

## Resource Taxes to Help Local Governments, Boost Western Development

China's central government has announced a package of measures to boost development in the country's Western areas, chief among which is a plan to extend the pilot implementation of a resource tax reform which began last month in the Xinjiang Uygur Autonomous region. The reform – which involves replacing the existing tax on the volume of a commodity produced with one levied according to revenue – initially applied to oil and natural gas produced in the province, but will be broadened to apply to coal, crude oil and natural gas produced in 12 provinces in Western China. Details were not provided on the timing of implementation, or the rate of taxation for coal.

In addition to amending the pricing of domestic resources, the tax reform would also represent a significant move to support local economies in the resource-rich inland regions that remain underdeveloped relative to the country's coastal areas. The resource tax reform is part of a new round of support measures for Western China announced in recent days, which include: i) the announcement by the NDRC of RMB682.2 billion in investment towards 23 new major infrastructure projects in regions including Sichuan and Guizhou provinces and the Tibet and Xinjiang regions (some of which appear to have been previously announced), and ii) the continuation of a preferential 15% corporate income tax rate for a period of ten years to support the development of favored industries in Western China.

Although it was not revealed which industries will benefit from this entitlement, a list of industries eligible for preferential tax published by the Ministry of Commerce in 2005 included agriculture & forestry, water conservation, coal, alternative energy & power transmission, nuclear power, oil & gas, steel, base metals, chemicals, building materials, pharmaceuticals, machinery, auto, ship construction, aerospace, light industries, textiles & garment, construction, urban infrastructure & real estate, transportation, telecom, other services and resource efficiency/environmental protection investments. Considering that some of these industries currently suffer from overcapacity, we believe the list could be revised for the upcoming period.

- **Higher costs in store for resource producers.** The reform of the resource tax will result in higher tax costs for resource producers. Collectively, these regions account for roughly 45% of the nation's coal output, 30% of crude oil output and 80% of natural gas production. The implementation of the resource tax in Western China will affect the tax burden of the three biggest coal producers – Shenhua, Yanzhou, and China Coal to varying degrees based on their exposures to the region. Based on production figures for 2009, almost all of Shenhua's upstream resources are located in the Western region, mostly in Inner Mongolia and Shaanxi. Close to a third of the upstream resources of Yanzhou Coal are located in Western China (Inner Mongolia), while less than 5% of China Coal's mines are in the region. It is worthy to note that upon the eventual rollout of the resource tax reform from Western China to the entire nation, Shenhua will experience almost no incremental impact, while China Coal will be affected the most.

- **Implementation of coal tax reform may be more measured.** The shift toward ad valorem tax rates (determined by the value produced) is taking on greater significance since the reforms now extend to coal, which serves as the country's mainstay fuel and a key input to many downstream production industries. Given the apparent concern of the government regarding inflation, as well as maintaining the profitability of downstream industries, policymakers may engineer a softer entrance into the new coal tax than the one for natural gas and crude oil by establishing an initial rate at the lower end of the reported range of 2-5%.

Although Chinese spot coal prices have more than doubled since 2007, the resource tax rate on coal production has not changed, leading to assertions in China, as elsewhere, that upstream miners have profited excessively. We recently spoke to several major coal producers, who were of the opinion that now is not the best time to roll out a nationwide ad valorem coal tax because of inflation concerns and the weakness of downstream industries, which are likely to shoulder some degree of cost pass-through. Although the NDRC's recent coal price directive required major coal producers to adhere to contract prices, standard clauses usually allow for these to be adjusted in the event of tax changes.

We think the government will closely gauge inflationary pressure and assess the impact of reforms in the twelve provinces before rolling out coal tax reforms on a nationwide basis.

- **Key policy objectives.** While there are uncertainties surrounding the timing of nationwide implementation and the rate of taxation, the government has made clear its intention to move forward with resource tax reforms under appropriate macro-economic conditions. In the medium-long term, these reforms will contribute towards the following key policy objectives:

- Reduce economic imbalances between the lesser-developed but resource-rich regions of Western China and the nation's coastal centers.
- Promote the more efficient extraction of the nation's natural resources by regulating upstream activity.
- Bolster local government finances, since a higher proportion of the resource tax will be paid locally.

