

# SO NEAR YET SO FAR

With so many issues facing it, will Tenaga Nasional get the tariff hike it is hankering for?

By James S

**T**HE negative news flow and bad media publicity recently certainly aren't helping Tenaga Nasional Bhd (Tenaga) if one considers that the national utility company is looking at the Government to approve higher electricity tariffs next year.

While most power analysts say the setback is probably only temporary, others are apparently not so confident.

To be sure, the investment community believes that a tariff hike for Tenaga is a foregone conclusion given the Government's commitment to reducing its overall fuel subsidies to the economy. This means allowing Petronas to raise the current gas price it charges Tenaga and the power industry, which has been fixed at RM6.40/mmBtu since May 1997.

## Tariff hike justified?

Foreign stockbroker Morgan Stanley, which recently initiated an Overweight coverage on Tenaga with a comprehensive 60-page report titled *Unlocking Value*, says a net tariff hike for Tenaga is justified on several grounds.

Firstly, the cost of gas price subsidies to the power sector by the Government is getting unbearable, with the price fixed at RM6.40/mmBtu versus a current market price of RM25.1/mmBtu (US\$6.61/mmBtu). (See Chart 1.)

The Government has not given Petronas approval to raise this price since May 1997, apparently aiming to stabilise electricity prices, which have also been fixed at the May 1997 level.

However, Morgan Stanley adds, with the subsidy having risen to as high as an estimated RM3 billion per annum, the Government may decide to raise the electricity tariff as early as January 2006, especially since Tenaga's long-term gas supply contract with Petronas expires in December this year.

Most analysts expect Petronas to raise its gas price to Tenaga by between 30%-50%, which may see an eventual 6%-11% tariff hike in electricity charges. Even then, the revised gas price will still be heavily subsidised by the Government versus its current market price.

Secondly, says Morgan Stanley, Tenaga's tariff remains one of the lowest in Asia, due mainly to its subsidised gas cost from

Petronas. It says even if Petronas raised its gas charge entirely to the current market price of RM25.1/mmBtu, Tenaga's electricity tariff at RM30.23 sen/kWh would only be in line with those in the other Asian countries (see Chart 2).

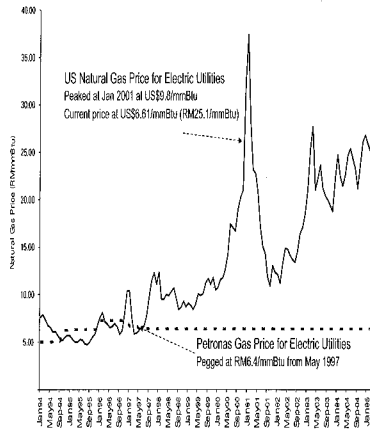
Thirdly, Tenaga's return on capital invested (ROCI) at 5.1% is low (deteriorating from 10.5% in FY94) when benchmarked against other utilities in the region and worldwide. The management in its 3QFY05 results briefing has apparently said that such sub-optimal return levels could jeopardise its ability to invest in power infrastructure.

Morgan Stanley, in expecting an 11.4% increase in Tenaga's electricity tariff in January 2006, says Tenaga's ROCI will then



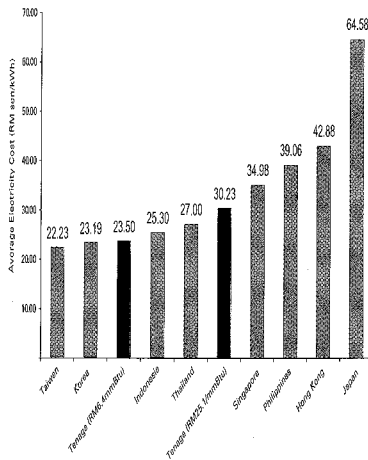
The investment community believes that an electricity tariff hike is a foregone conclusion given the Government's wish to reduce its overall fuel subsidies

