

# Electricity Sector

## More Positive Smoke Signals From Labour Policy

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The Labour Party's NZAS policy release provides a little more confidence that a deal to keep NZAS open for a few more years is likely. That said, in our view, the policy puts in writing what Government ministers have been saying for more than a month, that constructive negotiations with Rio Tinto (RIO) are ongoing, so in that context the positive share price reaction is a surprise. Whilst we view an extension as the most likely outcome of negotiations, there are still a variety of plausible scenarios.

### **Labour NZAS policy is a continuation of existing negotiations – nevertheless provides a little more certainty**

Labour's policy is to negotiate with RIO to ensure the smelter stays open for 3–5 years, enabling an easier transition for the Southland economy. In effect Labour is promising to continue current negotiations. Support for NZAS will come in the form of lower transmission charges, with Labour likely to accept a lower dividend from Transpower to ensure there is no increase in power prices for consumers. Labour has also set out four conditions for a deal, the two key conditions being continued staff employment and an agreement on land and aluminium dross remediation.

### **Environmental condition could be a stumbling block/result in an alternative outcome**

The environmental condition is interesting as it indicates the current legal requirements on RIO to remediate land are not significant (notwithstanding the NZ\$299m provision in NZAS's financial statements). Labour's language that it expects RIO will "do the right thing" is a further indication the current legal requirements are not onerous. That raises some questions: what did RIO assume when it announced closure? And will the combined Transpower/MEL/CEN reduced electricity price offer offset the increased remediation expectations? These are not trivial questions and in our view means an extended deal is not a *fait accompli*.

### **How important is option value to NZAS?**

In addition, if NZAS accepts a government deal it likely destroys any option value. We expect Meridian Energy (MEL) and Contact Energy (CEN) will sell the discount power NZAS currently receives to replacement demand (dairy/data centres/hydrogen). If RIO wants to preserve optionality (which has arguably increased in value over the past 2.5 months due to aluminium prices firming and ESG issues becoming more important), accepting a deal involving the Government is not an option. Alternatives would be reversing its July decision or accepting MEL's low priced offer to 2030. Current scenarios, as we see them, are summarised on the next page.

### **Surprising share market reaction, but more upside if NZAS does stay open due to increased dividend yield certainty**

All of the electricity stocks had a positive day, with CEN, MEL and Mercury (MCY) lifting +6.1%, +6.6% and +7.4% respectively. The share market reaction is surprising to the extent that in our view Labour's policy announcement puts into writing what Government ministers have been saying for the past month in various interviews – i.e. constructive negotiations with RIO are ongoing. That said, whilst share prices are closing in on pre-closure announcement prices, we see further upside if RIO announces an extension deal given the fall in interest rates and the strong performance of yield stocks.

The other relevant market we follow is the ASX electricity futures market. The reaction today was muted, but the FY22 price is above the pre-closure announcement price, implying a near 100% chance NZAS will stay open longer.

### **Dividend considerations**

If NZAS does stay open for longer, the main beneficiaries (as measured by an increase in our FY21 dividend forecast) are Genesis Energy (GNE), CEN and Trustpower (TPW) in that order. Whilst MCY and MEL had the strongest share price performance, we do not expect either company to lift FY21 dividends – for MCY that will occur in FY22 and MEL still needs to digest the strong FY20 performance, and it will be "paying" ~1.7cps worth to NZAS.

## Possible scenarios

Figure 1. Possible scenarios

Scenario	Rationale/thesis	FB probability
NZAS closes in August 2021.	RIO still wants to close NZAS and remediation requirements too great to accept the offered extension deal.	Unlikely
RIO reverses its decision and reverts to 12 month notice period (on a lower price than currently, but higher price than options below).	Changes at executive level and greater RIO emphasis on ESG causes reversal of original decision. Remediation costs now fully factored into decision. Also retains RIO optionality.	Highly unlikely
RIO accepts Transpower/MEL/CEN offer and extends for 3 to 5 years.	RIO still wants to close NZAS (for portfolio reasons) and was going to undertake remediation anyway – lower electricity price offer too good to refuse.	Probable
RIO reverses closure decision and decides to accept long-term deal to 2030.	RIO wants to maintain optionality/ESG considerations make staying open more attractive and accepting MEL/CEN long-term electricity price offer better than reversing decision.	Unlikely

