SECTOR RESEARCH | China/HK

Maybank Kim Eng

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China Oil & Gas

NEUTRAL (Unchanged)

Privatization will be a game changer

- Media reports NDRC considering combining and privatizing PetroChina and Sinopec's oil and gas pipeline assets.
- This is an integral part of the natural gas liberalization, which we highlighted in our initiation thesis last June. However, devils in the details, as both companies are public entities; transaction could require minority's approval.
- Still prefer CNOOC over Sinopec and PetroChina, as deal is still uncertain; however privatization suggests potential disposal gain for Sinopec and PetroChina.

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What's New

Sources close to the National Development and Reform Commission disclosed that the commission is studying the possible privatization of PetroChina and Sinopec's oil and natural gas transmission pipeline assets.

What's Our View

The 50,000 km of natural gas trunk pipelines in the country is almost entirely owned and operated by the two state giants, namely PetroChina and Sinopec. From our previous interaction with other unconventional gas companies, we learned that one of the key challenges for private enterprises is to gain access to the transportation pipelines, and furthermore determine an off-take pricing that is sufficient to generate an economical return. As a result, we can see that natural gas supply is still dominated by the state; the Big Three (PetroChina, Sinopec and CNOOC) accounted for almost the entire domestic supply in 2014.

The privatization of the natural gas pipelines is a vital step towards liberalization of the gas market, in our view, as it provides equal and fair access to the transmission infrastructure for private enterprises, which has been a key bottleneck for the development of China's natural gas industry.

*** Please refer to our sector report, "Energy Revolution; Unstoppable Force", dated 16th June 2014*

Stock	Mkt cap	Rating	Price	TP	Upside	P/E (x)		P/B (x)		Dividend yld (%)	
	(USD'm)		(LC)	(LC)	(%)	15E	16E	15E	16E	15E	16E
PetroChina	221,262.6	Sell	9.37	8.30	(11)	27.1	17.0	1.1	1.1	1.7	2.7
Sinopec	107,784.8	Hold	6.90	7.70	12	19.1	13.5	1.1	1.1	2.6	3.7
CNOOC	71,891.7	Buy	12.48	16.80	35	18.1	11.2	1.1	1.1	2.0	3.2
NewOcean	761.7	Buy	3.98	7.70	93	5.6	4.5	1.0	0.8	1.8	2.2

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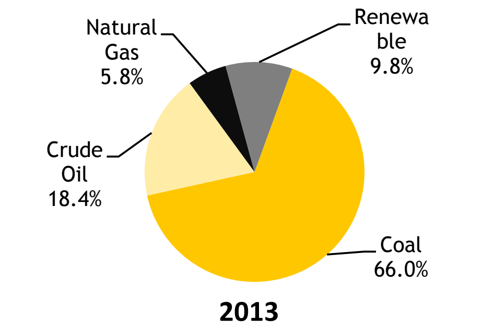
Natural gas reform – chicken and egg…

- Supply has been the key constraint to the popularization of natural gas in China, not demand.
- A monopoly in midstream infrastructure has been the key choke point for supply growth.
- Privatization of the West-to-East pipeline (Eastern section) is a major breakthrough and we believe liberalization of natural gas pricing is on the way.

Three factors are causing China's dependence on coal and refined products: 1) lack of an economical alternative; 2) limited access to pipeline infrastructure; and 3) lack of punitive action against energy wastage and pollution.

Energy mix – fossil fuels still account for over 84% of China's energy consumption. Over the past decade, the Chinese government set targets to reduce the country's high dependence on these highly pollutive energy sources, but these goals were not achieved. In our opinion, there are three key reasons why such initiatives failed. First is the lack of an economical alternative, second is limited access to pipeline infrastructure, and finally the lack of punitive action against energy wastage and pollution.

