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China's Cut To City-Gate Natural Gas Prices Will Fuel Volume Growth For Distributors

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HONG KONG (Standard & Poor's) Nov. 19, 2015--Standard & Poor's Ratings Services said today that China's decision to cut city-gate natural gas prices--the cost of gas for gas distributors--is likely to boost sales volumes for the distributors. The move is also a step toward more market-based pricing of natural gas, in our opinion.

"The price cut will help arrest the recent decline in natural gas volumes in China, and reduces downside risk to volume growth in our 2016 base case," said Standard & Poor's credit analyst Vincent Chow. "We anticipate that gas distributors will pass the lower natural gas prices on to customers to improve the competitiveness of gas over other oil-based energy sources. So, while their volumes will grow, their margins will remain stable."

The lower prices are unlikely to have an immediate rating impact on natural gas distributors in the country. In our view, China's slowing economy remains a key constraint for growth in the country's natural gas volumes. China's natural gas consumption grew merely 2.5% in the nine months to September 2015, compared with 7% in 2014.

We estimate that gas sales volumes of all Chinese natural gas distributors that we rate, barring Beijing Enterprises Holdings Ltd. (BBB+/Stable/--), grew at single digits or in the low teens during the period. The companies include ENN Energy Holdings Ltd. (BBB/Stable/--), China Resources Gas Group Ltd. (BBB+/Stable/--), Towngas China Co. Ltd. (BBB+/Stable/--), and China Oil and Gas Group Ltd. (BB/Stable/--). These growth rates are below our earlier

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expectation and reflect China's weak economy and natural gas losing its competitiveness to other oil-based energy sources. Gas sales of Beijing Enterprises Holdings remain robust because growth in the company's volumes is driven by the replacement of coal-fired power plants in Beijing with gas-fired plants. That said, the continuing growth in city gas volumes, together with the flexibility of gas distributors to adjust their capital expenditure depending on market conditions are likely to support the credit profiles of these companies.

On Nov. 18, 2015, the National Development and Reform Commission cut benchmark city-gate gas prices for nonresidential users by Chinese renminbi (RMB) 0.7 per cubic meter, equivalent to about 24% (coastal regions) to 38% (western region), effective Nov. 20, 2015. The gas suppliers and distributors are allowed to reach a settlement price for gas sales at a discount to the benchmark price, but no premium is allowed till Nov. 19, 2016. From Nov. 20, 2016, the government allows a 20% premium over the benchmark price. However, we believe a premium over the benchmark price is unlikely if demand for natural gas remains sluggish.

"In our opinion, the cut in natural gas prices demonstrates the Chinese government's commitment to support volume growth for natural gas," said Mr. Chow. "However, the price reset process for the gas in the country is still less transparent than that for oil or gas in the global market."

The government aims to set up a more market-based natural gas pricing mechanism over the next two to three years, which would benefit city gas distributors amid a likely oversupply of natural gas. Some of the measures we expect the government to take toward this goal are: removing the ceiling on natural gas prices; allowing more gas buyers and sellers by permitting third-party access to midstream infrastructure such as liquefied natural gas terminals and long-distance pipelines; and allowing more frequent adjustments to prices. Ultimately, we expect city-gate prices will be set based on the price for the gas on the Shanghai Petroleum and Natural Gas Exchange. Such transparency, together with more diversified gas supply, should reduce business risks for downstream gas suppliers.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.