Tenaga Fights Back

Faced with the prospect of a full market liberalisation, Tenaga Nasional Bhd must be wondering how long it can hold on to its position as the country's sole distributor of electricity. But it is not giving up easily.

By Halim Wahab and Bhupinder Singh

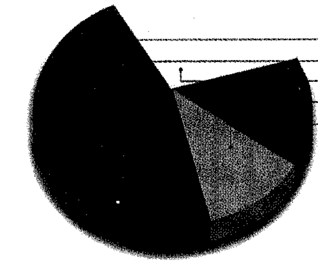
IT'S not often that state-controlled monopolies embark on measures to defend their core businesses. But this is precisely what national power utility company Tenaga Nasional Bhd has conscientiously been doing over the last two years.

Industry sources say Tenaga's status as a government-owned entity does not assure the company of its leading position as a generator and sole distributor of electricity when the present power industry structure is reviewed in 2007.

To worsen matters, aggressive generation-capacity expansion has resulted in overcapacity, which is costing the utility company some RM1.5 billion in energy-purchase bills, while its high gearing of above historic average has prompted it to divest its minority stakes in independent power producers (IPPs) to reduce debt, which stood at about RM30 billion as at Aug 31, 2003.

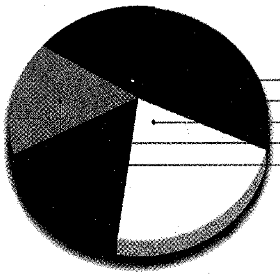
In retrospect, there were already moves to implement a power pooling system following the 1997 financial crisis that would allow for full liberalisation of the power-generation sector and remove restrictions on IPPs in relation to transmission and distribution (T&D) of electricity – until a major power blackout in California put paid to such plans.

TNB'S GENERATION MIX



GWh	%	
4,035.1	10.514	Hydro
13,476.4	35.116	Conventional Thermal (Coal)
10,962.9	28.566	Combined Cycle
5,724.6	14.917	Conventional Thermal (Oil/Gas)
4,178.3	10.887	Gas Turbine
38,377.3	100.00	

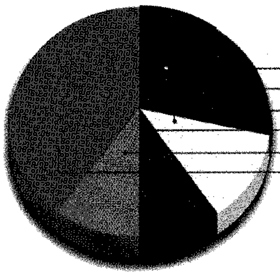
TNB'S INSTALLED CAPACITY AS AT 31 AUGUST 2003



National Grid

MW	%	
1,910.5	18.816	Hydro
2,980.0	29.350	Conventional Thermal (Coal)
2,050.0	20.190	Combined Cycle
1,560.0	15.364	Conventional Thermal (Oil/Gas)
1,653.0	16.280	Gas Turbine
10,153.5	100.00	

TOTAL INSTALLED CAPACITY INCLUDING IPPS



National Grid

MW	%	
1,910.5	11.246	Hydro
2,980.0	17.542	Conventional Thermal (Coal)
2,050.0	12.068	Combined Cycle
1,560.0	9.183	Conventional Thermal (Oil/Gas)
1,653.0	9.731	Gas Turbine
6,834.0	40.230	IPPs
16,987.5	100.000	

But the stark reality remains. Against the odds of a more liberalised market that began in the early 1990s with the formation of the IPPs, many are wondering how long Tenaga can continue to have a firm hold on its distribution business, especially in money-making regions, in the not too distant future.

Some say Prime Minister Datuk Seri Abdullah Ahmad Badawi's landmark speech to captains of Malaysian industry in the middle of last month leaves a clue of what might happen to the power sector post-2007.

In his speech, Abdullah noted that protected companies or monopolies are rarely ever leaders in innovation and creativity and that the government is in the midst of formulating a comprehensive competition policy to ensure sufficient levels of healthy competition across various industries.

Says an observer, 'Currently, private companies or independent power distributors which hold distribution rights to selected areas are the Northern Utility Resources Distribution Sdn Bhd for the Kulim High-Tech Park in Kedah and District Cooling Sdn Bhd for the KL International Airport in Sepang. Although their number will likely remain for now, nothing is certain after 2007.'

Nonetheless, Tenaga is not taking the possible threats lightly. Its president and chief executive officer Datuk Pian Sukro, in his first press interview since assuming the posts in October 2001, says the government's decision to maintain the status quo until 2007 is the basis of Tenaga's strategy to 'put its house in order' and position itself for the future.

Indeed, Tenaga's five-year T7 strategy, led by Pian under its corporate transformation programme, has so far borne favourable results. It is understood that to date, the initiatives have yielded a value of at least RM281 million for financial year (FY) 2003.

A breakdown showed that the transmission division registered the highest actual cumulative cashflow creation during the period, of as much as RM112 million, compared to RM85 million for the generation division and RM64 million for the distribution division.

