Potential city-gate tariff cut of incremental gas likely insufficient, but more frequent adjustments proposed

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What is new?
- According to Bloomberg, China may cut the non-residential city-gate natural-gas tariff for incremental gas by c.CNY0.15/m3, from CNY2.88/m3 to CNY2.73/m3. Given that the NDRC also plans to unify the base-volume city-gate tariff, whose tariff (at CNY2.42/m3 on national average) is lower than the incremental tariff (CNY2.88/m3), we could see the ultimate average city-gate tariff for non-residential gas being hiked by 10% from CNY2.49/m3 (blended base-volume and incremental-volume now) to CNY2.73/m3, instead of the original planned CNY2.88/m3 in 2015, according to Mr. Jun.
- According to Mr. Jun, the NDRC might increase the frequency to adjust the city-gate tariff, from usual practice of yearly during the summer time (June-September) to a monthly basis, through a linkage mechanism to spot market and domestic demand/supply.

What’s the detail?
- Mr. Jun commented that the incremental natural gas cost could be cut by c.CNY0.15/m3, from CNY2.88/m3 to CNY2.73/m3. Given that the NDRC also plans to unify the base-volume city-gate tariff, whose tariff (at CNY2.42/m3 on national average) is lower than the incremental tariff (CNY2.88/m3), we could see the ultimate average city-gate tariff for non-residential gas being hiked by 10% from CNY2.49/m3 (blended base-volume and incremental-volume now) to CNY2.73/m3, instead of the original planned CNY2.88/m3 in 2015, according to Mr. Jun.

• According to Mr. Jun, the NDRC might increase the frequency to adjust the city-gate tariff, from usual practice of yearly during the summer time (June-September) to a monthly basis, through a linkage mechanism to spot market and domestic demand/supply.

Our comments
• Background of gas-price reform. Since July 2013, China has implemented gas-price reform by linking the non-residential city-gate tariff to competing fuels (60% heating oil, 40% LPG) with a 15% discount, and targets to complete the reform by 2015 with base-volume tariffs (old volume in 2012) increasing gradually while incremental tariff, new volume since 2013) to see a one-time increase to CNY2.88/m3 at the national average. So far, China has increased its city-gate tariff twice (July-2013 and September-2014), with base-volume gas tariffs gradually aligning with more expensive incremental gas tariffs. Based on our calculation, natural gas is still at a 31% discount for vehicle usage and a 17% discount to industrial usage, respectively, before the recent oil price slump.
• Gas is less competitive under the recent oil price slump. However, the oil price slump since September 2014, which saw the WTI spot price drop from USD100/barrel to below USD50/barrel, has led to a significant 25-30% drop in prices of refinery oil products (heating oil, LPG, gasoline and diesel), minimizing the price competitiveness of natural gas to competing fuels, with only an 11% discount to vehicle fuel but a 14% premium to industrial fuels, potentially slowing down gas sales volume growth of gas distributors with potential unit dollar margin squeezes.
• City-gate tariff should see a cut to c.CNY2/m3, rather than the proposed c.CNY2.7/m3. In order to maintain the competitiveness of natural gas to the level before the oil price slump (10% discount to industrial fuel and 25% discount to vehicle fuel by end-2015), we estimate the unified city-gate tariff would have to be reduced to CNY2.02/m3. Therefore, the suggested CNY2.73/m3 unified city-gate tariff is not sufficient to maintain the natural gas price competitiveness, as advised by NDRC with 15% discount to competing fuels heating oil and LPG.
• More frequent city-gate tariff adjustment is a positive. However, we are delighted that China might potentially increase the frequency of tariff adjustments to avoid the potential arbitrage between the oil market and natural market at the end-user level.

Important disclosures, including any required research certifications, are provided on the last three pages of this report.
Stock recommendations. Due to the uncertainty of the city-gate tariff in 2015, we are becoming more cautious on the city-gas sector, and believe ENN Energy (2688 HK, HKD48.45, Outperform [2]) and China Suntien Green Energy (956 HK, HKD1.92, Hold [3]) could be more susceptible to negative earnings impacts on slumping oil prices for 1H15. We also note that CR Gas’s (1193 HK, HKD20.45, Hold [3]) gas sales-volume growth could be further slowed down on an insufficient city-gate tariff cut. Beijing Enterprises Holdings (392 HK, HKD61.45, Outperform [2]), which has over 70% of natural-gas consumption for heating and power generation with negligible industrial gas consumption, is likely immune from the substitution effect of natural gas under the current low-oil price market.

We also like Towngas China (1083 HK, HKD7.67, Buy [1]) given its gas-sales growth is focused on profitable provinces such as Shandong and Liaoning, instead of Sichuan which is a legacy province for Towngas China and has only a CNY0.15/m³ unit dollar margin.

