Corporate Snippet

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Policy boost — China Utilities

China Oil and Gas (603 HK, HK$1.04) STRONG BUY (unchanged)

Target price: HK$2.27 (+118.3%)

Priority in gas resource allocation. China's National Development and Reform Commission (NDRC) has announced new "Policies on the utilization of natural gas resources" to preserve the country's natural gas resources and promote their rational utilization. The new polices classify gas usage into gas for cities, fuel for industrial production, fuel for power generation and a raw material for chemicals and categorize it into "priority", "concession", "restricted" and "prohibited", based on social, economical and environmental considerations. Natural gas for city dwellers will be considered as priority usage and city gas project operators, such as China Oil and Gas, will be given priority in gas allocation. We believe this policy is positive for the company, as it will help it secure a stable gas supply.

Limits on coal gas projects. The development of greenfield natural gas-fueled generating units in major coal production districts will not be approved, under the new policies, as the government intends to curb the exploitation of coal gas resources.

Ensuring proper allocation. The government has prohibited the use of natural gas as a raw material for the production of methanol. Greenfield LNG projects sourcing gas from major gas fields will not be approved. However, existing LNG projects and those under construction will be exempted. In our view, the measures aim to ensure that natural gas is properly allocated across the country according to estimated demand. City gas projects source gas from sections of major gas transmission trunk lines adjacent to them, based upon their annual gas volume allocation. Since LNG is transported by trailers, it can be taken anywhere in the country. If more city gas project operators use LNG as their gas source, the natural gas allocation and supply/demand situation will be disturbed. We believe the new measures will negatively affect the development of LNG greenfield projects adjacent to major gas fields, such as the Sulige Gas Field in Inner Mongolia and the newly discovered Puguang Gas Field in Sichuan Province.

Ban on mine mouth projects. Although China Oil and Gas's first LNG plant Xining, Qinghai, which will source gas from the Sebei Gas Field, is not subject to the new restrictions, the selection of a location of its second and third LNG plant will be affected. Also, China Gas' (384 HK, HK$2.63, SELL) planned RMB1.2b LNG plant in Xuanhang county, Dazhou city, Sichuan province (annual production capacity of 0.5m m^3), near the Puguang Gas Field (reserves of 370.0b m^3) may be adversely affected. In the worst-case scenario, the government may terminate the development of the project.

Beneficiary of PetroChina's downstream move. PetroChina is expected to venture into China's downstream natural gas distribution market soon, which will be a nightmare for most of Hong Kong-listed downstream natural gas distributors. As China's largest natural gas producer (76.0% of the output in 2006), PetroChina owns most of the country's natural gas transmission pipelines, which would make it the strongest player among downstream gas distributors, with controls of resources and major oil and gas transmission infrastructure. Most importantly, it designed the blueprint for China's natural gas development. Unlike its peers, China Oil and Gas will benefit from PetroChina's downstream move, which will probably require a partnership with existing player to minimize execution risks. China Oil and Gas is a good candidate as it develops and operates its city natural gas projects via a 51:49 JV, CCNG (China City Natural Gas) with the China Pipeline Bureau, a wholly-owned subsidiary of CNPC and the country's largest pipeline infrastructure contractor. It also has a proven track record in the industry and profound knowledge of the city gas distribution market.

West-to-East Pipeline Phase II. China Oil and Gas and its subsidiary, CCNG, said it would acquire a city natural gas project in Nanchang, the capital Jiangxi province, located at the starting point of West-to-East

Pipeline Phase II. With an annual gas transmission capacity of 12.0b m^3, the trunk line will supply gas to six cities in the eastern part of the country. With a size of 7,400.0 km and population of about 4.75m, Nanchang is one of China's 35 largest cities. Located on the banks of the Gan River and adjacent to the Yangtze, it is the largest industrial city in Jiangxi with GDP up 15.2% YoY in 2006 and per capita GDP up 14.5% YoY. Its rapid industrialization and urbanization is fuelling demand for natural gas and the company's gas projects in the city are expected to contribute about RMB60.0m in connection fee income and RMB27.6m in after-tax profit between FY12/07F and FY12/08F.

Earnings upgrade. We revised up our earnings forecasts by 14.6% to HK$72.1m for FY12/07F and 11.5% to HK$178.4m for FY12/08F on 15 August to reflect the connection fee income generated by the Nanchang project.

Disclosure of interests: SBI E2-Capital Securities Ltd. acted as the Placing Agent for China Oil And Gas Group in December 2006 and May 2007.