Macro Notes

Macro Update: NDRC Intervenes to Lower Thermal Coal Prices

Price Controls and Slack Seasonal Demand Weigh on Rebar Futures

May 24, 2018

NDRC announced new measures on Tuesday (5/22) to cap thermal coal prices and bring market prices below its price ceiling of RMB 570 per metric ton before June 10. Domestic markets have responded as one would expect, and there has been a selloff in commodities that has spanned the supply chain. This has included futures for thermal coal, coke, and rebar. This announcement by the NDRC compounded existing market expectations for softening seasonal demand based on worse than expected monsoons in central and southern China, as well as temporary production and construction curbs ahead of the meeting of the Shanghai Cooperation Organization in Qingdao in early June.

Our view is that slower seasonal demand and NDRC's attempts to boost coal production will weigh on the coal and rebar price rally between now and mid-June. But, it is important to keep in mind that NDRC's objective is to contain prices within a bounded range, and there is still an effective price floor. After mid-June, however, we expect coal and rebar prices to rally as summer demand materializes and more restrictive environmental control measures further restrain production.

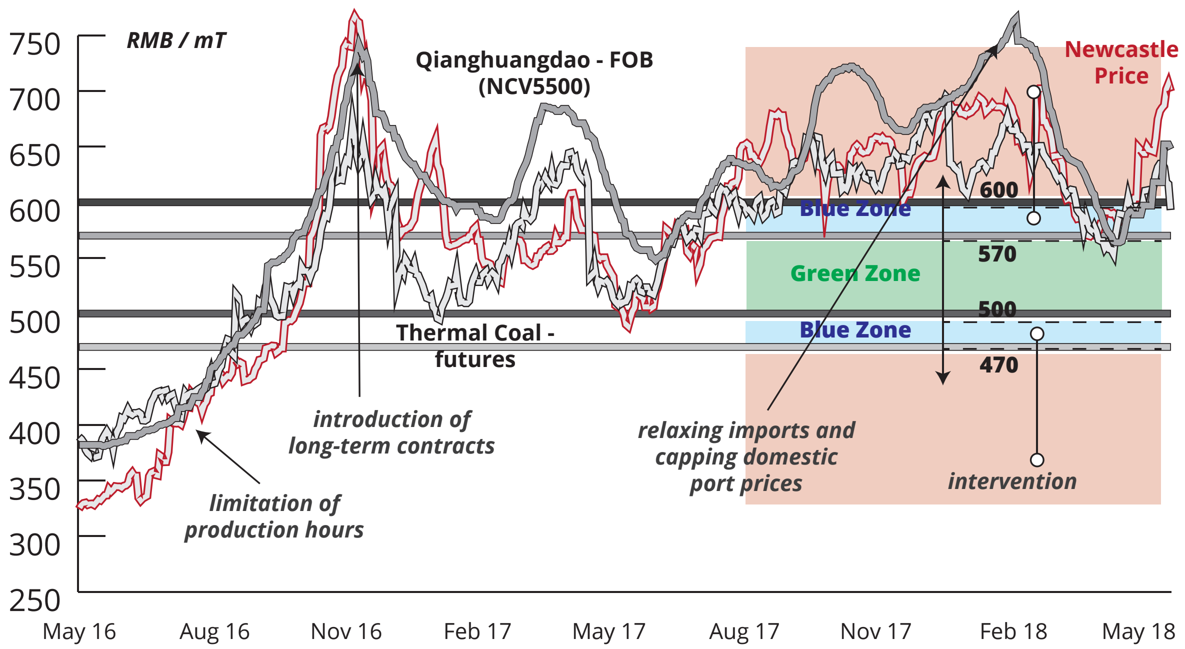
NDRC Shows It Still Has Teeth

- Reports indicate that the NDRC called an emergency meeting of delegates from major state-owned coal mines, trading companies, thermal power plants, port authorities and industrial associations on May 22 where it urged all parties to bring thermal coal price back to the RMB 570 per metric ton level.

- Recall that NDRC has been operating a "traffic lights system" for thermal coal since late 2016 that guides intervention to keep thermal coal prices within the RMB 500-570 mt range, otherwise know as its "green zone".

- To help ensure that the price range remains binding, the agency requires large state-owned coal mines and thermal power plants (who accounted for 75% of supply and demand in 2017, and whose market share should increase to 80% for 2018) to sign monthly and annual long-term procurement contracts based on a benchmark price of RMB 535 per metric ton. This represents the NDRC's effective price floor.

