underpinned their acquisitions in the resources sector: Australia's abundant and high quality energy resources, geographic proximity, relative political stability, experienced workforce and mature institutions.

Yet Chinese investment in Australia's energy infrastructure sector is not as deeply embedded as could be expected considering the strong trade ties between the two countries and the overall volume of Chinese off take.

Undoubtedly, there is ample scope for greater Chinese investment and participation in Australia's energy supply chain, given the complementary long-term energy requirements and objectives of both countries.

Australia is seeking investment partners in large and long-term energy infrastructure projects. China is seeking deeper integration in Australia's energy and resources sector to secure long-term access to resources, technologies and markets.

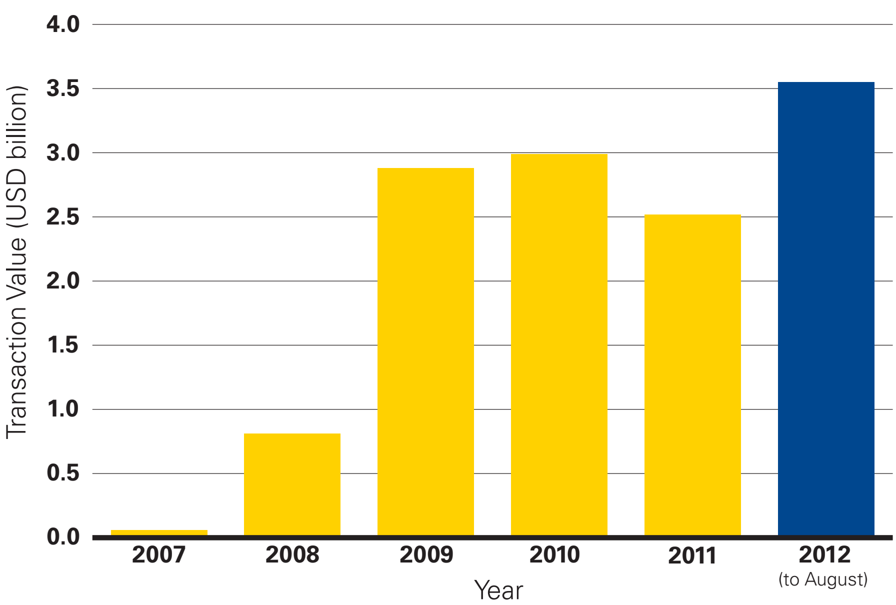
While there are challenges, there are also considerable opportunities to be seized.

Chinese company, Goldwind International Holdings (HK) Ltd, is the world's second largest manufacturer of wind turbines. Picture shows the first wind farm of its Australian subsidiary, Goldwind Australia Pty Ltd, at Morton Lane in Victoria.

China's investment in Australia's energy sector: the facts

In the past 6 years[1], Chinese companies completed 24 deals in Australia's energy sector[2] with a total value of USD12.8 billion. The transactions were completed by 14 Chinese corporations/groups. Of these, 6 deals were worth more than USD1 billion in value each and together, represented 81 percent of the total transaction value for the 6 years. The large size of the small number of deals is a characteristic of China's energy and resources investments, although more pronounced in Australia.

Chinese investment in Australian energy industries by year[1]