Company officials say since two years ago, Tenaga has been implementing measures to defend its core business, in particular its generation and distribution market share. It also entails efforts to reduce T&D losses and optimise cost management, and position itself for growth by enhancing accountability and a performance-based culture, and leveraging and building capabilities to reduce the competency gap.

In FY2003, Tenaga made a net profit of RM1.1 billion on the back of a RM16.5 billion revenue. According to a consensus forecast, the figure will likely rise to RM1.3 billion this year on a revenue of RM17.5 billion. The company says in 1Q2004, it made a net loss of RM26.4 million, due mainly to forex translation, compared to a profit of RM663.2 million previously.

Why transmission and distribution?

The importance of Tenaga having a strong grip on its T&D operations cannot be overlooked. As Pian says, 'As far as transmission and distribution are concerned, they are Tenaga's natural monopoly. It doesn't make sense to have two grids or distribution systems. The idea of breaking up distribution to various regions or states also is not advisable. If you break up distribution there will be no cross subsidy and it will create problems.'

In line with this, he says, the focus of Tenaga's capital expenditure (capex) will be on the distribution side and technology that will change the way the utility company works.

Last year, Tenaga came under fire following a major blackout on Sept 1, 2003 in the northern region which affected Perak, Penang, Kedah, Perlis and Kelantan. Tenaga had said the failure was due to an unexpected combination of several factors happening simultaneously, but did not expect the financial loss due to the blackout to be much because it was a public holiday in most of the affected states.

Pian says Tenaga is well aware of the problems and financial losses incurred by businesses when there are blackouts.

'When there is a trip in power supply by circuit-breakers, it's not that we want to do it but because we want to avoid a catastrophe. We don't want interruptions as we lose revenue, credibility and get blamed but it's unavoidable. We are trying our best to minimise such interruptions,' he says.

Pian draws attention to the system average interruption duration index (SAIDI), which states the number of minutes of interruption due to the system experienced by a customer in a year. Based on the index, it has dropped from a high of 731.04 minutes in FY96/97 to 70.83 minutes in FY02/03.

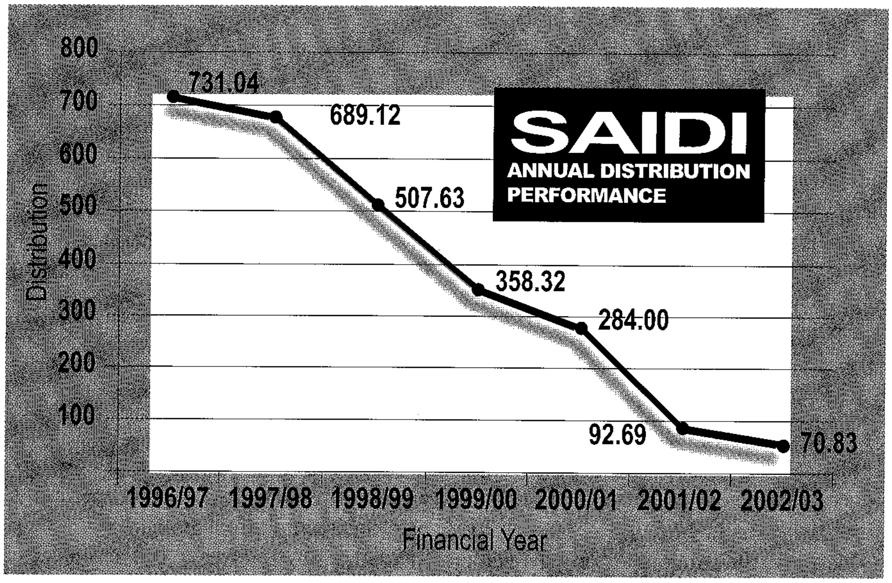
Tenaga is the dominant integrated utility player in the peninsula and Sabah. The company currently owns 60% of the country's generating capacity and almost all of its T&D network.

Tenaga's focus on T&D in part reflects the company's transformation from an integrated utility to the 'transco+' model (a T&D monopoly plus generation assets).

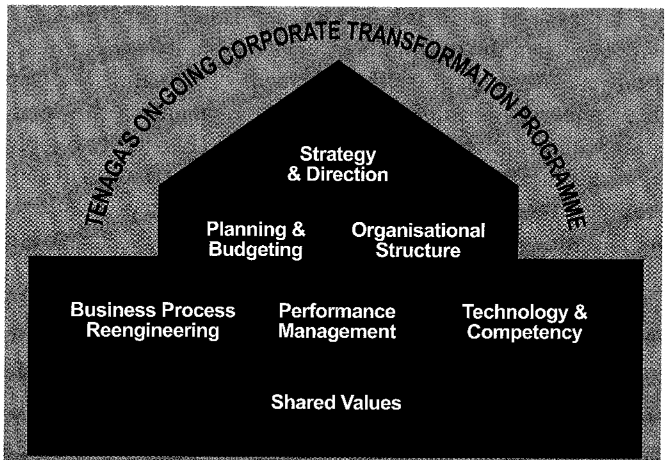
'That does not mean the company would place less emphasis on generation. Tenaga's role in it would remain important no matter what the industry develops into going forward,' says Pian.

