POWER

Downgrade to NEUTRAL

(Previously Positive)

Initial Thoughts on Sector Reform Plans

KEY INVESTMENT HIGHLIGHTS

- **Cabinet approves 10-Year Masterplan for power sector reform, some details shared by the Minister**
- **Transmission & distribution to remain monopoly in the mid-term, a Third Party Access framework to be worked on**
- **Transition to capacity and energy markets from the traditional PPAs, fuel sourcing to be liberalized – interesting to see the implication of the shift from a single bulk buyer of fuel to more distributed ones**
- **Old capacity to be allowed back into the system via NEDA+, potentially benefits expired IPPs**
- **Sector downgraded to NEUTRAL following our recent downgrade of Tenaga (NEUTRAL, TP: RM14.40). YTL Power (BUY, TP: RM0.88) and Ranhill (BUY, TP: RM1.45) are our top sector picks; not ruling out potential comeback of YTL Power in the domestic power scene**

In-line with indications over the past 12 months, the Cabinet has approved a 10-year Masterplan to reform the domestic power sector. While details have yet to be ironed out, the key reform initiatives are: (1) To allow generators to source their own fuel to optimize cost (2) To move from a PPA regime to a capacity and energy market (3) To establish a TPA (Third Party Access) framework and network charges for the grid (4) To facilitate green energy producers and consumers.

T&D remains a natural monopoly in mid-term. T&D asset ownership is to remain with Tenaga as a natural monopoly in the mid-term. However, a TPA-like model (Third Party Access) is likely to be adopted to facilitate new players' access to the national T&D infrastructure. A TPA framework is expected to be finalized by end-2022. In the meantime, to facilitate P2P (peer-to-peer) RE trading, an RE buyer is allowed to enter into a 3rd party contract with an RE supplier to acquire a minimum 20MW directly from the supplier while Tenaga will be paid a fee for utilization of its grid network. Under the IBR, tariffs are already unbundled; transmission accounts for 10% of the current RP2 regulated tariff (4.03sen/kwh) while distribution accounts for 18% (7.15sen/kwh) – this should provide a base yardstick as to the expected charges for access to the grid. Given the monopolistic nature of asset ownership, T&D is likely to remain under a regulated regime. Whether electricity retailing is done by Tenaga or via 3rd parties, electricity consumption, hence the volumes funneled through the T&D network, is likely to remain similar. T&D accounts for the bulk of Tenaga's regulated earnings (See Exhibit 4).

EXHIBIT 1: RP2 TARIFF COMPONENT

RP2 Tariff Component (sen/kwh)	RP2	% of Total
Generation (Single Buyer)	27.05	68.6%
Transmission	**4.03**	**10.2%**
Distribution	**7.15**	**18.1%**
Customer Services	0.96	2.4%
Single Buyer Operations	0.19	0.5%
Grid system operations	0.06	0.2%
Total	**39.45**	**100%**

COMPANY IN FOCUS

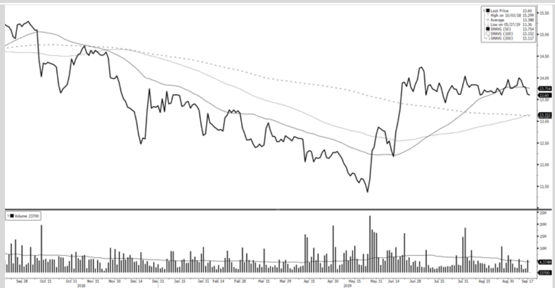
Tenaga Nasional Bhd

Maintain NEUTRAL | Unchanged Target price: RM14.40

Price @ 17th September 2019: RM13.60

- T&D likely to remain a natural monopoly in the mid-term, bulk of regulated earnings remain intact for now
- Power generation likely to see more competition in the long-run from gradual shift towards a more merchant-like market vs. traditional PPAs previously