### **Xinjiang as a Testing Ground**

The existing output-based resource tax applies to six categories of natural resources: crude oil, natural gas, coal, ferrous metal minerals, non-ferrous metal minerals and crude salts. As prices of different resources have been deregulated to follow market mechanisms, a reformation of resource taxes is needed to better reflect price changes of underlying products. The government initially expressed its intention to reform the resource tax nationwide several years ago, however inflationary pressures and subsequently the effects of the global financial crisis delayed the launch of reforms.

On a pilot basis, the adoption of an ad valorem duty for oil & gas began last month with the Xinjiang Uygur Autonomous Region chosen as the first venue for the reform. Starting from June 1, a tax of 5% has been levied on the value of oil and gas sales for producers in the province (with various concessions for the production of heavy crude, sour natural gas and resources mined using tertiary methods). This is a move that will increase revenue for the local government as part of a series of support measures recently introduced for the region. The launch of the oil and gas tax reform in Xinjiang province was a particularly opportune first step as it addresses perceptions of economic imbalance by boosting local government revenues in a province where oil and gas production amounts to over a fifth of GDP.

On June 1, the Ministry of Finance issued a notice detailing the reform of resource taxes levied on crude oil and natural gas in Xinjiang. The new ad valorem tax differs from the previous tax, which was

calculated based on volume extracted. In particular, the government levied a rate of RMB0.02 – 0.15/m<sup>3</sup> of natural gas and RMB8 – 30/ton of crude oil, while the new tax charges 5% on revenues generated. The Xinjiang Administration of Taxation estimates that the increase in government revenues will be RMB2.38 billion for the province in 2010. There were a few concessions regarding the new tax rule, which effectively mean that some of the province's oil & gas output is taxed in the 3-3.5% range.

1. Mined oil and natural gas used towards the further mining of oil and natural gas is not taxed
2. Heavy crude and high sulfur-content natural gas receive a 40% discount
3. Resources mined using tertiary methods receive a 30% discount.

The concessions are very much in agreement with the government's focus on higher-value added development. The second and third concessions were both targeted towards resources that are more expensive to extract and require more sophisticated technologies, indicating the government's willingness to subsidize the economy's transition towards a more technologically advanced model. The third concession also exhibits the green initiative of the government, by providing incentive to exhaust non-renewable resources more thoroughly.

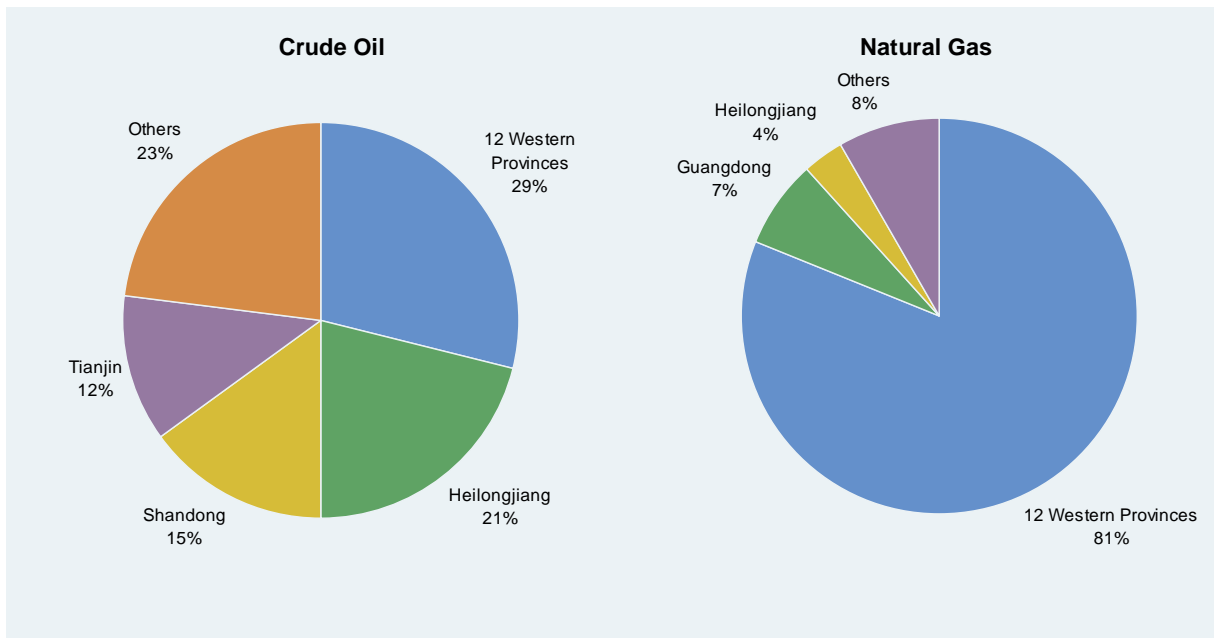
### The Prospect of Nationwide Coal Tax Reform