'If you strip Tenaga of the generation business there are instances when the IPPs have failed to deliver. When demand is there, you still need a government-owned company like Tenaga to became a generator of last resort.'

Consistent with its strategic focus, T&D expenditure, which has grown by an average 9% over the last five years due to high repairs and maintenance needs as demand continues to be strong, accounts for 22% of Tenaga's cost base while administration accounts for about 6% and miscellaneous items 4%.



At the heart of getting its house in order is balancing cashflow for capex, financing and operations requirement with cash inflows. The company has allocated an annual capex budget of about RM4 billion over the past few years due to growth in facilities and replacement requirements. Demand for electricity has grown by an average of 7% annually in the past three years, compared to 13% in the 1990-97 period before the 1998 financial crisis (power growth trend is about 2% above real GDP growth).



Note: According to Tenaga, the corporate transformation will make it a more focused, efficient and capable organisation, delivering more value to its customers and shareholders. At the heart of this transformation are the building blocks that will be the foundation to stimulate change and improvement within the organisation.

Finance charges amount to a third of net cash from operations, of which post taxes barely covered capex by 1x. Tenaga has consistently paid out dividends in the range of 10%-15% of net profit. The shortfall in cash outflows has been financed with debt in the past five years, which has stabilised at some RM30 billion.

'Tenaga's high capex, leverage and substantial financing cost have drained cash and pressured ratios over the past five years and they will continue to do so if no major capex or debt reduction plans are put in place. Such efforts would be challenged by an ongoing need for capacity and T&D investment due to the strong electricity demand,' says Charles Chang, an analyst at FitchRatings, in his credit report on the company.

High capex has so far stopped Tenaga from coming out with a material debt reduction effort, he adds, and this has affected its credit rating, but the steady cashflow situation and track record in the debt market has kept the company in good stead with the financial markets.

Tariff hike can make the difference

The real solid avenue for Tenaga to relieve some of the pressure on its balance sheet, according to Hwang-DBS Securities

Bhd research head Teh Chi Chang, would be through a favourable change in the electricity tariff structure – last done in May 1997 when the average rates were increased from 21.7 sen/kWh to 23.5 sen/kWh.

'Ultimately only better tariff terms will help Tenaga solve its financial requirements. Divestment of generation asset in IPPs is a one-off thing and going forward, there will be less cashflow from such decisions,' he says.

That door to salvation was somewhat shut last March when the Minister of Energy, Communications and Multimedia (ECM) announced that there will be no increases in electricity tariff until the next tariff review in 2006.

Pian says the company is preparing for any eventuality.

The issue of tariff is a touchy one, more so when the country is in an election year. Absence of tariff adjustment has meant that the rate has failed to keep pace with inflation, resulting in a 6.5% real decline in realised average rates between 1997 and 2002, according to FitchRatings.

Utilities in most countries are an instrument of social and economic policy and it's no different with Tenaga. The profit motive is not necessarily the prime objective of bodies like Tenaga.

This is confirmed in no uncertain terms by Pian himself. 'The word "utility" means to provide utilitarian function. We are not here to make filthy profits. The Electricity Act of 1949 clearly states that our function is to provide electricity at reasonable prices. To make money is not the main point but we need to remain financially viable because the whole industry depends on Tenaga and the whole nation's growth in turn depends on the industry,' he says.

The government holds an 85% interest in Tenaga and has always seen to it that all decisions affecting Tenaga's operations are consistent with its policies.

Tariff adjustment in Malaysia is decided by the Energy Commission (EC), formerly the Department of Electricity and Gas Supply, which is responsible for regulating the electricity sector, implementing the sector's governing statue (Electricity Supply Act 1990, amended 2001) and advising the government on power policies.

The EC's Committee for Planning, Implementation and for the Supply of Electricity and Tariffs (CPISET) meets three times yearly to review issues like tariff rates, service standards, supply plans and other issues related to the sector.

To help make Pian's job easier, the government has made sure that Tenaga's exposure to fuel price volatility is neutralised by keeping a lid on the gas price at RM6.40 per mmbtu until 2005, supplied by national oil company Petronas under the Managed Market Model.