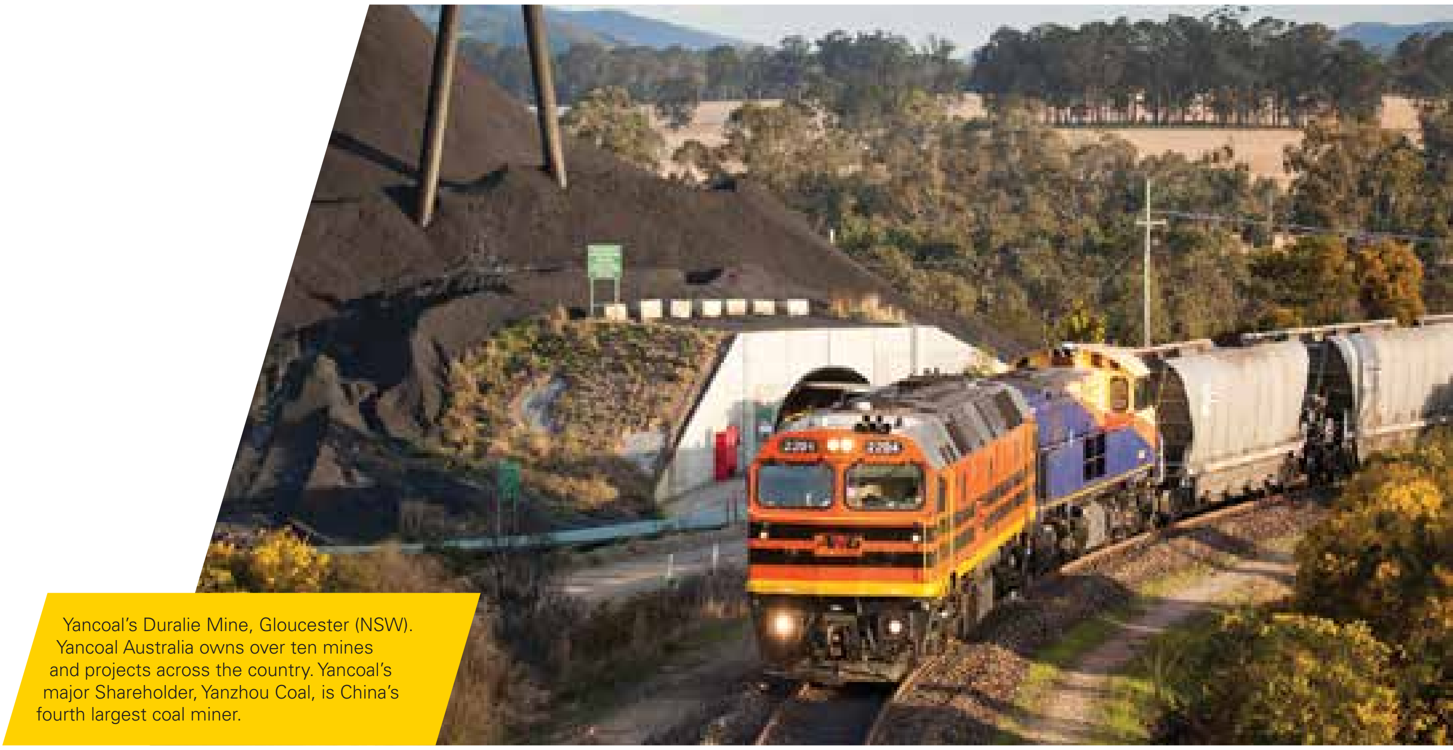
Individual examples include Yancoal's USD2.8 billion acquisition of Felix Resources Ltd in 2009, Sinopec's USD1.5 billion investment in Australia Pacific LNG in 2011 and CNOOC's investment in and major off take agreements in Queensland coal seam gas and shale gas projects.

During the period of our analysis, Chinese investment in Australian energy industries increased steadily. After 2 years of relatively low activity below USD1 billion, investment jumped significantly in 2009 and stayed at a high level of close to USD3 billion in 2010 and 2011. The volume of investment so far in 2012 shows an extension of this rising trend, with a notable increase to USD3.5 billion.

Chinese energy interests in Australia are dominated by investments in the coal and gas industries. Coal projects have attracted the largest amount of investment, just below 50 percent of total energy investments over the period of our analysis. Investment in gas comes a close second, at 43 percent.

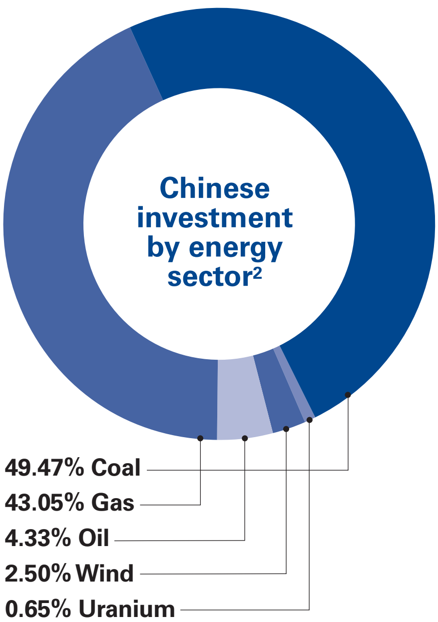
1 KPMG-University of Sydney database, from September 2006 to August 2012.

2 KPMG-University of Sydney data analysis: energy industries covered include thermal coal, mixed thermal coal and coking coal (but not pure coking coal ventures), liquified natural gas (LNG), oil, wind, and uranium.



Yancoal's Duralie Mine, Gloucester (NSW). Yancoal Australia owns over ten mines and projects across the country. Yancoal's major Shareholder, Yanzhou Coal, is China's fourth largest coal miner.

Notably, our data shows that there is Chinese direct investment in three other energy sectors: oil, wind and uranium. The volume in each of these sectors is very small in comparison with coal and gas. There was only one investment in oil which was discontinued by the two partners, Sinopec and AED Oil Limited. Investment in wind energy currently contributes 2.5 percent and is expanding. Investment in uranium accounts for 0.65 percent, however we believe there is significant interest as this sector opens up, given China's enormous nuclear energy project pipeline and ambitions.