China Gas (384 HK, HKD12.60, Outperform [2]) is in the process of increasing its gas-sales contribution from residential households, especially from heating demand in northern provinces, to maintain its 25% distribution-gas sales-volume growth target without margin squeeze. Residential gas is not impacted under the gas-price reform.

Oil and Gas: the price history since 2011

Discount of natural gas to competing fuels for industrial and vehicular usages since July 2013

Source: Bloomberg, NDRC

Source: NDRC, Daiwa research
## China: provincial city-gate hike details for non-residential gas, and exposure of city-gas operators (2014)

<table>
<thead>
<tr>
<th>Province</th>
<th>Base volume tariff (CNY per m³)</th>
<th>Tariff discount to Guangdong (%)</th>
<th>Incremental volume tariff (CNY per cm)</th>
<th>Premium for incremental volume (%)</th>
<th>Major gas operators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guangdong</td>
<td>2.82</td>
<td>6%</td>
<td>3.15</td>
<td>5%</td>
<td>ENN, HKCG</td>
</tr>
<tr>
<td>Guangxi</td>
<td>2.69</td>
<td>6%</td>
<td>3.15</td>
<td>5%</td>
<td>CRG, CGHL</td>
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<tr>
<td>Shanghai</td>
<td>2.84</td>
<td>1%</td>
<td>3.32</td>
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<td>1%</td>
<td>3.31</td>
<td>0%</td>
<td>ENN, HKCG</td>
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<td>3.30</td>
<td>1%</td>
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<td>Anhui</td>
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<td>3.23</td>
<td>3%</td>
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<tr>
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<td>7%</td>
<td>3.15</td>
<td>5%</td>
<td>ENN, CRG, CGHL</td>
</tr>
<tr>
<td>Beijing</td>
<td>2.66</td>
<td>8%</td>
<td>3.14</td>
<td>6%</td>
<td>BEIH</td>
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<tr>
<td>Tianjin</td>
<td>2.66</td>
<td>8%</td>
<td>3.12</td>
<td>6%</td>
<td>CR Gas</td>
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<td>Hebei</td>
<td>2.64</td>
<td>8%</td>
<td>3.12</td>
<td>6%</td>
<td>ENN, CSQ</td>
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<tr>
<td>Liaoning</td>
<td>2.64</td>
<td>8%</td>
<td>3.12</td>
<td>6%</td>
<td>TCCL</td>
</tr>
<tr>
<td>Shandong</td>
<td>2.64</td>
<td>8%</td>
<td>3.12</td>
<td>6%</td>
<td>ENN, TCCL, CGHL</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>2.62</td>
<td>9%</td>
<td>3.10</td>
<td>7%</td>
<td>TCCL</td>
</tr>
<tr>
<td>Hubei</td>
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<td>3.10</td>
<td>7%</td>
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<tr>
<td>Hunan</td>
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<td>7%</td>
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<td>Shanxi</td>
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<tr>
<td>Heilongjiang</td>
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<td>18%</td>
<td>2.90</td>
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</tr>
<tr>
<td>Shaanxi</td>
<td>2.35</td>
<td>23%</td>
<td>2.79</td>
<td>19%</td>
<td>TCCL</td>
</tr>
<tr>
<td>Guizhou</td>
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<tr>
<td>Yunnan</td>
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<td>16%</td>
<td>Kunlun, COG</td>
</tr>
<tr>
<td>Hainan</td>
<td>2.32</td>
<td>23%</td>
<td>2.78</td>
<td>19%</td>
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<tr>
<td>Chongqing</td>
<td>2.32</td>
<td>23%</td>
<td>2.78</td>
<td>19%</td>
<td>CRG, CGHL</td>
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<td>Ningxia</td>
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<td>Inner Mongolia</td>
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<td>2.48</td>
<td>34%</td>
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<td>Qinghai</td>
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<td>48%</td>
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<td>Xinjiang</td>
<td>1.81</td>
<td>58%</td>
<td>2.29</td>
<td>45%</td>
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</tr>
</tbody>
</table>

### National average

<table>
<thead>
<tr>
<th>Hike</th>
<th>Weight average (as of 2011) (CNY/m³)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.42</td>
</tr>
<tr>
<td></td>
<td>2.68</td>
</tr>
</tbody>
</table>

### Notes

- **Base volume tariff and Incremental volume tariff**: These terms refer to the base and incremental costs associated with gas distribution, with tariffs expressed in CNY per m³.
- **Premium for incremental volume**: This represents the additional cost per unit increase in volume, calculated as a percentage of the base volume tariff.
- **Tariff discount to Guangdong**: This indicates the discount applied to the tariff in Guangdong Province, expressed as a percentage.

**Source:** NDRC, Daiwa

**Note:** Cells highlighted in yellow show the narrowing of the tariff discount to Guangdong; cells in light blue show the provinces with higher-than-national-average city-gate tariff hike percentage over 2014-15

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In the interests of timeliness, this document has not been edited.
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