Corporate Snippet

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Gas distributor with high growth potential — China Utilities

China Oil and Gas (603 HK, HK$0.59) — Not Rated

Business description. China Oil And Gas Group is principally engaged in: 1) the distribution of pipelined natural gas and construction of pipeline networks; 2) the operation of natural gas refill stations.

Leverage on partner's strength. The group operates its pipelined gas business through its 50.0%-owned JV with China Petroleum Oil & Pipeline Bureau, China City Natural Gas Co., Ltd. (CCNGCL). China Petroleum Oil & Pipeline Bureau, a wholly-owned subsidiary of China National Petroleum Corporation (CNPC), is a leading oil and gas pipeline network contractor in China. It has engaged in the development and construction of many major pipeline network projects, including the world-renowned "West to East" natural gas pipeline. Capitalizing on its partner's strong background, the group should gain access to new gas projects in China, as well as natural gas sources, which are scarce these days, in our view.

Pipelined gas business. Currently, CCNGCL operates two pipeline gas projects, Xinling and Liling. The 45.0%-owned Xinling project is the only pipeline gas provider and distributor in Xinling, Qinghai. In 2006, the Xinling network distributed about 350.0m cubic meters of natural gas. The ISO 9001 certified project is the group's major source of revenue. With an estimated sales volume of about 44.0m cubic meters in 2006, the group's 20.0%-owned Liling project in Hunan is smaller but offers high growth potential as Liling is one of China's major ceramic manufacturing bases.

No major impact from connection fee removal. From 27 December 2006, pipelined gas distributors in Guangdong are no longer allowed to collect gas connection fees from customers, according to the Price Control Administration of Guangdong Province (PCAGP). The move prompted concerns that other Chinese provinces may follow suit. In 2006, connection fees accounted for 51.6% of the turnover of China Gas (384 HK, HK$1.68, NR) and 50.2% of Xinao Gas (2688 HK, HK$7.85, NR). It is estimated that connection fees accounted for only 20.0% of the group's revenue in FY03/06A and therefore even if the measure initiated by Guangdong is implemented nationally, the group will escape relatively unscathed.

Gas stations. The group has obtained approval to operate natural gas stations in Nanjing, Jiangsu province; Binzhou and Qingyun, Shangdong province; and Maanshan, Anhui province. Natural gas stations are expected to enjoy more lucrative profit margins than the pipelined gas distribution business due to their higher ASP per cubic meter. Local Price Control Administrations set natural gas prices based on the price of substitutes. Since petroleum product prices are relatively high, natural gas for vehicle use tends to be priced higher. On the other hand, natural gas for households and industrial usage is priced lower, as coal and electricity are relatively cheap in China.

Growth driver. An increase in the sales volume and ASP of pipelined gas will be the growth catalyst of the group's JV, CCNGCL. Besides, the group's natural gas stations will start to contribute to the group from FY12/07F.

Notes: SBI E2-Capital Securities Ltd. acted as the Placing Agent for China Oil And Gas Group since December 2006.