Chinese State-Owned Enterprises (SOEs) are, overwhelmingly, the dominant investors, accounting for 99 percent of China's investment in Australia's energy sector. The largest of these is Yancoal – a Shandong-based, provincially owned SOE, which dominates Chinese investment in Australia's coal sector.

In the gas sector, the major players are Sinopec, PetroChina, and CNOOC, with 24 percent, 13 percent, and 10 percent of total volume respectively. Together, these four companies account for 94 percent of Chinese investment in Australian energy.

Entry strategies

SOEs have generally utilised two strategies that are specific to their investments in Australia – technology deploying, and technology seeking. These strategies are utilised for specific investments. Both strategies are linked to off take and securing China long-term access to resources.

The technology deploying strategy is best illustrated by Chinese investment in the coal sector. Using Yancoal's activities as an example: the company entered the Australian market with technology that had been tested in China but was unavailable when it purchased Southland Mine (Austar). The deployment of this technology required substantial capital input. Yancoal therefore provided both technology and capital, and worked with local Australian management and staff to jointly run operations.

The technology seeking strategy is exemplified by investments into the gas sector, where Chinese were eager to learn through investment participation from their international and Australian partners. China's substantial investment in Queensland's coal seam gas sector is a typical example involving the whole value chain of upstream exploration to downstream development.

Together with local and international joint venture partners, Chinese investors participate in gas exploration, gas well services, pipeline building, and gas transmission – all the way to downstream gas-fired power generation and gas liquefaction to export LNG to the international market. These partnerships open commercial and technological avenues for the transfer of a wide range of technologies to Chinese partners and provide international partners with entry points into the Chinese domestic market.

Both the technology deploying and the technology seeking strategies create spillovers to other Australian industries such as finance, professional services and infrastructure. For instance, financing requirements for LNG projects involve large funding commitments by Chinese banks and syndicated loans with Australian and international partners.

Australia's energy landscape – the long view[3]

Australia's demand for energy over the next decade and beyond is set to grow formidably. According to the latest official projections[4] Australia's total energy production (excluding uranium) is expected to more than double to the equivalent of over 28,000 petajoules by 2035. Over the same period electricity-generating capacity in Australia is expected to grow by about 1.4 percent a year to 348 terawatt hours in 2035.

The funding challenge is significant and projections suggest a shortfall is likely.

The 2011 report of the Federal Government's Investment Reference Group[5] (IRG) suggested the total investment required in new electricity generating plant (and associated transmission, distribution and gas pipeline infrastructure) between now and 2030 could amount to AUD240 billion in today's dollars. This figure equates to an average annual investment of just under AUD13 billion. Australian Treasury has estimated that more than AUD200 billion will need to be spent on new generating capacity alone by 2050.

Electricity projects in Australia currently under construction, or firmly committed, have a total capacity of 2,688 megawatts (i.e. around 5 percent of present national generating capacity) involving an estimated capital cost of AUD4.84 billion[6].

In late 2011 the Bureau of Resources and Energy Economics (BREE) reported there were over 100 major 'advanced' resource and mining projects already in the development pipeline in Australia with an estimated capital cost of more than AUD231 billion[7]. BREE lists a further proposed 167 generation projects classified as 'less advanced' with a potential capacity of 47,187 megawatts. It further lists 302 less advanced projects with a potential capital spend of more than AUD224 billion.

Infrastructure Partnerships Australia and the Business Council of Australia estimate that we currently face an infrastructure deficit requiring a AUD450 billion to AUD700 billion investment in today's dollars.

All of these projects contribute to the growing challenge of meeting funding requirements in order to satisfy growth in demand domestically and from trading partners such as China and other countries. Foreign capital is necessary to assist in funding the required massive investment in energy and related infrastructure – a reality that has been a long-established and vital element of Australia's economic expansion and prosperity over previous decades.

If Australia is to extract maximum benefit from its energy resources over coming decades, direct investment in these resources by growth nations such as China is critical. Strategic partnerships that involve both investment and participation in Australia's energy supply chain could help satisfy the overall financing need and ease supply bottlenecks for exports.

3 Extracts from: KPMG - *Australia's Energy Challenge,* 2012.

4 Bureau of Resources and Energy Economics. *Australian Energy Projections to 2034-35.* December 2011.

5 The Investment Reference Group was established to advise the Minister for Resources and Energy on the extent to which policy uncertainty arising from proposals for carbon pricing were affecting energy-related investments in Australia. The Group's report contains a useful discussion of the energy investment environment in Australia. Much of this discussion appears to have escaped the draft Energy White Paper.