### CHART 1: PETRONAS' RISING GAS SUBSIDY



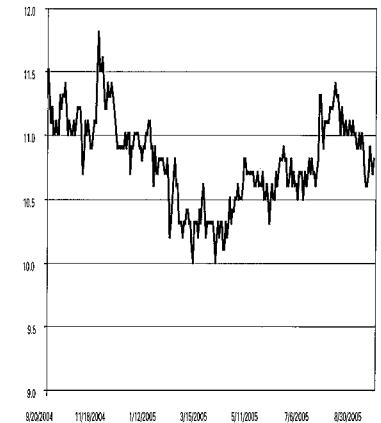
Source: Morgan Stanley Research

### CHART 2: ASIAN UTILITIES ELECTRICITY RATES IN 2004



Source: Morgan Stanley Research

### CHART 3: SHARE PRICE CHART OF TENAGA



Source: Bloomberg

rise to a more reasonable 7.5%, although it will still be below that of other dominant power players in Asia.

Fourthly, it adds, a tariff hike will not impact Malaysia's manufacturing competitiveness as an analysis by the National Economic Action Council in 2004 revealed that electricity cost accounts for only 2.0% of the average production cost of Malaysia's manufacturing sector.

It also believes that the Government, being the major shareholder in Tenaga via Khazanah's 37% shareholding, will allow a market-oriented and transparent hike to attract foreign investors via the government-linked companies (GLC) reform concept.

In fact, other government-linked entities like Bank Negara Malaysia, Petroliaam Nasional Bhd and the Employees Provident Fund, if added together, are believed to control close to a total 80% stake in Tenaga.

According to local stockbroker Hwang-DBS Vickers Research, Tenaga's foreign shareholding stood at 12.5% as at August 2005.

#### So near yet so far?

However, some analysts say that a tariff hike may not benefit Tenaga's earnings after all. In an update investment note dated Sept 13, 2005, local stockbroker AmResearch says the Government may approve a tariff hike that is only sufficient

to cover the gas price increase. In other words, it's the Government and its budget that will benefit (by virtue of a smaller gas subsidy) rather than Tenaga itself from the tariff hike.

The research house adds that with the Government having announced measures to curb the cost of living in the country as a result of spiralling crude oil prices and a spike in the August consumer price index (CPI) to 3.7%, its highest level since 1998, it is unlikely the current administration wants to be seen as favouring Tenaga over the man in the street.

Foreign stockbroker Credit Suisse First Boston (CSFB), in its update note dated Sept 9 in response to media reports that the Cabinet had decided not to increase electricity tariffs for the time being, says it believes Tenaga would get a tariff increase at some point in 2006.

However, it adds, the tariff increase would be channelled towards covering higher gas prices and might not be as exciting as some are expecting. It says for every net or premium hike of 1% (over the gas price hike), Tenaga's net profit would increase by 7%-8%.

AmResearch, in expecting a premium hike of just between 0.5%-1.0%, says the whole affair is still a tricky balancing act for the Government between showing its concern for the rise in the rakyat's cost of living and the need to monetise its shareholdings in Tenaga through the

GLC reforms strategy.

It says a way of resolution for the Government could be to restrict the hike only to the commercial and industrial sectors (which account for 80% of Tenaga's sales) while maintaining the tariff for the remaining users, typically the households.

Still, it's not a perfect solution as given time, the businesses are likely to pass down the cost (more often in a disproportionate manner) to the consumers in the form of higher price of goods and services.

#### It won't be immediate

OSK Investment Research says in a recent visit note to the Energy Commission (EC), which regulates the power industry in the country, that the tariff hike will not be immediate, most likely only in 2006.

It says it was told by the EC that even if it did recommend a tariff hike to the Government, consumers should not be burdened by the hike and should not be made to pay for increases related to 'inefficiency' on Tenaga's part.

