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HANDS-ON CHINA REPORT
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Jing Ulrich

Managing Director, Chairman,
China Equities & Commodities
+852 2800 8635
jing.l.ulrich@jpmorgan.com

Is a Shift Underway in China's Coal-IPP Dynamic?

China's annual coal contract price negotiations concluded this month with prices settled at 6-7% above last year's level (~RMB540/ton), according to our discussions with industry contacts. This settlement is shy of earlier market expectations for a ~10% hike. This outcome and improvements in weather conditions at China's main coal port of Qinhuangdao have caused coal prices to stabilize at around RMB830/ton after a four-month rally (see Figure 1). Some market participants expect spot prices to soften after the peak season ends in March, thereby narrowing the gap between contract and spot prices from ~RMB230/ton at present. This year's coal contract agreement was struck for 1.64 billion tons of coal sales (roughly 50-55% of China's likely output this year).

Figure 1: Qinhuangdao spot prices (RMB/ton)



Source: Bloomberg

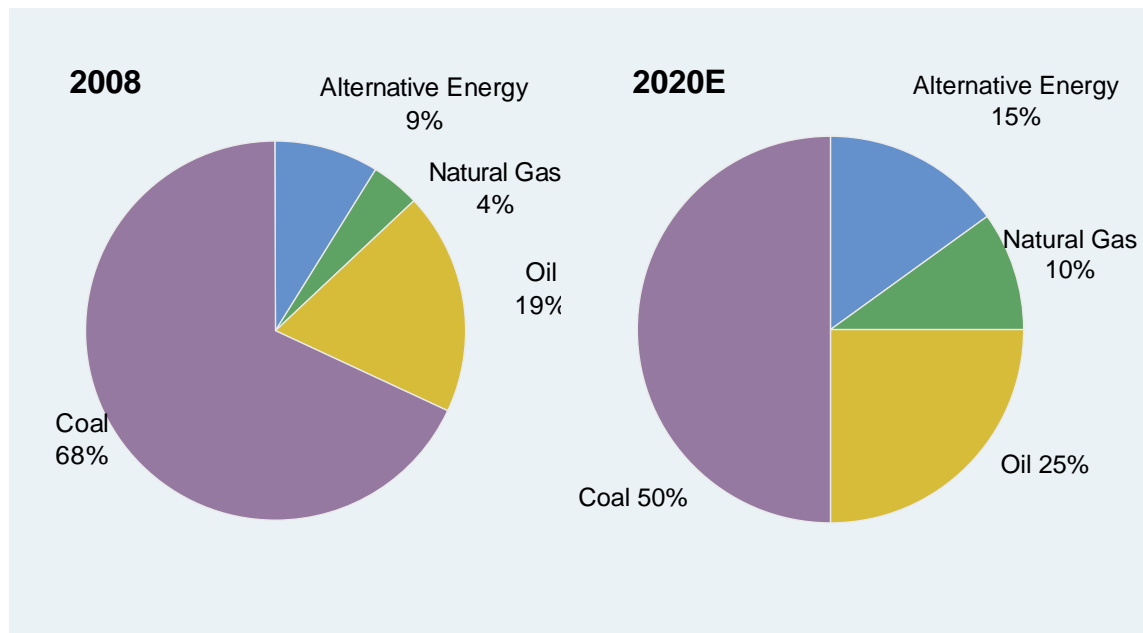
The government's focus on pre-empting inflation suggests that an electricity tariff hike is unlikely in the near-term. Since 2001, Chinese coal prices (which were deregulated in the early 1990s) have increased 330% but regulated retail electricity tariffs have increased only 15-20%. This has created a very positive dynamic for the major coal producers, but as we go forward, several factors must be monitored and weighed against our generally bullish outlook for the coal sector:

- **End to seasonal disruptions.** Qinhuangdao port reopened on January 21 after three days of closure, with daily coal delivery volumes climbing higher (though, as of January 21, still 29% below pre-closure levels). The coming Chinese New Year holiday will also bring lower power demand, suggesting that the worst of the winter disruptions could be behind us.
- **Consolidation running its course.** The government's policy of consolidating small coal mines in Shanxi province is running its course and we might expect to see a meaningful pick-up in the province's coal output going forward. Falling production from Shanxi was a key factor behind coal shortages in 2009 because the province's coal is of higher quality than coal mined elsewhere in the country. China closed 1,088 small coal mines last year and saw Inner Mongolia surpass Shanxi as the nation's biggest coal producing region.

- **Diversification in fuel supplies, energy mix.** According to the government's current energy mix targets, the contribution of alternative energy to China's power mix is expected to rise from 9% in 2008 to 15% in 2020. Over this period, China's reliance on coal is expected to decrease from 68% to 50%. According to the China Electricity Council, the country is expected to add approximately 85 GW of installed capacity planned for in 2010, of which 30 GW will come from alternative energy.

At the same time, China's five major power generation groups are increasingly pursuing the strategy of vertical integration. Datang is aiming to boost its coal self-sufficiency from 20% at present to 25% by end-2010, and eventually reach 40% self-sufficiency by 2015. Huaneng Group aims to expand its upstream coal business in 2010 to reach 30 percent self-sufficiency in coal.

Figure 2: Structure of China's Energy Consumption



Source: BCA Research

Conclusion

- Given the passage of the peak coal demand season and easing of transportation bottlenecks, the near-term upside for coal spot prices may be capped.
- The worst may now be over the power sector. China's state grid expects electricity consumption to increase by 9% in 2010 (5.96% in 2009) with growth rates in the first half higher than in 2H10 due to the lower base effect.

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