6 Bureau of Resources and Energy Economics. *Major Electricity Generation Projects.* November 2011.

7 Bureau of Resources and Energy Economics. *Mining Industry Major Projects.* October 2011.

> **"To successfully meet Australia's long-term energy security challenges, we need innovative finance solutions, an efficient market, effective policy and reporting tools that support the attraction of capital."**

Michael Bray,
National Chairman, Energy & Natural Resources, KPMG

The way forward

We find compelling evidence that Chinese investors are attracted to the engineering and scientific aspects of energy projects, including in relatively new sectors of interest such as clean coal technology and uranium, which represent significant opportunities for an era of beneficial new strategic partnerships.

Chinese interests include technology exchange and transfer, involvement in building and operating energy-related infrastructure assets where Chinese companies can add value (downstream opportunities like refineries and petrol stations are attractive), the secure and stable off take of high quality resources, and the scope for improved profitability through the use of Chinese technologies and materials.

We also find that Chinese companies are interested in providing finance in both new and established forms, as part of their broader investment objectives.

Chinese investors want equity stakes and major operating roles in new infrastructure projects – i.e. active participation, rather than being passive investors. Chinese banks are increasingly active in international syndication, but it must be noted that they traditionally have not been solely a financial investor in their investments and ventures abroad.

Overall, Chinese investment in Australia's energy infrastructure is limited and not fully commensurate with China's share in off take from coal mines and gas fields.

Australia should recognise that a trade relationship that is not underpinned by an appropriate investment relationship is unnecessarily vulnerable, particularly in times of market downturn.

On the flip side, securing long-term massive energy infrastructure project investment in new assets will help underwrite Australia's prosperity and employment opportunities.

China's worldwide track record in infrastructure construction for road and rail, ports, pipelines and power grids should be recognised and utilised in Australian projects.

Based on our intelligence, and as evidenced by visiting Chinese companies and attendance at recent New South Wales and Victorian Premier delegations to China for infrastructure presentations, we firmly believe Chinese companies remain very interested in making long-term energy and infrastructure investments in Australia.

As noted in our most recent report[8], Chinese investors are constantly learning and adapting to the investment landscape in Australia. They recognise the importance of forming partnerships with strong Australian companies, clearly communicating their strategic intentions and addressing concerns openly.

It is also critical that Australia creates a welcoming environment for Chinese investment in this country. Australia must also address other well documented concerns including relatively high operating costs, declining productivity, inconsistent and voluminous regulatory processes and changing tax environments.

8 KPMG Australia and The University of Sydney China Studies Centre: *Demystifying Chinese Investment,* August 2012.

KPMG and the University of Sydney China Studies Centre have formed a strategic relationship to publish research and insights on doing business with China. The first product of the relationship was *Australia & China: Future Partnerships 2011* published in September 2011, followed by *The Growing Tide: China's outbound direct investment in Australia* in November 2011. In August 2012 we published *Demystifying Chinese Investment: China's outbound direct investment in Australia.*

Our full report - *The Energy Imperative: Australia-China Opportunities* – will be published in October. To receive your copy, please register with yvonnelu@kpmg.com.au

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KPMG's China Practice

KPMG's Global China Practice is a network of 50 countries providing high quality, consistent services to China inbound and outbound investors globally. This represents a long-term commitment and sustainable advantage to KPMG and our clients.

In Australia, KPMG's dedicated China Practice acts as a priority gateway advising on inbound and outbound investment transactions between Australia and China. We assist our clients to develop truly regional strategies to help mitigate risk, improve performance, create value and most importantly capitalise and realise the business and investment opportunities arising from China's growth.

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KPMG's ENR Practice

KPMG provides services, methodologies and original thinking to address the challenges and key issues that matter to Energy and Natural Resources (ENR) companies. Our audit, tax and advisory methodologies form the foundation of our approach. We consider industry challenges from multiple angles, pooling our knowledge and specialist industry expertise to develop holistic services that meet our clients' challenges and requirements.

KPMG in Australia has a strong footprint in the ENR sector, providing a broad array of services to global and Australian ENR majors (with operations within our borders and overseas), mid-cap resources organisations, services companies and government bodies that oversee/regulate the industry.

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University of Sydney China Studies Centre

The China Studies Centre was established by the University of Sydney in 2011 as a major initiative of the University's 2011-2015 Strategic Plan. The China Studies Centre represents a commitment by the University to cross-disciplinary research and public education including cooperation with external partners. The Centre's open research architecture facilitates interaction between Australian researchers working on China, Chinese academics and external partners with specific expertise.

The Centre's China Business Development team works on projects concerned with new and changing markets emerging from China's deepening marketisation and privatisation of public services and state monopolies. These projects anticipate new trends and create new knowledge for Australia China cooperation.

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