Source: Forsyth Barr analysis

## Dividend estimates if stays open for longer

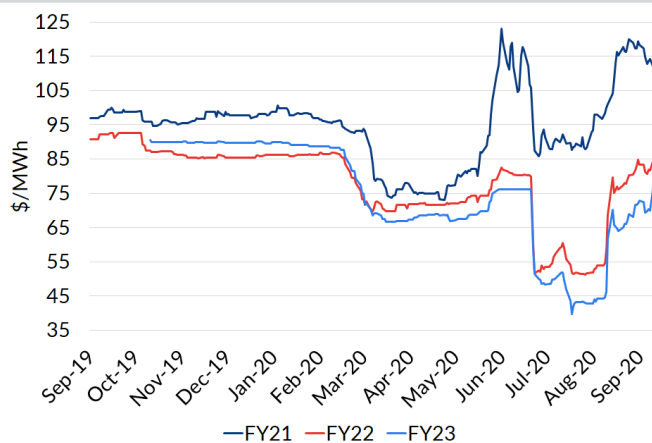
Figure 2. Dividend scenario if NZAS extends

Coy	FY21 dividend (assumes August 2021 closure)	Cash dividend yield	FY21 dividend (assumes extension deal)	Cash dividend yield	Comment on dividend assuming extension deal is negotiated
CEN	32.0	4.8%	36.0	5.4%	Reduced -3cps from FY21 – 39cps due to providing support for NZAS extension contract
GNE	14.0	4.7%	17.5	5.9%	Lift back to be consistent with current dividend policy. 17.5cps is +0.3cps higher than FY20 dividend
MCY	17.0	3.3%	17.0	3.3%	MCY stays with guidance – but FY22 increase more likely after Turitea windfarm commissioning
MEL	16.9	3.4%	16.9	3.4%	Special div not reinstated and no increase due to FY20 earnings being so high and NZAS support
TPW	30.0	4.2%	32.5	4.6%	Lift back to FY20 32.5cps dividend

Source: Forsyth Barr analysis

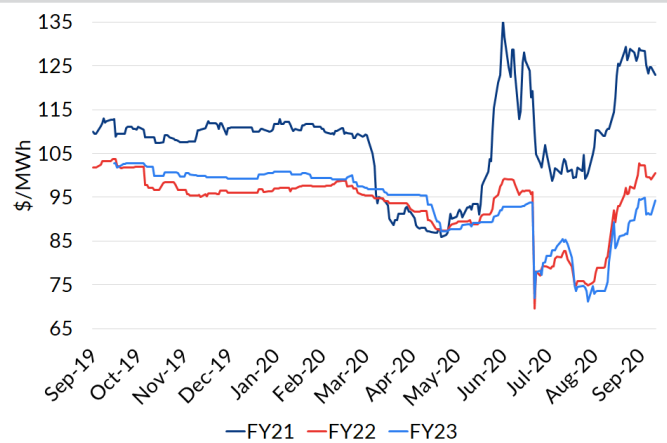
## ASX electricity futures and share price movements

