

TENAGA STRIKES BACK?

In the big local power shake-up, it would seem that national utility player Tenaga Nasional stands to benefit, with Independent Power Producers seeing red.

By James S

IT LOOKS like a case of déjà vu – but only this time, it may be for real. After about 10 years since their birth, the Government is now forcing the Independent Power Producers (IPPs) to come to the negotiation table again with Tenaga Nasional Bhd (Tenaga) to review what seems to be lopsided power purchase agreements (PPAs) – or at least, that's what the Government thinks – with the national utility company. There have been calls to renegotiate these PPAs in the past, especially since the last revisions were made back in 1998, triggered by the Asian financial crisis. But each time, the sticky issue did not muster enough support from the IPPs, who, understandably, do not want to get involved at the expense of risking their own water-tight PPAs. Even the 1998 revision involved only small administrative changes and there were no structural changes per se, despite the severity of the financial crisis on Tenaga and the country at large.

As such, what will cause the IPPs to come voluntarily to the table this time around, especially since they have really no legal obligation to do so? Fortunately for Tenaga, this time, it has secured the helping hand it needs, and no other than the Government itself. According to a recent report by Merrill Lynch, ironically entitled 'Power Trip – Malaysia Lacks Long-Term Solutions', the Malaysian Government is on a drive to improve the efficiency of State-Owned Enterprises (SOEs) or Government-Linked Companies (GLCs) as part of its reform initiative. Part of this initiative, the report says, is to get the electric power, gas and water industries' regulatory frameworks right. And in the power sector, the Government is looking at changing the PPAs between TNB and the IPPs.

Forcing the hands of the IPPs

In the past few months, the Malaysian utility sector has certainly seen an

enormous amount of news, relative to the previous five years or so. Apart from the reform initiatives, it's clear that Tenaga has been troubled by the rapid rise in energy commodity prices for the past few years such as gas and coal – so much so that the Government had no choice but to step in to help it reverse its negative cash flows and ensure that the national utility company had enough funds to meet its RM4 billion to RM5 billion capital expenditure yearly. Obviously, part of Tenaga's predicament has also been caused by the high reserve margin imposed on it by the Government and, more prominently, its capacity payments to the IPPs to buy their generated power.

The Government bit the bullet earlier this year and allowed Tenaga to raise its electricity tariff by 12% despite the unpopularity of the move with the public, whom had earlier endured a sharp increase in petrol prices after part of the subsidies were lifted by the Government. Even then,

the tariff hike was much lower than what Tenaga had demanded, and it had also not factored in the subsidy still for its gas prices by Petronas.

As such, somebody needs to pay further to help out Tenaga, especially if gas prices are raised by Petronas. And given the current restlessness of the general public, they are not likely to be in a mood to see another round of increases in electricity tariffs so soon. Unfortunately, rightly or wrongly, the IPPs are seen by the authorities as the ones with deep pockets to help 'contribute back to the industry' after all their profits over the years at the 'expense of Tenaga'.

A win-win situation?

In addition to allowing the tariff hike, the Minister of Energy, Water and Communications (MEWC) Datuk Seri Dr Lim Keng Yaik has added that the MEWC

TABLE 1: REQUIRED EXTENSIONS FOR CAPACITY PAYMENT REDUCTIONS*

Change to Gen 1 capacity payments	Extension required for NPV neutrality
Reduced by 10%	2
Reduced by 20%	5
Reduced by 30%	12
Reduced by more than 40%	ve

* Assumes 10% discount rate, with no terminal value
Source: Macquarie Research

this end, it says that reductions in capacity payments are likely to be met with extensions to PPA concession periods.

However, by its estimates, the PPAs would have to be extended by between two and 12 years to account for capacity payment reductions of between 10% and 30%. In the event that capacity payments

of the IPPs. As such, it would appear that there are certainly no guarantees that the IPPs will be left unscathed by any new PPAs, although analysts are not expecting the last scenario to happen as it will negate the win-win solution approach expounded by the Government.

Firing the first salvo

According to a report by JP Morgan Research in late June entitled 'Examining The Downside on the IPPs', meetings between Tenaga, the IPPs and the Government have already started. In its report, JP Morgan said that the Energy Commission (EC) had outlined a few proposals, which include:

- A 20% cut in capacity payments for the first five PPAs under a supplementary

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is looking at two further changes, that is, the renegotiation of the long-term PPAs Tenaga signed with the IPPs, and the reinstatement of the CPI-X tariff mechanism, which was applied by the Government for a short while back in the mid-1990s.

The Government has stated that it wants a 'win-win' solution, meaning that the new PPAs should lead to lower purchased power costs for Tenaga but at the same time not negatively impacting the long-term returns of the IPPs. According to Merrill Lynch, this can be achieved by 're-setting' the PPAs' timeframe and giving them a new lease of life. The PPAs may also have to include a variety of new clauses, including, for example, incorporating demand risk-sharing characteristics.