Domestic Chinese media reports earlier this year suggested the Ministry of Finance had decided to impose a new ad valorem tax on coal at 2-5% of revenues generated. We think there are several likely reasons why the pilot implementation for oil & gas has so far proceeded more swiftly than for coal:

1. **The tax structure of coal is more complicated.** Currently there are over 10 taxes and fees applicable to the mining and sales of domestic coal, compared to less than 5 for natural gas and crude oil. In addition, since a new ad valorem tax on coal will be similar to certain taxes already in place, the introduction of the new tax may accompany some form of streamlining of the current coal tax system.
2. **Coal plays a greater role in costs to downstream industries.** Coal is a key input to many downstream production industries, including thermal power, fertilizer, cement, and steel, and claims a large portion of costs. The introduction of a new coal tax will likely bring upward pressure to coal prices, potentially squeezing profit margins of the downstream industries that are already facing a host of other issues (i.e. the inability of thermal power producers to pass on coal cost increases, overcapacity in the steel industry and rising coking coal costs, etc.). Although the NDRC's recent coal price directive required major coal producers to adhere to contract prices, standard clauses allow for these to be adjusted in the event of tax changes.
3. **China has entered the traditional high coal-consumption season.** With China experiencing a recent heat wave, power producers have been stockpiling coal to accommodate increased consumption. At this point in time, the government will be mindful of the potential impact on prices resulting from a revised tax regime for coal.
4. **Xinjiang was an ideal province for piloting natural gas and crude oil levies, but other provinces are more suitable for the introduction of a new coal tax.** Xinjiang is a leading province for natural gas and crude oil production (see Figure 1). According to TX Consulting, in 2009, the volume-based taxes on crude oil and natural gas should amount to RMB 1.12 billion. In comparison, a 5% ad valorem tax at US\$60/barrel of crude oil would have brought the amount to RMB5.24 billion. As a minor coal producing province, a coal tax pilot in Xinjiang will not be representative for the nation. More significant coal producing provinces like Inner

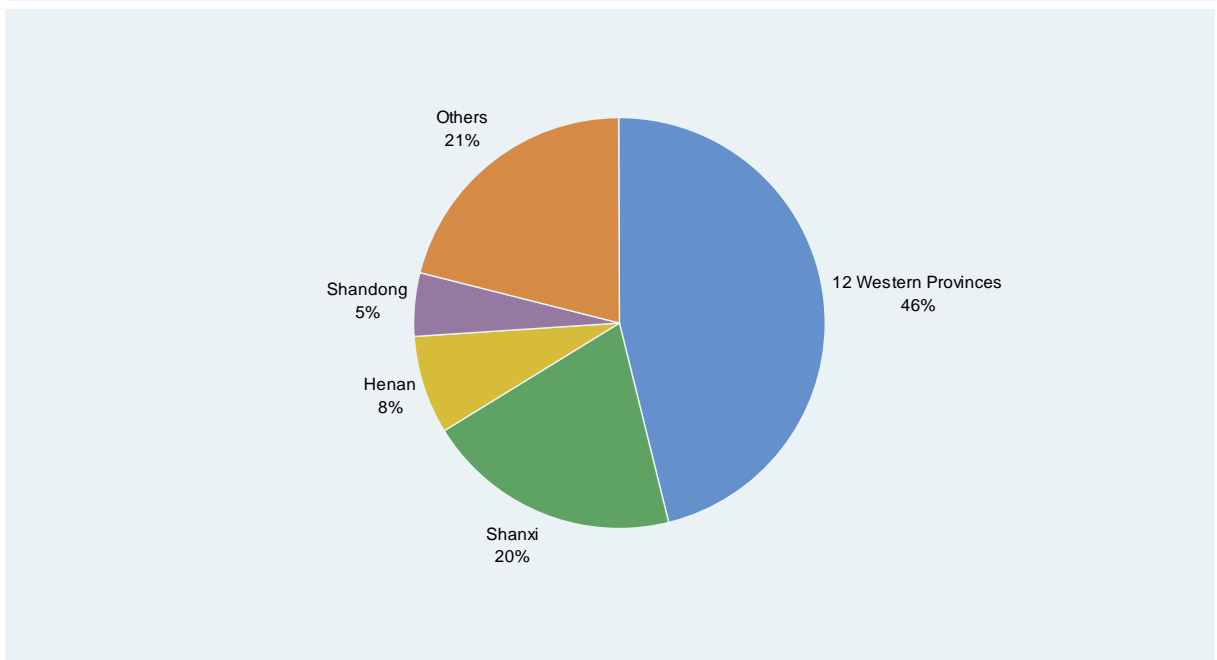
Mongolia, Shaanxi, Guizhou and Sichuan are now included among regions that are slated to undergo resource tax reform (see Figure 2).