Figure 1: China's energy sources



Source: Maybank Kim Eng

In 2013, coal and refined products accounted for 66% and 18% of China's total energy sources. This is definitely an improvement compared to over 90% dependence in 2000. However after a decade of promotion natural gas accounts for only 5.7%, still far from the government's target of 7.5% We believe two key factors deterring the successful implementation of the government target are the competitiveness and the availability of alternative sources such as natural gas, wind and solar.

Demand has always been there…

Based on levelized cost of energy (LCOE) analysis, per kilowatt costs of natural gas and onshore wind are indeed lower than conventional coal. Different from other studies, the LCOE analysis factored in not only investment cost and fuel expenditure, but also included the operating and maintenance expenses, asset life, as well as utilization hours. In a free economy, if a product is offering a superior return, demand will surge and the government target should be achieved.

Unfortunately, China is not a free market, particular not in the energy sector; the missing links are market pricing and access to the pipeline infrastructure.

Figure 2: Levelized Cost of Energy (LCOE) Analysis

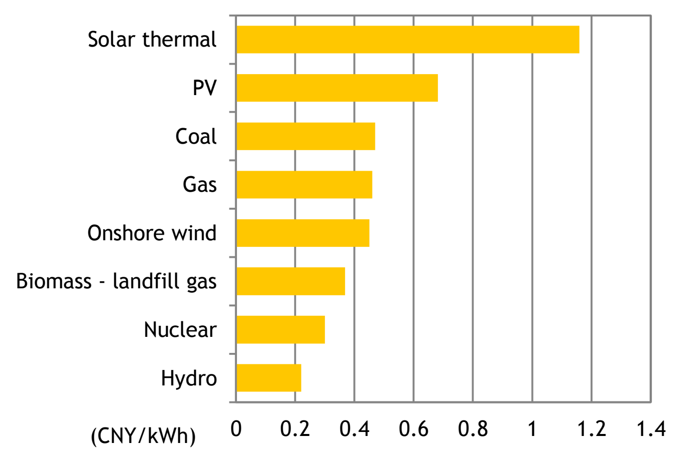
$$\mathrm{LEC} = \frac{\sum_{t=1}^{n} \frac{I_t + M_t + F_t}{(1+r)^t}}{\sum_{t=1}^{n} \frac{E_t}{(1+r)^t}}$$

where

- LEC = Average lifetime levelized electricity generation cost
- I_t = Investment expenditures in the year *t*
- M_t = Operations and maintenance expenditures in the year *t*
- F_t = Fuel expenditures in the year *t*
- E_t = Electricity generation in the year *t*
- r = Discount rate
- n = Life of the system

Source: Wikipedia, Maybank Kim Eng

Figure 3: LCOE analysis on various energy sources



Source: Wikipedia, Maybank Kim Eng

China's natural gas supply comes from three mains sources: domestic production, and importation via pipelines and via LNG. Due to the vast distance of transportation, the importation cost of natural gas is very high and can account for as much as half of the total procurement cost. In 2013, we estimate the average importation cost was around CNY3.5CM (USD14/mmbtu), which includes an average of CNY0.5/CM of transportation cost, while the domestic average C&I selling price was still south of CNY2.75/CM last year.

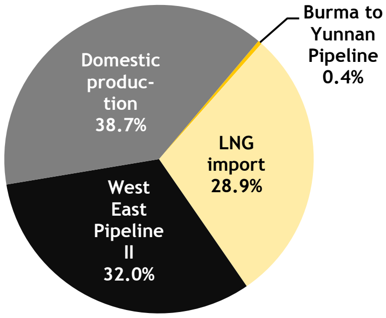
The market has been undersupplied…

The lack of return does not provide the economic incentive for investment in conventional and unconventional natural gas production from the State-owned enterprises. More importantly, sub-par return deters investment from private enterprises, which in our view is a critical factor for the development of natural gas in China.