Share price chart



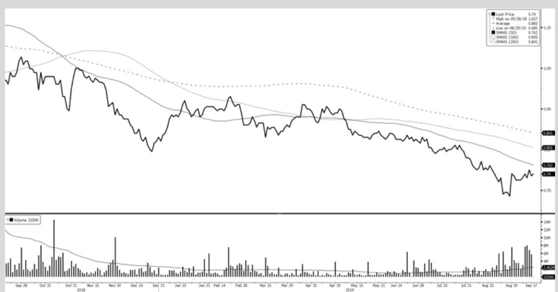
YTL Power Bhd

Maintain **BUY** | Unchanged Target price: RM0.88

Price @ 17th September 2019: RM0.73

- NEDA+ provides an avenue for expire IPPs to re-enter the market via competitive bidding
- Not ruling out a potential comeback into the domestic power sector via both competitive generation market and entry into retailing

Share price chart



ANALYST

HAFRIZ Hezry

hafriz.hezry@midf.com.my

03 -2173 8392

Capacity and energy market. The Government is planning to do away with the existing PPA structure which essentially guarantees both capacity payment and energy payment (the latter, via the fuel cost pass-through mechanism). While future PPAs are still expected to involve capacity payments (which covers the fixed cost element of a power plant), there will be no more locked-in energy payments. Additionally, future PPAs will have much shorter tenures than the current 21-year PPAs. The impact of this move is gradual given that the last PPA will expire some time in 2045 (before taking into account the latest Tadmax and Gurun PPAs). MESTECC intends to roll out the new PPA structure with a first capacity auction by end-2023, earliest.

How low are we willing to go? It is unclear at this point how the new PPA structure/hybrid market will pan out for power producers i.e. whether the bulk of the profit element will still remain in capacity payment, and if so, in times of heightened competition, whether players are willing to sacrifice these (indirectly, by accepting lower energy payment) to bid for dispatch. As it is, the returns for a power plant has already been driven down to single-digits (mid-to-high single-digits) and it would be interesting to see how low players are willing to go to gain a slice of the pie, in a more volatile revenue and profit environment (essentially, in a higher risk market).

Old capacity to be allowed to return? In the meantime, power producers with excess capacity or expired PPAs are allowed to return to the system via the NEDA+ platform – to sell capacity and energy via spot contract to the Single Buyer. This move is a potential positive for players with expired/expiring capacities such as YTL Power and Malakoff. The former has only been given a short-term extension of its 1st Generation Paka IPP (585MW) which will expire in mid-2021, while the latter entails a lot of 2nd Gen IPPs which will gradually fall off over the next decade. Tenaga too, will see a number of its SLA-based plants and PPAs expiring over the same period.