Meanwhile, according to a report to its clients on the issue by Macquarie Research, the research house believes that from a valuation standpoint, the Government is genuine in stating that any restructuring of the power industry will leave the IPPs' valuations intact. To

are reduced by 40%-50%, as per the terms of the Generation 2 and Generation 3 PPAs (see accompanying story) midway through their concessions, it is likely that the value of these IPPs could be adversely impacted even if the PPAs were extended to perpetuity. The above estimates are based on a 10% discount rate, which is similar to the discount rates used on most

- The supplementary agreements will allow for a 15-year extension on the PPAs at the same discounted rate to ensure that the remaining net present value (NPV) of the respective concessions remain intact,
- The savings from lower capacity payments will allow the current

TABLE 2: IMPACT OF SUPPLEMENTARY AGREEMENTS ON TO THE FIRST FIVE PPAs

Company	Stake	Plant	MW	FCF to equity	FCF to firm	FY07 EPS	FY08 EPS
YTL Power	100%	Paka & Pasir Gudang - base load	1,212	-37%	-20%	-15%	-14%
Malakoff	95%	Segari Energy Ventures - base load	1,303	-31%	-17%	-10%	-7%
Tanjong Plc	100%	Telok Gong - peaking	440	-14%	-10%	-6%	-4%
Genting	60%	K. Langat - base load	720	-5%	-5%	-3%	-2%
Sime Darby	75%	PD Power - peaking	440	-5%	-5%	-2%	-2%

* assumes depreciation of assets will be adjusted on 15-yr extension of concession period
Source: JP Morgan

subsidised gas prices to rise. JP Morgan estimates the savings to be RM552 million here alone, which will allow gas prices to rise from RM6.40 per mmbtu to RM7.50 (just above the industrial rate) without affecting Tenaga's profitability. However, note that the new price level will still remain highly subsidised as the global market price is estimated to be around RM30.00 at present, and

- The deferment of large-scale IPP projects, namely, Phase 2 and 3 of Malakoff's Tanjung Bin plant and the 1,400-MW Jimah plant.

Note that the EC is currently led by its new Chairman and CEO Datuk Pian Sukro, who has been mandated to turn the commission into a full-fledged regulatory body where executive powers would eventually be held. The commission is central in drafting key proposals for the Government in the sector's reform.

IPPs' earnings and dividends will be hit

JP Morgan cautions that the above proposals merely represent the wish list of the Government and the final agreement is likely to be watered down by the IPPs. Still, it says the above terms could be used to project a worst-case scenario to estimate the potential downside to the IPPs, assuming the above terms are applied to the first five PPAs or commonly known as the Generation 1 IPPs.

As shown in Table 2, the impact on the near-term earnings of pure IPP players like YTL Power International (YTL Power) and Malakoff are more pronounced, while it is much smaller on the other IPP players like Tanjong Public Limited, Genting and Sime Darby (who are not pure IPP players and have other large core businesses). Despite the hit to earnings, JP Morgan points out that the discounted cash flow (DCF) net present value (NPV) valuation of the respective IPPs should be intact, given the likely 15-year extensions to the concession period. Still, the research house believes that these IPP market valuations could be hurt if they

can't maintain their dividend payout policy (see Tables 3 and 4).

Macquarie Research agrees, concluding

that the IPPs are set to see their short to medium-term earnings and dividends come under pressure despite NPV values

remaining relatively unchanged. It estimates that every 10% reduction in Generation 1 IPP revenues will affect the listed IPP profits by up to 7%. Note that dividends have been a major driver of the IPPs' valuation in the past and thus affect the market valuation and sentiments of the IPP stocks.

TABLE 3: ANALYSIS OF ABILITY TO MAINTAIN DIVIDEND PAYOUT POLICY AFTER CUT IN CAPACITY PAYMENTS

	FY07E FCF to equity	cut in capacity payment	FCF after sup. agreement	FY07 debt due	FY07E net cashflow	FY07E div	surplus/ deficit
YTLP	509	-195	314	225	89	369	-280
Malakoff	480	-155	325	505	-180	-	-180
Tanjong	440	-63	377	80	297	209	88
Genting	1762	-81	1681	115	1566	147	1419
Sime Darby	1243	-63	1180	258	922	487	435

Source: JP Morgan

Industry restructuring favours Tenaga

Macquarie Research believes that efforts to restructure the power industry will be incrementally positive, especially for Tenaga. It adds that the recent announcement by the Government of a reduction in reserve margins from 30%-35% to 20%-25% is also a positive

