

**RECURRING DREAM OR INCESSANT NIGHTMARE?
FOREIGN DIRECT INVESTMENT IN CHINA'S POWER INDUSTRY**

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ABSTRACT

Many foreign investors in China's power generation industry, having tasted a "boom" in the early to mid 1990s, are now experiencing a "bust". Their earnings in power projects have been gravely affected by the default, tariff reductions and renegotiations of contractual schemes relating to power sales to the Chinese offtakers. Based on statistics and interviews with more than 55 power developers, investment bankers, lawyers and other personnel with extensive experience in the industry, we focus on 2 prominent power projects – Fujian Meizhou Wan and Shandong Zhonghua as examples of a failed project and successful project respectively. We ask three basic questions. Why are many such contractual schemes for power sales unstable? What went wrong with the initial investment strategies of many investors? What lies ahead?

For Question 1, we identify 4 major factors that affected the stability of these contractual schemes – (1) the tariff differential between foreign-invested plants and local plants; (2) the value that foreign-invested plants offered to justify their higher tariffs; (3) the availability of legal recourse in the event of default; and (4) the presence of "soft factors" enmeshing mutual obligations and interests. We explain that the agreed generation tariffs of many foreign-invested plants are much higher than those of local plants. This tariff differential is a major factor contributing to pressure by the Chinese offtaker to reduce tariffs, with or without contractual default. Whether this pressure can be accommodated, mitigated or otherwise rendered negligible depends on the next 2 factors. As we will analyze in the paper, the dynamics in this quartet of factors have changed in such ways over the last decade to the disfavor of many foreign investors. Some foreign investors, however, continue to thrive in the industry due to company-specific and/or province-specific factors.

For Question 2, we investigate the key assumptions made by foreign investors, by simulating an industry analysis using Michael Porter's 5-Forces Model. We find that there are 3 major factors affecting the initial investment strategies of many foreign investors. As a starting point, contractual schemes lie at the heart of the matter because: foreign investors have tried to use them to mitigate risks, unverifiable assumptions in their pre-investment analysis and information barriers. This was underlined by a misjudgment of the state and significance of the Rule of Law in China. However, this Rule of Law thesis cannot answer question 2 alone. We identify 2 other factors in the equation – the Limits of Human Nature (explaining why the mindset of many foreign investors was biased towards investing) and the Limits of Human Foresight (explaining how events, beyond business fluctuations in the scope of ordinary assessments, could have materially affected the outcome of the investments).

Finally, for Question 3, we observe current projections of robust future power demand – a sign that the next "boom" may be near despite the horrors of the recent "bust". In light of this *déjà vu*, we explore the possible role of foreign investors at the start of this new investment cycle, and we conclude that, in future, the main way in which foreign investors can participate in China's power industry in future will be through the capital markets. Therefore, these foreign investors, perhaps interested in another round of direct investment in power projects, should seriously ask themselves whether they truly stand at the turn of the tide.

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