OSK Research says the EC questioned whether Tenaga really needed the money from the tariff hike. The EC apparently wants to see a higher level of efficiency from Tenaga in using its existing assets and according to OSK Research, the EC does not see Tenaga suffering financially without a tariff hike.

**TABLE 1: ASIAN ELECTRIC UTILITY AND MALAYSIAN UTILITY COMPARABLES**

Company name	Share price (Sept 2, 2005)	Currency	P/E		EV/EBITDA		EV/NOIAT		EV/NOA		RNOA		P/B		ROE		Dividend yield		Net debt/capital	
			2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E	2005E	2006E
Tenaga (Integrated)	10.9	RM	28.5	17.7	10.7	9.1	27.2	22.6	1.4	1.4	5.2%	6.1%	2.2	2.0	7.6%	11.4%	1.2%	1.8%	63.3%	62.4%
Malakoff (IPP)	7.6	RM	13.3	12.9	9.8	9.4	15.9	17.3	1.5	1.4	9.2%	7.8%	2.1	1.9	15.0%	14.2%	3.0%	3.0%	67.9%	67.0%
Malaysian Average			20.9	15.3	10.3	9.3	21.6	20.0	1.4	1.4	7.2%	7.0%	2.2	2.0	11.3%	12.8%	2.1%	2.4%	65.6%	64.7%
Korea Electric Power	32700.00	KRW	8.0	7.9	5.9	5.4	14.4	13.3	0.6	0.6	4.6%	4.8%	0.5	0.5	6.5%	6.2%	3.7%	3.7%	29.6%	28.3%
CLP Holdings	45.75	HKD	11.9	11.3	11.0	10.7	13.3	13.1	1.8	1.7	16.3%	13.5%	2.2	2.0	20.9%	19.7%	5.2%	5.5%	32.4%	31.6%
Hongkong Electric	37.7	HKD	12.4	11.5	11.1	10.2	14.0	12.7	1.8	1.7	13.3%	13.9%	2.0	1.9	17.1%	17.4%	4.9%	5.4%	21.8%	17.9%
Reliance Energy	577	INR	16.9	15.2	12.7	12.1	19.3	17.6	1.7	1.4	11.0%	10.8%	1.6	1.5	10.9%	10.5%	1.0%	1.0%	-41.7%	-17.9%
Tata Power Co	468.2	INR	19.2	17.9	14.9	14.4	21.7	20.9	1.6	1.5	7.7%	7.9%	1.9	1.8	10.6%	10.6%	1.5%	1.5%	32.9%	41.3%
Origin Energy Ltd.	7.38	AUD	18.9	17.7	15.7	12.0	23.0	17.8	1.5	1.4	16.3%	8.1%	2.2	2.0	15.0%	12.0%	2.0%	2.3%	29.4%	25.8%
Asian Integrated Utility Avg			14.6	13.6	11.9	10.8	17.6	15.9	1.5	1.4	11.5%	9.8%	1.7	1.6	13.5%	12.7%	3.0%	3.2%	17.4%	21.4%
China Resources Power	5	HKD	9.6	8.0	9.0	7.9	11.3	10.2	1.3	1.2	15.5%	14.1%	1.6	1.4	20.2%	20.5%	2.6%	3.1%	42.6%	45.8%
Datang Int'l Power	5.85	HKD	11.3	9.8	11.2	9.3	17.1	14.0	1.2	1.2	9.0%	9.4%	1.7	1.6	16.3%	17.3%	4.1%	4.7%	58.1%	57.9%
Huadian Power Int'l	2.1	HKD	13.1	11.0	12.0	12.9	21.2	21.5	1.0	1.0	6.6%	6.1%	1.1	1.0	10.2%	9.7%	2.0%	2.4%	58.8%	65.8%
Huaneng Power	5.6	HKD	15.4	13.1	10.0	8.8	17.1	14.5	1.4	1.3	11.4%	9.8%	1.9	1.7	12.6%	14.1%	4.3%	3.8%	51.4%	50.7%
NTPC	103	INR	16.9	14.6	10.1	9.1	15.1	13.3	2.1	1.9	15.5%	16.4%	2.0	1.9	13.0%	14.0%	2.1%	2.3%	-18.1%	-9.5%
Asian IPP Average			13.3	11.3	10.5	9.6	16.4	14.7	1.4	1.3	11.6%	11.2%	1.7	1.5	14.4%	15.1%	3.0%	3.3%	38.6%	42.1%
Asian Electric Utility Avg.			14.0	12.5	11.2	10.2	17.1	15.3	1.5	1.4	11.6%	10.4%	1.7	1.6	13.9%	13.8%	3.0%	3.2%	27.0%	30.8%