TABLE 5: DOMESTIC POWER SECTOR VALUATIONS

	FYE	Price (RM/s)	EPS GWTH (%)		PER (X)		EV/EBITDA (X)		P/CF (X)		GDY (%)		Rec
			FY06	FY07	FY06	FY07	FY06	FY07	FY06	FY07	FY06	FY07	
Tenaga	Aug	8.95	60.3	52.4	18.0	11.8	9.7	8.0	5.2	4.9	2.8	4.2	OP
Tanjong	Jan	12.80	16.7	16.2	11.8	10.2	8.2	6.9	8.0	6.8	6.2	6.6	OP
Malakoff	Aug	9.45	-1.1	42.9	16.7	11.7	11.9	8.8	6.7	5.5	3.3	4.7	MP
YTL Power	Jun	1.89	-8.2	6.4	14.3	13.4	7.7	7.8	6.0	5.9	5.3	5.3	MP
Sector Avg			11.0	33.5	15.7	11.5							

FY06 & FY07 refer to those of FY07 & FY08

Source: RHB Research

TABLE 4: FY07F DIVIDEND AND YIELDS OF MAJOR IPPs

	Price (RM)	Div yield	DPS (sen)	Payout ratio
Malakoff	9.30	4.4%	41	38%
YTL Power	1.89	5.3%	10	50%
Tanjong	13.30	7.9%	105	60%
Genting	21.60	1.3%	29	11%

Source: Macquarie Research

development for the national utility company. The research house expects the introduction of a tariff formula to improve Tenaga's earnings visibility further.

To underscore its argument, Macquarie Research points out that the recent tariff increase has made Tenaga's valuations undemanding versus its regional peers, while its return on equity (ROE) is set to jump from only 8% to 17% by financial year (FY) 07.

RHB Research, in a report on the PPAs' review, agrees, concluding that Tenaga is the sole winner of the whole review as it says that the Government is apparently keen to bolster Tenaga's earnings at the expense of the IPPs. RHB Research estimates that Tenaga's FY07-FY08 forecasts could actually rise by 13% per annum if the IPP capacity payments are reduced by 10%, and by 20%-25% per annum if IPP payments for the 2,100-MW coal-fired Tanjung Bin power plant are deferred.

Rising fuel cost impact on Tenaga also muted

Macquarie Research expects that while thermal coal prices are likely to remain buoyant and gas prices will be raised over the next 12 months, it believes that the

impact on Tenaga will be muted. Likely reductions in IPP payments, coupled with the potential introduction of a tariff formula, are likely to absorb the higher fuel costs, it concludes. The research house believes that the market has not

factored this into the valuations of Tenaga and local power players as yet.

Tenaga valuations now attractive

A number of analysts are betting that Tenaga's period of relative underperformance to its IPP peers in Malaysia in the last couple of years is about to end. According to RHB Research and Macquarie Research, the recent tariff hike has brought Tenaga's multiples well within regional ranges and made its shares attractive versus the domestic IPPs (see Table 5). With industry restructuring likely to benefit Tenaga, the risk-reward payoff appears to be clearly in Tenaga's favour at the expense of the historically well-favoured IPPs.

It's not all clear for Tenaga though

According to RHB Research, if the Government goes on to defer the new plants, Tenaga will effectively be handed a triple win. However, it's not a home run yet for Tenaga as the research house believes that the economic slowdown will translate to lower electricity demand. In its report, it said that it had earlier expected demand growth to recover to 5.5% in FY06, but has now had to cut its demand growth

assumption from 5.5% per annum to just 4.0% for FY06-FY08. Accordingly, RHB Research has cut its FY06-FY06 earnings per share (EPS) forecasts for Tenaga by 9%-17% and its DCF-derived fair value for Tenaga to just RM10.30 per share from RM11.50 previously, implying a smaller 12% upside to the current share price of RM9.20.

Another concern with some analysts is that the authorities still seem to lack a clear vision as to what the energy and utilities industries should look like in the long term. Merrill Lynch believes that a medium (10 years) to long-term (20 years) energy planning plan is urgently needed in Malaysia. It remarks that the Government appears to think that all of the 'evils' in the electric power industry can be resolved by doing away with legally binding contracts. On another point, it notes that as gas reserves are gradually drawn down over the next decade, there is little clear planning as to the long-term energy mix for the industry. This, it says, is manifested, for example, by a failure to meet renewable energy source targets set a few years back.

Conclusion

The current Government review of existing PPAs between Tenaga and the IPPs is likely to lead to lower rates for IPPs, especially Generation 1 IPPs. While the concession periods of the PPAs are likely to be extended as compensation, there appears to be some significant downside risk to their earnings and dividends over the medium-term. Most analysts favour Tenaga in the coming industry shake-up, which is getting a helping hand from the Government itself, while some other analysts are critical of the whole review. 