Besides unappetizing returns, another hurdle for private-sector investment / involvement in the natural gas industry is limited access to infrastructure. The 50,000 km of natural gas trunk pipelines in the country is almost entirely owned and operated by the two state giants, namely PetroChina and Sinopec. From our previous interaction with other unconventional gas companies, we learned that one of the key challenges for private enterprises is to gain access to the transportation pipelines, and furthermore determine an off-take pricing that is sufficient to generate an economical return. As a result, we can see that natural gas supply is still dominated by the state; the Big Three (PetroChina, Sinopec and CNOOC) accounted for almost all supply in 2012.

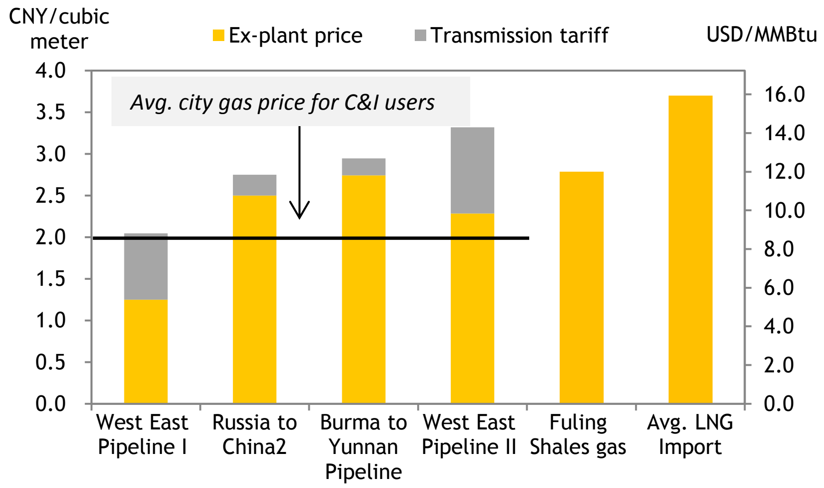
And in our humble opinion, this deadlock can only be solved with the liberalization of natural gas pricing, and public access to natural gas pipelines. The recent announcement of PetroChina's Eastern gas pipeline stake disposal can be the beginning of this long-awaited privatizing process, which represents a small yet critical step for the country's energy reform.

Figure 4: China's natural gas supply sources



Source: Maybank Kim Eng, Platts, National Bureau of Statistics

Figure 5: All-in cost of natural gas supplies, including transmission tariffs



Source: Maybank Kim Eng

Current C&I average ASP is still far below the cost of imported gas. Therefore, we believe two things will happen: first the average city gate price will continue to increase; and secondly more domestic production will become apparent to capture this market.

Privatization of W2E pipeline might release the choke point

The selldown of the Eastern natural gas pipeline is a milestone towards the liberalization of the natural gas market in China, in our view. According to management, PetroChina is open to disposing all of its holding in the pipeline, allowing passive financial investors to take full ownership of these assets while PetroChina maintains its operatorship.

We believe this is the preliminary step towards a full liberalization, where equity will eventually be issued via a public offering. This public vehicle will not only serve as a window to the capital market, taking care of the financial requirements for future capital expenditure. More importantly, it will provide a transparent midstream platform for all upstream gas suppliers, not only the incumbent SOEs, but the new independents who are deprived from access to the pipeline infrastructure in the country.

Privatization of the Eastern pipeline is a preliminary step towards full liberalization, in our view, eventually providing a platform for all upstream gas suppliers, including the new independents who were deprived from access before.

Using the industry model in the US or Europe, with an established independent midstream transportation industry, industry participants can freely access the gas transportation facilities with transparent upload and off-take pricing among upstream producers, distributors and end-consumers. This way the market price of natural gas will ultimately be driven by supply and demand. This mechanism will encourage optimal allocation of capital, and eventually encourage the participation of the upstream gas production industry, thus boosting domestic gas supply.

Figure 6: PetroChina's pipeline network in China

Source: PetroChina

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