Figure 1: 2009 Crude Oil and Natural Gas Production Distribution



Source: CEIC

Figure 2: Coal production distribution by province

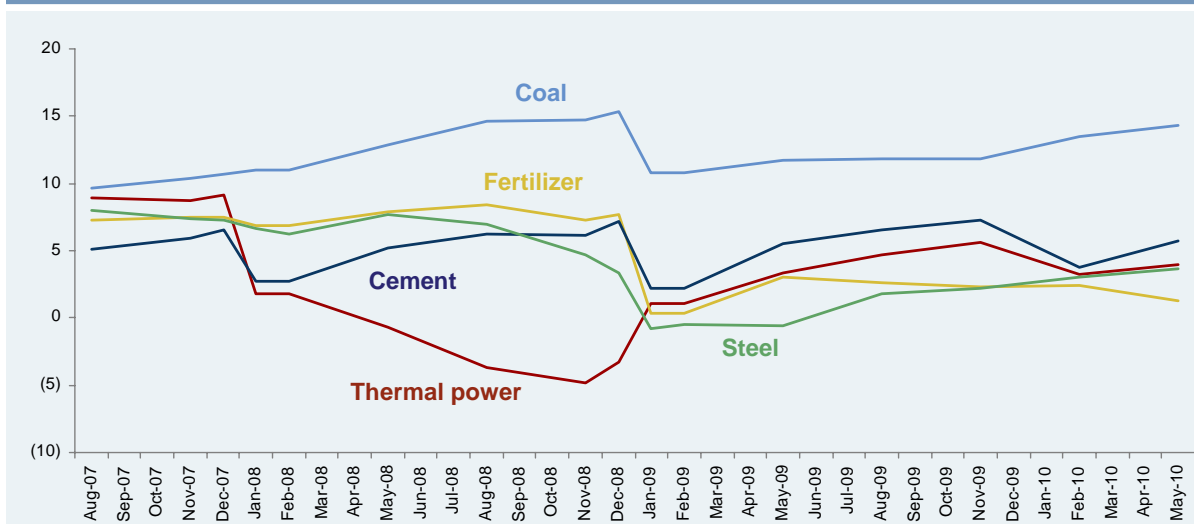


Source: CEIC

From the recent release of price guidance on thermal coal issued to major coal producers, it is clear that the government intends to keep thermal coal prices stable for the time being. However, the relatively accommodating directives still leave room for possible price increases (thermal coal prices are still allowed to rise as long as they are not led by the leading coal producers in the roundtable session), so we expect policymakers may be more inclined to proceed with implementation when signs of moderating inflation are more evident. At this stage, we are mindful of the impact to corporate

earnings once the new tax materializes for coal producers, but also for downstream industries, which are in a much weaker position to weather cost increases (see Figure 3).