NDRC's Price Controls for Thermal Coal Succeed in the Short-Run, But Effectiveness Appears Transitory at Best



• It is believed that this year's annual long-term contract specifies a range of RMB 560-570/mt, which is close to the NDRC's annual price ceiling.

• **Our view is that there are strong policy convictions behind the NDRC's latest efforts to rein in thermal coal price increases.** Accordingly, we expect them to be effective in the short-term, but, based on recent price trends, such effectiveness is often transitory. This time around NDRC's proposed measures and price targets are very specific and come with a rigid deadline for compliance.

• For example, the agency demanded that all parties lower NCV 5500 thermal coal FOB prices at major domestic ports in the North to RMB 570 per metric ton before the June 10 deadline. "Major ports in the north" clearly refers to Qinhuangdao, and the current FOB price at Qinghuangdao is still at RMB 648 per metric ton. So, there are still some room for spot price to fall (a decline of at least 12% is needed).

Other measures NDRC is considering to lower thermal price include:

1) State coal mines and power plants must bring thermal coal prices below RMB 570/metric ton before the deadline;

2) All major power plants should cut their thermal coal inventories by 5 days from the current level (roughly 15 days) before the June 10 deadline, defer their purchases of coal after prices fall below the price ceiling, and may be prohibited from paying prices higher than RMB 570/metric ton threshold. In the interim, NDRC and China Railway Corp will ensure and subsidize a steady supply of thermal coal to power plants;

3) China Railway will increase coal freight capacity by 200 million-300 million metric tons this year (roughly accounting for a 20% increase over 2017 levels);

4) Expediate customs inspections for imported coal, but the annual import quota will remain unchanged from last year. It is interesting to note that among NDRC's price control initiatives, the agency did not stipulate a price ceiling for imported thermal coal, but only a cap on the amount of imports. **Therefore, power plants along the coast facing shortages of thermal coal may have an incentive to continue paying prices for imports above the NDRC ceiling price;**

5) Crack down on trading companies and futures companies' fake invoicing, manipulation of thermal coal price indexes, unjustified excess inventories at thermal power plants and other end users, such as steel mills.

Slack Seasonal Demand and Production Suspensions

• Market participants have responded to NDRC's initiatives broadly across commodity markets, triggering selloff from thermal coal, to coke and rebar futures. The thinking is that if NDRC is determined to cut thermal coal prices via increased transportation and output of coal, then it should lead to broader cost reductions for other downstream sectors, including steel mills.

• Moreover, markets are expecting slower seasonal demand for coal and steel between now and mid-June for several reasons. First, the current monsoon season in central and southern China appears to be more severe than expected, causing suspensions to construction projects and factory operations, as well as lower residential and industrial demand for electricity and steel.

• Second, the annual Shanghai Cooperation Organization summit has rotated back to China as the host country this year. The summit will take place between June 9-10 in Qingdao (Shandong province) and it has been reported that construction sites and factories around Qingdao will be suspended for 20 days before the summit. Note: Shandong is a major industrial province in China, specializing in refinery, aluminum and steel production (roughly 10% of total steel production in China).

• Third, the State Council launched "inspections" to prevent the reopening of illegal and small steel smelters as of May 15, which should conclude by June 15. During the "inspections", iron ore, scrap and coke prices will all face more downside pressure.

• All in all, slower demand for coal and rebar caused by with seasonal and regulatory factors should help NDRC to lower coal prices before the June 10 deadline.

• **But, the key question is can NDRC still control prices after mid-June? Our short answer is 'probably not'.** The latter half of June represents the beginning of the peak season for residential power usage and construction activity. Given the current demands from NDRC and the conclusion of the State Council's inspections of steel smelters, the peak season will arrive when power plants are carrying very low inventories (likely 5 days, vs a normal level of 15-20 days) and when steel production ramps back up. As a result, thermal power plants, construction companies and commodity trading companies will scramble to bid up existing supplies for restocking. The alternative would be serious power blackouts and delays to construction activity.

• **Therefore, although we expect coal and rebar prices to come down between now and the middle of June as a result of NDRC's price controls and slack seasonal demand. But, it is likely that prices will bounce back during the latter half of June, which may trigger NDRC to intervene again by the end of Q3 to moderate prices ahead of the peak demand season that begins in October.**