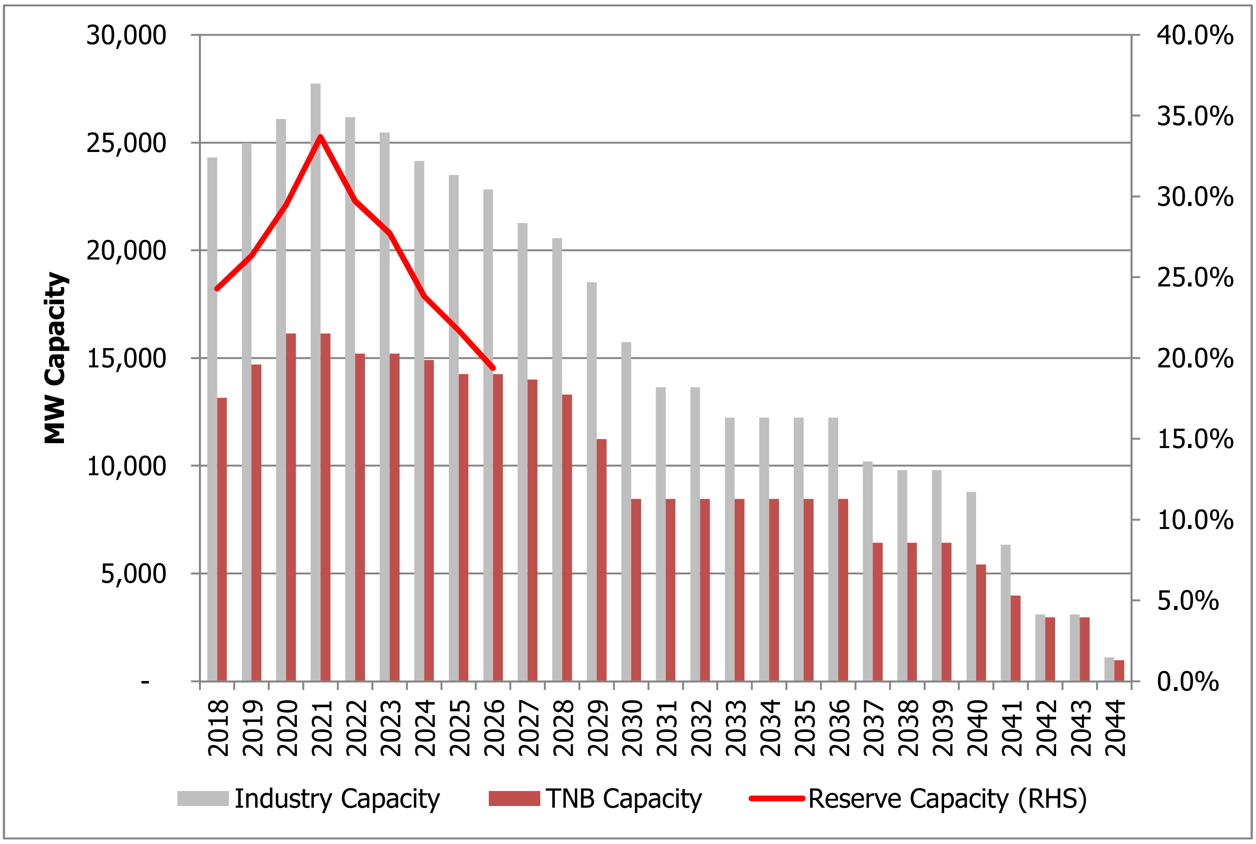
EXHIBIT 2: OUTGOING VS. INCOMING PPA CAPACITY BY KEY PLAYERS

2019-2029 (MW) (Cumulative)						
Operator	**Outgoing capacity**	**Portion of outgoing capacity**	**Incoming capacity**	**Net incoming/(outgoing) capacity**	**Hydro**	**Net (ex-hydro)**
TNB	5,352	47%	3,440	(1,912)	1,299	**(613)**
Edra	2,151	19%	2,242	91	-	**91**
Malakoff	2,729	24%	-	(2,729)	-	**(2,729)**
Total	**10,233**		**5,682**	**(4,551)**		**(3,251)**

Source: EC, MIDFR

Implication on "effective" reserve capacity. The majority of 1st gen PPA extensions are expiring in the next three years, while the 2nd Generation PPAs will start to expire from 2020 onwards. We estimate circa 1.6GW of installed capacity to expire by end of RP2 (end-2020) with the first 2nd Gen IPP to expire being Edra's Pahlawan Power (322MW CCGT) in August 2020. However, incoming new capacity is expected to far outstrip expiring capacity in the near to mid-term. Jimah East will add an additional 2000MW (coal) capacity by end-2019 while Southern Power Generation (SPG, under Track 4A) will further add another 1440MW (CCGT) capacity by end-2020. This compares to a total of 1654MW of outgoing capacity in the same period. Reserve capacity is estimated to peak sometime in 2021 (before taking into account the latest Tadmax and Gurun PPAs), before falling thereafter to ~24% by 2025. However, if old capacities are allowed to return into the system, "effective" reserve capacity could rise to as high as 40% (assuming all expired capacity from 2017 onwards, including the 1st Gen IPPs that received extensions returns to the system). There is no impact on PPA-based IPPs as returns are already largely fixed via capacity payments, but this might eventually create intense competition once the transition to the capacity and energy market becomes more prominent.

