NEW ZEALAND EQUITY RESEARCH
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Electricity Sector
Four More Years — NZAS Open For Longer

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Rio Tinto (RIO) has announced it has accepted Meridian Energy's (MEL) lower electricity price offer and will continue operating NZAS until at least 31 December 2024, with the electricity contract terminating at that point in time. Interestingly there is currently no deal with the government, with discussions ongoing. The deal is a positive for the sector as it provides certainty for the next four years. Our forecasts, target prices and ratings are all under review.

New electricity deal information

The 572MW electricity contract is actually two separate contracts, one for 400MW and one for 172MW. The 400MW contract has a fixed term to 31 December 2024. The 172MW contract has more optionality and RIO can, with six months notice (available from 1 January 2022), terminate the 172MW contract (i.e. the first date it can terminate is 1 July 2022). Contact Energy (CEN) has indicated it is supporting ~100MW of the 572MW (17%) (+20MW more than it currently provides). Whilst the contract price is confidential, we know it is better than the price RIO rejected in July 2020. We estimate RIO's annual saving is ~NZ$100m, which equates to a revised contract price of ~NZ$35/MWh, ~-NZ$20MWh lower than the current price. There is no CPI uplift and the revised contract takes effect immediately.

Finding replacement demand of critical importance

MEL (and CEN's) focus over the next few years is to find replacement electricity demand. We believe that in 18–30 months RIO will likely seek to extend the electricity contract beyond 2024. It is in MEL's interests to have found alternative demand sources, such that it can enter any future negotiations requiring a market price for electricity. The 60MW+ data centre announcement pre-Christmas is part of that strategy. Transpower's lower South Island transmission upgrade helps and reduces the amount of replacement demand required (Transpower has confirmed there is no impact on the upgrade project which is due for completion in May 2022). Other sources of new demand include process heat (e.g. dairy factory conversion, we see 50MW to 100MW as likely) and green hydrogen.

For the first time RIO has relinquished its option value (albeit for a cheap electricity price). It is up to MEL (and CEN) to ensure RIO doesn't still have pricing power in 2022/2023 (assuming it seeks a contract extension).

Sector earnings, target prices, ratings and dividend forecast under review

All of our sector forecasts, target prices and ratings are under review. Relative to our current forecasts (which assume NZAS closes on 31 August 2021), Genesis Energy (GNE) is the big winner. Its gas contracts will have largely rolled off by the end of 2024 and we no longer expect extreme retail price competition. Whilst CEN and MEL had the biggest short-term downside from NZAS closing, they are also going to be receiving less for their electricity (as noted above), hence, their earnings upside is muted (MEL more than CEN).

From a dividend perspective we expect sector dividends to revert to pre-NZAS closure announcement levels, with the exception of CEN and MEL. MEL ceased its special dividend at the FY20 result and we do not expect it to be reinstated. CEN's old dividend was 39cps. It is likely to provide revised guidance at its 1H21 result in February 2021. Our initial thinking is it will reduce its dividend -3cps to 36cps, slightly more than the -2cps lower the NZAS electricity price warrants. We detail indicative sector dividends over the page.

Generation development implications

With NZAS staying around for longer, we expect CEN and MEL to both push go on new builds that were put on hold when RIO announced NZAS was closing. CEN's NZ$600m, 150MW Tauhara geothermal development is likely to be first underway (an announcement at CEN's 1H21 result is a strong possibility). At this stage we do not believe it will have to raise equity, albeit it is a possibility. MEL's 160MW Hawkes Bay Harapaki wind farm is also likely to go ahead. GNE will also have confidence to push ahead with its support for new renewable electricity builds.

Indicative dividend

Figure 1. Indicative dividend

	July 2020 forecast Pre-NZAS closure		Current forecast NZAS closes Aug `21		Indicative dividend NZAS open for longer	
	FY21	FY22	FY21	FY22	FY21	FY22
Cash dividend (cps)						
CEN	39.0	39.0	32.0	32.0	36.0	36.0
GNE	17.5	17.8	14.0	14.0	17.5	17.8
MCY	16.2	18.1	17.0	17.0	17.0	18.1
MEL	21.5	21.3	16.9	16.9	16.9	17.1
TPW	32.5	34.0	32.0	30.0	34.0	34.0
Cash dividend yields						
CEN	4.0%	4.0%	3.3%	3.3%	3.7%	3.7%
GNE	4.7%	4.8%	3.7%	3.7%	4.7%	4.8%
MCY	2.3%	2.5%	2.4%	2.4%	2.4%	2.5%
MEL	2.7%	2.7%	2.1%	2.1%	2.1%	2.2%
TPW	3.8%	4.0%	3.8%	3.5%	4.0%	4.0%

Source: Forsyth Barr analysis

Indicative dividend change comments:

- **CEN** likely to trim its dividend vs. July 2020 forecast due to lower electricity price provided to NZAS. Our current thoughts are it will lower its dividend -3cps (-8%) to 36cps.
- **GNE** dividend likely to stay at pre-July 2020 levels.
- **MCY** FY21 dividend guidance surprised on the upside at the FY20 result, hence, the FY21 dividend increase vs. the July 2020 forecast.
- **MEL** ceased its special dividend programme at the FY20 result. We expect MEL to maintain its current ordinary dividend, but with new development projects likely, and the significant support to NZAS in the form of a lower electricity price, the special dividend is unlikely to resume.
- **TPW** paid a higher than expected 1H21 interim dividend at its November 2020 result, hence, we are likely to lift our FY21 dividend forecast above the July 2020 forecast.

Indicative FY22 EBITDAF and EV/EBITDAF

The indicative FY22 EBITDAF equals our pre-NZAS closure announcement (July 2020) EBITDAF forecast, less the reduction in NZAS revenue for CEN and MEL.

Figure 2. Indicative FY22 EBITDAF and EV/EBITDAF

	Jul-20	Current	Indicative	Change vs. current forecast		Indicative FY22
	$m	$m	$m	$m	%	EV/EBITDAF
CEN	474	397	457	60	15%	17.4
GNE	433	386	433	46	12%	11.9
MCY	542	495	542	48	10%	19.9
MEL	813	677	730	53	8%	30.1
TPW	209	190	209	19	10%	15.9

Source: Forsyth Barr analysis

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