E = Morgan Stanley Research estimates

Source: Company data, Morgan Stanley Research

### Improve efficiency and services first

This is especially so after several ministers had criticised the utility company in the media recently for shortcomings such as late connectivity, power outages and lacklustre customer service.

The media has frequently quoted Energy, Water and Communication Minister Datuk Seri Dr Lim Keng Yaik as saying that the electricity tariff would not be increased for the time being until issues such as the above were addressed by Tenaga, and that it should not be a burden to the population.

### More than just a tariff-hike excitement?

To be fair, analysts say prospects for the power utility stock appear to be improving since a new management was appointed in July 2004 under the GLC reform theme.

Morgan Stanley says the new management has shown increased corporate transparency, citing that in its recent 3QFY05 results announcement, management openly compared the actual cost savings targets to allow investors to monitor management's performance.

It says management is also on track to meet its RM825.5 million cost-saving plan for FY05.

Local stockbroker K&N Kenanga, in raising its rating on Tenaga to a Buy on Sept 8, points out that Tenaga has strong regional expansion potential to increase

electricity sales to neighbouring countries such as Thailand (which has a tight 20% reserve margin) and Indonesia (now on negative reserve margin).

### Investment concerns

However, most analysts are still putting an Outperform recommendation on the stock, citing the timing and quantum of the tariff hike. Other concerns include rising coal prices, its other major sources of fuel for its power plants, and possibly selling pressure on the stock as Tenaga's major government-linked shareholders prepare to trim their stakes.

For example, Khazanah could easily sell its 37% direct stake lower as the stock price moves up without worrying about the Government losing control of the utility.

While the market expects the Government to gradually relieve Tenaga of its considerable social responsibilities and provide a more level playing field for it vis-à-vis other independent power producers (IPPs) in the country and even its regional peers, analysts say the former concern is not about to disappear any time soon.

For example, says Morgan Stanley, Tenaga's decision to spend RM1.0 billion to acquire bankrupt power company, Northern Utility Resources, was unnecessary amid the current high reserve margins in the country and the fact that

the price did not reflect Tenaga being the sole potential buyer then.

Probably more telling is that even after factoring in a potential tariff hike adjustment, Tenaga will still be trading only 'in line' with its regional peers (see Table 1) and with the other two Bursa Malaysia bellwethers, Malayan Banking Bhd and Telekom Malaysia Bhd, according to Morgan Stanley.

Note that this assessment is based by the research house on a full-year impact, ie, on FY07 earnings onwards only. Until then, Tenaga's valuation would apparently not be that attractive.

### Conclusion

It appears likely that a tariff hike will finally be approved for Tenaga next year, eight years after the last hike in 1997. However, given that the Government intends to maintain its caring and conservative image with the population, it is uncertain whether Tenaga will really get to benefit from the hike in terms of its bottom line.

The news flow recently has not been favourable to the company and it may take a lot more public relations exercise than just 'Powering the Nation' adverts to get the Government and the public to accept a tariff hike in its favour.

Most analysts have a fair value of between RM11.50 and RM13.00 for the stock. **mb**