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HANDS-ON CHINA REPORT
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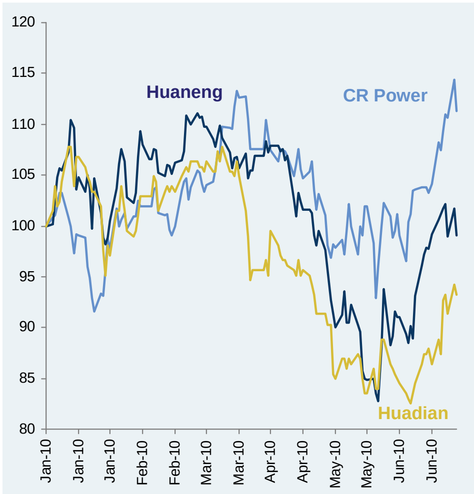
New Price Guidance Affects Sentiment for Coal Stocks

China's National Development and Reform Commission (NDRC) recently directed the country's major coal producers to abide by contract coal prices agreed at the start of the year. According to a statement published by the NDRC, coal miners have been asked to return any extra income from additional price increases before the end of June and secondly, to refrain from initiating spot price increases. Without any indication as to how long these controls will remain in place, Chinese coal stocks have been rattled by investor concerns about future margins (see Figure 1), although coal companies continue to make good profits at current price levels.

Figure 1a: Relative performance of coal companies (%)

Figure 1b: Relative performance of IPPs (%)



Source: Bloomberg

The new controls appear designed to manage inflationary expectations and to discourage coal miners from exacting higher-than-contracted prices from power producers that stand at risk of incurring losses this year (and for whom coal accounts for ~70% of costs). With more than 40% of power producers operating at a loss in the Jan-May period, this effort to contain coal prices provides a near-term alternative to hiking electricity prices at a time when policymakers do not want to see inflationary pressures increase. We note that the new price controls are not as extreme as those implemented in July 2008, when the NDRC capped the FOB prices of coal at major ports at the June 19 level (after earlier requiring coal producers to settle contract prices and cap mine-mouth prices below this level). With CPI inflation expected to moderate from July/August, we do not believe this action necessarily signals wider government intervention in pricing.

- **Revised contract prices.** China's annual contract price negotiations concluded in January, with prices increasing 6-7% from 2009 levels. However due to the large price differential (~32%) between spot and contract prices, some producers have reportedly revised contract prices as much as 10% above benchmark – although based on our discussions, this does not appear to be the prevalent case. The benchmark contract price signed by China's largest coal producer China Shenhua and IPPs for 5,500 kcal/kg coal is RMB 570/ton, while comparable spot prices currently stand at about RMB 755/ton (Figure 2).

Figure 2a: QHD spot and domestic contract (RMB/t)

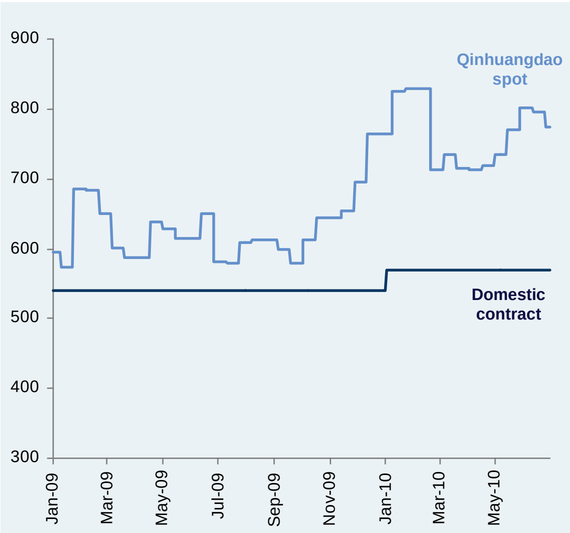
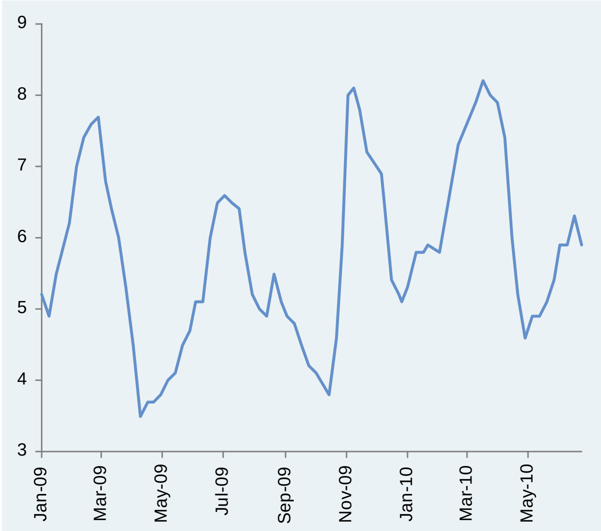


Figure 2b: QHD coal inventory (mn tons)



Source: CEIC, Bloomberg, J.P. Morgan

- **Coal price ceiling currently preferable to electricity tariff hike.** Under China's electricity and coal price linkage policy, if the average spot coal price increases by more than 5% over a 6-month period, the government will increase the price of electricity to absorb 70% of the increase in cost to IPPs. During China's previous bout of high inflation experienced in 2007-2008, the condition for an electricity price hike was satisfied in May of 2008, however the policy was not enacted since CPI inflation at the time was 8.5%.

  Coal price growth has picked up in 2010, and the price increase over the 6-month period ending on May 1, 2010 was 20.9%. Power producers have been operating on thin margins, and the proportion operating at a loss during the same period has hovered above 40%. As a consequence, IPPs have appealed for an increase of electricity prices to pass through costs and balance the profitability of coal and power producers. With May CPI growth at 3.1% (already exceeding the annual target of 3%), we believe that the situation is similar to May 2008, when the government was reluctant to increase electricity prices due to lingering inflation concerns.

  However, current CPI growth is much more modest relative to 2008. As such, the government may take further action on electricity pricing later this year, when there is more clarity on the full-year CPI growth.

- **Coal demand/supply balance should improve in 2H09.** Although China's electricity consumption grew by 23% in Jan-May 2010, the China Electricity Council projects that total consumption in 2010 will grow by just 9%. This implies that power consumption growth may slow in 2H10, due to the higher base from 2H09 and moderating FAI growth.

  - Indeed domestic production of energy-intensive materials such as aluminum and steel are showing early signs of slowing. Crude steel production in May increased 1.3% from April but was down 1.9% after adjusting for calendar days. Similarly, aluminum production declined 1.4% MoM. Domestic production could moderate further as a result of recent measures to limit electricity discounts for high energy consuming industries and the removal of steel export subsidies.

  - The supply of hydro electricity increased 3.8% MoM in May after 8 months of consecutive decline due to unusually dry weather conditions. Hydro-electricity accounted for 16.4% of electricity production in May, compared to 12.5% in April and historical levels of 18-20% during the summer rainy season.

- The completion of maintenance work on the Daqin railway in mid-May has contributed to higher coal inventories at IPPs before the peak summer season. Inventory at major power plants increased to 18 days at June 20, compared to 15 days at the end of March.