Gas-based generation at the end of last June accounted for 64% of Tenaga's fuel bill. Energy purchases from IPPs and fuels account for two thirds of Tenaga's cost base.

Debt management under control

As circumstances beyond the control of Tenaga caused its debt to grow (forex exposure accounts for half), some relief could come if the government decides to re-peg the ringgit.

Indeed, the depreciation of the US dollar has raised the spectre of a possible review in the ringgit peg to the US currency. With 25% of Tenaga's forex exposure in US dollar and 25% in yen, a significant appreciation of the ringgit would turn Tenaga's fortunes for the better.

The Malaysian Institute of Economic Research (Mier) says while the peg is safe at the moment, continued depreciation

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WHAT THE STRATEGIC DIRECTION ENTAILS

Improve Government and Regulator relationship management
– Defend Generation and Distribution market share

Increase customer satisfaction

Powering nation building
– Meeting socio-economic objectives

Maintain sustainable growth

Improve project planning and delivery

Improve procurement and materials management

Achieve O&M excellence
– Improve generation availability and forced outage rate; Distribution supply quality and reliability

Reduce Transmission & Distribution losses

Optimise cost management

Enhance accountabilities and performance-based culture

Leverage and build capabilities
– Reduce competency gap

Enhance employee satisfaction

Note: Most of the initatives are already in various implementation stages. The management is closely and regularly reviewing the progress of the initiatives. Some early problems encountered have been successfully removed. At the same time, efforts are continuously being made to communicate Tenaga's strategy to all staff across the Group, targeting to create and inculcate awareness, understanding and commitment.

Phase one (235MW) was initiated in 1995 – three years after the Malaysian power sector saw the emergence of local IPPs – and built in 1998, but LPL did not commence operation until Sept 2001 due to economic and political turbulence in Pakistan, which cost Tenaga dearly. The first was the balance of payments crisis in 1998 and the other the military coup in 1999.

Phase one is now operating at full capacity, according to Pian. LPL supplies power to Pakistan's Water and Power Development Authority under a power purchase agreement (PPA). The plant secures its gas supply under a gas supply agreement with Sui Northern Gas Pipelines Ltd. LPL accounted for 2.3% of Tenaga's installed generation capacity as at the end of financial year 2003 and contributed to about 2% of its revenue.

sheet leaves the company with little room for major undertakings.

Meanwhile, Tenaga is looking at exporting electricity to use up the remaining 20% of its 50% excess generated capacity, as the government is comfortable with only a 30% reserve margin.

'But it requires a government-to-government-level contact. The region has adequate resources and each country has its own grid in place. What's left is only the interconnection grid,' says Pian.

Interconnection with Singapore has been in place since the 1980s while with Thailand, Tenaga has two interconnections. It currently has an agreement with the Electricity Generating Authority (EGAT) to exchange 300MW of power via a 110km transmission line connecting Tenaga's facilities in Gurun to Thailand's

The difficulties Tenaga Nasional faced under phase one in Pakistan has made it wary about progressing to the second phase.

The difficulties Tenaga faced under phase one has made it wary about progressing to the second phase, involving the construction of another 235MW plant.

'They (the Pakistanis) are trying to persuade us to build the second plant but we want to play it safe,' says Pian. 'We want to bring it into non-recourse financing because at the moment it is financed with our own money. If possible, I want to divest partially the stake (in LPL) and use the money to build the second phase. The demand for electricity in that particular region is there but we are looking at it very carefully.'

The focus of Tenaga's foreign investments has also shifted to the Asean region and the Middle East. 'We know the Asean region, while government relations with the Middle East are good. It would be more on a joint-venture basis, especially with our IPP friends,' says Pian.

FitchRatings analyst Charles Chang expects Tenaga's ventures abroad to remain small and opportunistic, with limited impact on group performance. He believes Tenaga's domestic capital expenditure needs and its burdened balance

Klong Ngae. EGAT owns and operates 25km of the line and Tenaga the rest. EGAT is now seeking to increase the supply by another 300MW in 2005 and 2006 as demand there is expected to outstrip domestic generation capacity.

The other interconnection between Thailand and Malaysia is a lower capacity line between Sadao and Bukit Keteri. Other cross-border lines include a Thailand-to-Laos link. Cooperation to foster energy trade (gas and power) in the region is gaining ground. The 10-member Asean countries agreed last year to connect their power grids by 2016 to share power reserves.

Interconnection, according to an EGAT official, will save countries like Vietnam, Indonesia, Malaysia and Thailand some US$1.6 billion as the countries are expected to spend some US$119 billion on new power plants over the next 13 years. Interconnection projects currently planned are between Thailand and Cambodia and Vietnam and Cambodia by 2005.

So far, the lack of progress on power trade is due primarily to the fact that governments in the region do not want to be overly reliant on foreign supply. mb