

UBS Investment Research**Macro Keys****China's Energy Price Reform—Is It for Real?**

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In the last week of 2012, China announced a potentially far-reaching price reform which has received little notice: Starting from January 1 2013, China would terminate dual pricing for coal, end the key contracts between major power producers and coal companies, and end the inter-provincial railway transport allocation quota. In addition, the announcement sketched a mechanism for linking on-grid power tariff with coal prices – if coal prices in a given year moved by more than 5%, on-grid power tariff will be adjusted and power companies will be asked to absorb no more than 10% of the increase in cost (down from 30% previously). In essence, this is an important step towards “letting the market play a fundamental role in allocating resources”, an objective for the upcoming reforms outlined by the 18th Party Congress.

How significant is this? Should investors care?

At the moment, the move is not a big deal. Power demand, while having rebounded, is not particularly strong, coal supply seems abundant and rail transport is not tight. In such an environment, the announced energy price reform does not result in any price adjustment in either coal or power right away. The demand-supply balance will change eventually and the true test will come when power demand increases strongly, and/or coal prices rise significantly.

Over the medium term, this reform could be hugely important.

First, coal is very important in China. China consumes about 3.5 billion tons of coal a year, or more than 70% of its total energy consumption (its oil consumption of almost 10 million bbd accounts for less than a quarter of the total). Almost 60% of the coal is used in producing electricity, of which a significant portion was under price control through “key contracts” while the rest is priced “freely” in the market. While the share of coal under price control has dropped markedly over the years, in 2012 it still accounted for almost a quarter of China's total coal consumption, according to the NDRC.

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Second, dual coal pricing, together with controls on power tariff and railway transport, has led to serious distortions in the economy. The NDRC has acknowledged that under the old system, contract coal prices have often been consistently and significantly below market prices; have led to unfair competition among different power and coal companies; and the frequent breakup of contracts in times of big price movements has led to episodes of coal and power shortages. In our view, the more significant distortion for the economy at large is that the energy price subsidy resulting from the control of power coal prices, rail transport and power tariff has led to inefficient use of energy, over-built in energy-intensive heavy industries, and have worsened structural imbalance in general. At the sector level, the controls have led to disorderly development of smaller coal mines, resulting in significant damage to coal resources and the environment; further mismatch of power demand and power supply in different regions; and restricted the development of the arguably more effective rail transport sector as more than half of the railway's capacity is used to transport coal at a fixed low rate.

Therefore, the ending of dual coal pricing, the promise of linking power tariff with coal prices, and the abolishment of rail transport quota for coal, could pave the way for further significant reforms in the pricing of electricity and developing a more market-oriented transport sector. The resulting reduction in energy subsidy and increase in energy price volatility, if the government largely abstains from resuming prices controls in the future, would be negative for the energy-intensive sectors initially but should be positive for the power sector and large coal companies, and in the long run, this should reduce China's energy appetite and help improve the allocation of energy resources and reduce structural imbalances.

In this light, the announced reform is indeed very significant, though the true test will come only when coal prices rise significantly and/or power market is tight. After all, China has tried to push through energy price reforms many times in the past. Will the government be true to its word and adjust power tariffs when coal prices rise, even if the economy already faces inflationary pressure in general? If faced with power shortages in the East coast in the future, will the government not command the railway system to put aside other demand to transport coal at no extra costs? More importantly, if higher power tariff leads to sizeable losses in some energy intensive sectors, will the government, especially at the local level, let these companies shut down their capacities instead of engineering a bailout? Only time will tell. For now, we think China has taken a major step in the right direction.

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