China raises gas prices, and hopes for Russia supply deal

Reforms set to boost state-run PetroChina's finances and could help the country seal a gas supply deal with Gazprom, writes Damon Evans

Making a connection: China hopes to tap Russian gas supplies

CHINESE regulators have announced major gas price reforms that will boost state-run PetroChina's finances and could help the country finally seal a long-discussed gas supply deal with Russia's Gazprom.

China's powerful economic planning body the National Development and Reform Commission (NDRC) will raise average city-gate natural gas prices by 15% to 1.95 yuan ($0.32) per cubic metre (cm) – or about $8.90 per million British thermal units (Btu) – for non-residential users from 10 July. Significantly, it will also tie incremental gas sales to an oil-linked formula, which could see prices increase as much as 50% in China's industrial heartland on the east coast.

It is the first big increase in domestic gas prices in three years. The NDRC hopes to avert a supply crunch by spurring new investment in the sector. It also hopes to take the financial pressure off PetroChina, the country's largest gas producer. The company's gas and pipeline business posted a loss of 2.1 billion yuan last year.

The move could also help usher in a deal for new piped gas supplies from Russia. Gazprom, whose sales to Europe are declining along with the region's overall demand, has been pursuing a supply deal with China since at least 2004. But disagreements over routes and pricing have stalled negotiations.

Russia has argued that it needs prices similar to what it gets in Europe to economically justify the development of its huge East Siberia reserves. But PetroChina's parent company China National Petroleum Corporation (CNPC), which has led negotiations with Gazprom, has refused to agree to European prices.

The negotiations have stalemated over the issue, and China has instead pursued pipeline deals with Russia's Central Asian neighbours and liquefied natural gas suppliers in Australia and around the world.

PetroChina lost nearly 42 billion yuan importing gas last year – the state-owned company is forced to absorb the difference between higher import prices and lower domestic city-gate prices.

PetroChina imported Central Asian gas last year at 2.48 yuan/cm and liquefied natural gas (LNG) at 3.95 yuan/cm, according to analysts at investment bank HSBC.

But the new pricing system offers a substantial mark-up for incremental supplies, potentially opening the door for Russian gas.

Price rises

City-gate prices across the east coast are predicted to rise 50% to $15/million Btu or 3.30 yuan/cm as the price of future demand is set at 85% of an oil-linked formula, estimates from Bernstein Research show. This would result in netbacks of close to $9/million cf in the provinces of Shanghai, Guangdong and Zhejiang.

The prices for existing and incremental gas sales volumes are targeted to converge by the end of 2015, though the price at which they converge will depend on a number of factors such as global oil prices and government appetite to increase prices further.

By early 2016, piped gas supplies from Central Asia should breakeven if all reforms are pushed through. This will be a big driver in setting prices and positive for additional gas supplies, Gavin Thompson, a specialist on Asian gas markets at Wood Mackenzie, told *Petroleum Economist.*

He added there would be a preference for East Siberian pipeline gas because its shorter shipping distance makes it competitive against central Asian supplies.

On top of this, there is more scope for contractual flexibility. Gas from Turkmenistan is likely priced against European netbacks. Whereas China would be the key market for East Siberian gas and any deal eventually struck will be attractive for both buyer and seller, said Thompson.

"There has been some gamesmanship around pricing but PetroChina and Gazprom should be closer to doing the deal than ever before. The reforms can be seen as an enabler," Tony Regan, an Asia-focused gas consultant at Tri-Zen, told Petroleum Economist.

In March, Gazprom and CNPC signed a pact outlining the possibility of gas supplies to China starting in 2018, at a rate of 38 billion cm/y. The deliveries, from fields in Eastern Siberia could reach as much as 60 billion cm/y eventually.

In June, Gazprom's chief executive, Alexei Miller, voiced hope that the Russian player would seal the basic terms for exporting large volumes of pipeline gas to China in September.

Realistically, there could be 10 billion to 20 billion cm/y shipped from Russia to China by 2018 if the pipeline plans come to fruition, predicts Tri-Zen.