Figure 3. BEN futures price

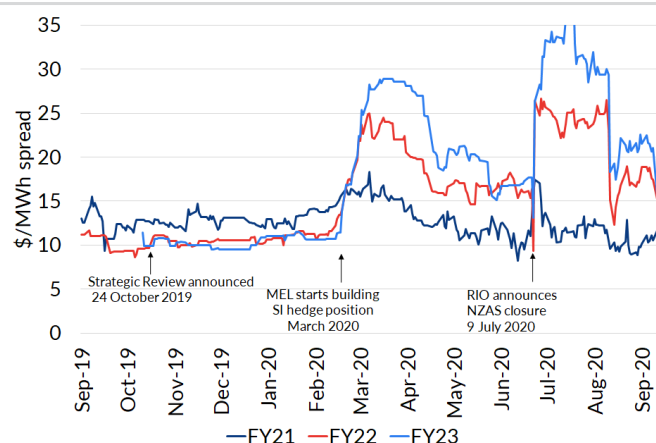


Source: IRESS, Forsyth Barr analysis

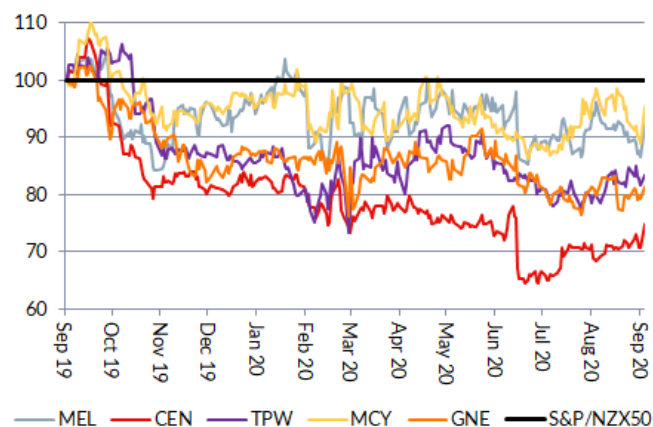
Figure 4. OTA futures price



Source: IRESS, Forsyth Barr analysis

**Figure 5. OTA-BEN spread**


Source: IRESS, Forsyth Barr analysis

**Figure 6. Share price movements**


Source: Thomson Reuters, Forsyth Barr analysis

**Figure 7. Market multiples**

Company	Code	Price	Target	Target	Rating	Mkt Cap	EBITDAF (x)		EBITDAF - capex (x)	
			Price	Return			FY21	FY22	FY21	FY22
Contact Energy	CEN	\$6.65	\$8.00	25.1%	OUTPERFORM	4,758	13.2	14.6	16.0	17.9
Genesis Energy (excl Kupe)	GNE	\$2.96	\$3.00	6.3%	NEUTRAL	2,756	13.1	15.0	15.7	18.5
Mercury	MCY	\$5.09	\$5.30	7.5%	NEUTRAL	6,927	15.8	16.3	18.6	19.2
Meridian Energy	MEL	\$4.96	\$5.50	14.4%	OUTPERFORM	12,700	17.9	21.4	19.4	23.5
Trustpower	TPW	\$7.09	\$6.55	-3.4%	NEUTRAL	2,219	14.9	14.9	17.2	17.1
Sector average							14.9	16.2	17.3	19.1
Tilt Renewables	TLT	\$3.56	\$4.10	15.2%	OUTPERFORM	1,339	15.7	10.2	18.1	11.2
Genesis Energy (incl Kupe)	GNE	\$2.96	\$3.00	6.3%	NEUTRAL	3,065	10.8	11.5	12.6	13.5

**Figure 8. Market multiples continued**

Company	PE (x)		Adjusted PE (x)		Cash Div Yield		Gross Div Yield		Free Cash Flow Yield	
	FY21	FY22	FY21	FY22	FY21	FY22	FY21	FY22	FY21	FY22
Contact Energy	48.0	53.2	20.9	23.8	4.8%	4.8%	5.7%	5.7%	5.6%	5.9%
Genesis Energy (excl Kupe)	86.1	100.0	22.7	23.4	3.5%	3.2%	4.8%	4.5%	6.6%	4.5%
Mercury	42.0	51.4	25.5	28.1	3.3%	3.3%	4.6%	4.5%	1.1%	2.3%
Meridian Energy	44.1	60.9	27.2	33.1	3.4%	3.4%	4.5%	4.4%	3.2%	2.5%
Trustpower	30.9	30.5	25.3	25.0	4.2%	4.2%	5.9%	5.9%	4.9%	4.9%
Sector average	47.3	55.1	24.2	26.4	3.8%	3.8%	5.1%	5.0%	4.3%	4.0%
Tilt Renewables	501.0	353.7	33.5	21.5	0.0%	0.0%	0.0%	0.0%	1.8%	7.3%
Genesis Energy (incl Kupe)	43.2	42.5	16.5	15.9	4.7%	4.7%	6.6%	6.6%	8.8%	7.1%

Source: IRESS, Forsyth Barr analysis

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