Figure 3: Relatively Lower Downstream Profit Margins Vulnerable to Cost Pass-through



Source: CEIC

### Encouraging More Efficient Use of Resources

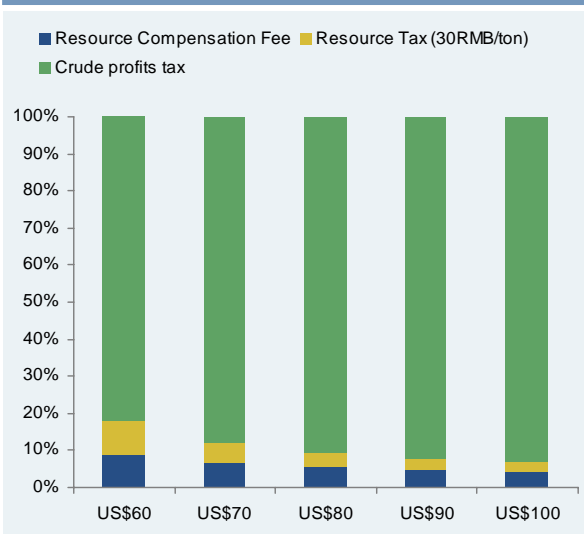
The coal industry has long been criticized for not thoroughly using mine resources. If the ad valorem coal tax is introduced with a concession that encourages more thorough extraction of resources, as there was for the natural gas and crude oil tax (concession 3), coal producers will have greater incentive to exhaust mine resources more completely.

### Rebalancing Tax Allocation

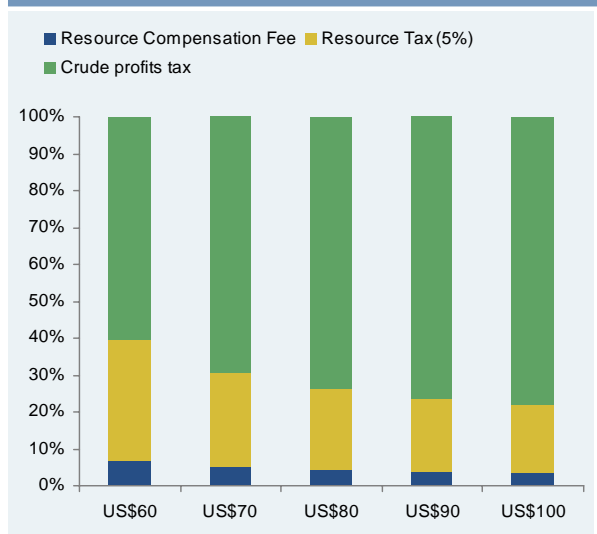
Currently, the majority of revenues from resource taxes and fees accrue to the central government and the remainder is shared between governments at the provincial and municipal levels. Additionally, the substantial increase in resource tax, which is allotted to the local government, will increase the share of revenues at the municipal level. This will aid in creating a softer landing for the economy as the central government is withdrawing from the fiscal stimulus, at the same time increasing self-sufficiency of local governments. According to TX Consulting, the distribution of revenues from resource taxes and fees for crude oil is approximately 77% for central, 18% for provincial, and 5% for municipal governments. Taking the introduction of a 5% rate for the new ad valorem resource tax on crude oil for example, and assuming US\$80/barrel of crude oil, the new tax will shift the balance of revenues from 93:7 to 76:26 between the central and municipal governments respectively. See Figure 4 for a comparison of tax allocation before and after the shift toward an ad valorem regime for crude oil.

Currently over 90% of taxes paid by coal companies belong to the central government. In the event of a 5% ad valorem tax, the ratio will shift to approximately 50:50. This would infuse local governments with a substantial amount of capital and progress towards a tax structure that is supportive of more self-sustainable and autonomous governments at the local level, instead of being directly funded by the central government.

**Figure 4a: Previous crude oil tax structure based on \$60 - \$100USD/barrel**



**Figure 4b: New crude oil tax structure based on \$60 - \$100USD/barrel**



Source: TX Consulting

Based on China Shenhua Energy's 2008 financials, the company's total tax burden will increase by almost 100% as a result of a shift to a new ad valorem tax at 5% of revenues. For Yanzhou coal, which posted revenues of RMB 19.8 billion in 2009, a new ad valorem tax at 5% of revenues would increase the resource tax from RMB125 million to RMB990 million, an almost 7-fold increase. The company's total tax burden would also approximately double as a result of the shift.

**Appendix 1: Region Affected by Resource Tax Reform (Shaded in Yellow)**



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