Any progress would be a "wonderful catalyst" to monetize East Siberia's vast underdeveloped gas reserves by selling them into the Pacific market, added Regan.

In addition to pipelines sending gas to the Chinese market, Gazprom is eyeing the Pacific port of Vladivostok as a potential LNG export hub targeting neighbouring Asian markets.

Although a potentially important step to furthering pipeline deals, there is likely to be a minimal short-term effect on the country's LNG market.

Despite the price increases, Tri-Zen's Regan does not expect a surge in LNG import deals. China has pre-contracted around 50 million tonnes per year of LNG shipment for 2020, which Regan believes should be enough to meet demand considering potential piped supplies are now a real possibility.

Wood Mackenzie's Thompson, though, said he expects there to be a little more appetite for spot sales into eastern China over the next two to four years.

Fears of serious gas supply shortages, as well as unacceptable financial losses at PetroChina, have prompted the pricing reforms.

PetroChina had reportedly started cutting back gas supplies earlier this year in a bid to pare its losses, but that sparked concerns of potential shortages in the coming winter months.

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Nevertheless, Beijing is expected to proceed cautiously on further liberalization. A full move towards oil-linked gas prices could jeopardize the government's plans to reduce its dependence on coal, which made up about two thirds of the country's total energy mix in 2012, in favour of cleaner-burning natural gas, noted Olivia Boyd, an analyst at IHS Global Insights.

China's gas consumption has risen sharply in recent years. And the government is keen to increase its role in the energy mix to help reduce the smog that is choking its cities. Demand has increased from 46 billion cm in 2005 to 147 billion cm in 2012. Policymakers want gas to meet 10% of China's energy needs by 2020, up from less than 5% today.

But the NDRC is worried that without further progress to more market-based pricing there will be scant incentives for investment in further LNG imports and domestic upstream production.

China has not lifted its national city-gate gas prices since 2010, despite the fact that the average price of gas imports climbed by 95.2% between January 2010 and April 2012, according to data from consultancy IHS CERA.

That is not welcome news for everyone. As upstream players look set to gain from higher prices, gas distributors – the beneficiaries of low city-gate prices –will likely see their profits dented.

Still, credit ratings agency Fitch says distributors will be able to pass the cost increases on to a large majority of their commercial and industrial customers, which make up around 80% of China's gas consumption.

To cushion the blow for consumers, local governments are expected to provide subsidies to utilities, public transportation and natural-gas powered taxis, all of which will bear the brunt of the price rise.

Once the new pricing system takes hold natural gas will sit at 60% of the cost of gasoline for transportation, NDRC estimates show.

Initially gas demand will slow, but the improved economics for producers and importers will fuel long-term investment in the sector, limiting the risk of supply shortages, Boyd said.

But crucially Beijing has yet to outline a long-term plan for reforms and domestic gas prices will remain below import levels.

China has little choice but to continue raising prices if it wants its producers to meet supply targets.

At a glance

China is lifting average city-gate natural gas prices – or the delivered wholesale price of gas to each region – by 15% to 1.95 yuan ($0.32) per cubic metre (cm) for non-residential users from July 10.

Incremental sales volumes will be set at 85% of the average second-half 2012 price for a basket comprising 60% imported fuel oil and 40% imported liquefied petroleum gas.

As a result, city-gate prices for new demand in the eastern provinces of Shanghai, Guangdong and Zhejiang, are predicted to rise 50% to $15 per million British thermal units (Btu) or 3.3 yuan/cm.

Existing gas sales volumes are defined as the 112 billion cm of gas consumed in 2012. This includes onshore conventional gas production, as well as pipeline imports and LNG supplies that were fed into the domestic pipeline grid. Incremental volumes in 2013 are predicted to be about 11 billion cm.

China does not regulate prices for offshore and unconventional gas production, as well as some other LNG volumes.

Incremental gas prices tied to the oil-linked formula will not be adjusted until the end of 2015. In the meantime, prices for existing gas supplies will rise in steps to converge at the same level as incremental gas prices by 2015.

Gas prices for residential customers have not been raised and will be set by local governments. ●