EXHIBIT 3: INDUSTRY PPA CAPACITY VS. RESERVE CAPACITY

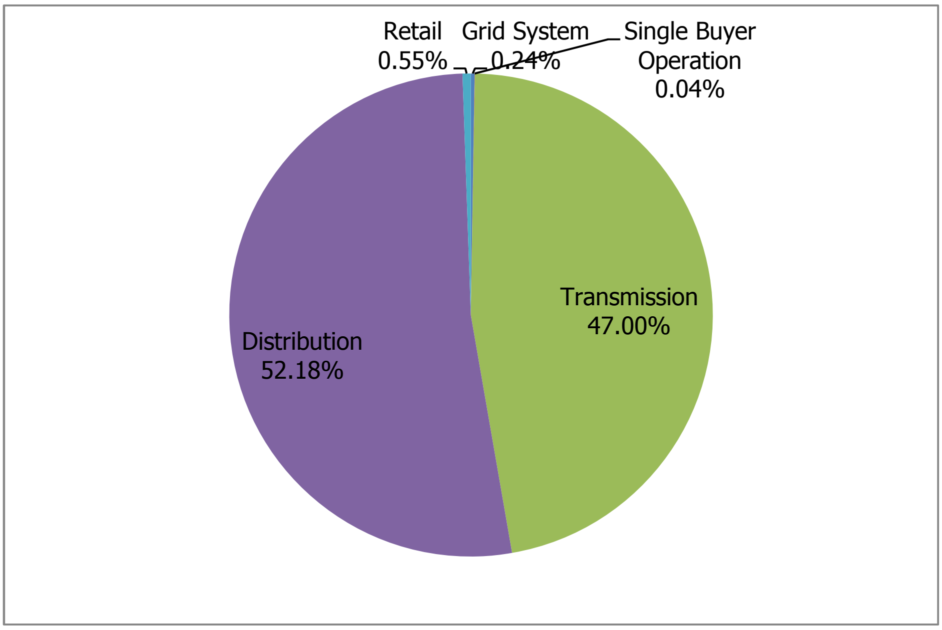


Source: EC, MIDFR

Fuel sourcing liberalization. Currently, Tenaga is the sole supplier of coal to the power sector via wholly-owned TNB Fuel Services Sdn Bhd. Meanwhile, gas for the power sector is supplied by Petronas via a Gas Supply Agreement (GSA) with Tenaga. Tenaga does generate small commissions from fuel sourcing (a small percentage of the value of fuel sourced, we understand). However, Tenaga sources fuel in bulk i.e. one buyer for an entire industry's consumption. It would be interesting to see how much lower fuel sourcing cost can be brought down if the purchases are broken down, or if Tenaga itself can bring down fuel sourcing cost if driven by market forces. Assuming a 0.5% fee charged for coal supplies to the power sector, we estimate RM59m revenue from coal supply commissions, based on the value of coal supply in FY18. This is ~1% of Tenaga's overall group earnings. The EC is expected to offer supplementary agreements to IPPs to enable them to source their own coal and gas (if they decide to opt for this) in 1H21.

Opening up of the retail market. The opening up of the retail market has been one of the most expected moves in the sector reform. Our brief first thoughts: (1) If cost of sourcing electricity for new retailers is similar, Tenaga will be a tough competitor given its current dominance in the retail segment and a strong balance sheet backing (2) If new retailers are willing to undercut Tenaga, this potentially means lower returns than the current 7.3% Tenaga is getting under the regulated framework. On the flip side, if more value added is offered as part of the new competitive landscape and liberalised market, this could actually mean increased returns for both Tenaga and the new retail players. Tenaga is estimated to generate earnings of RM19m-RM20m from the retail segment, accounting for just 0.4% of group earnings and 0.6% of regulated earnings. The pilot opening up of the retail segment is expected in 2Q21.

EXHBIIT 4: ESTIMATED BREAKDOWN OF TENAGA'S REGULATED EARNINGS



Source: EC, MIDFR

Downgrade sector to NEUTRAL. Following our recent downgrade of Tenaga, we downgrade the power sector to NEUTRAL (from POSITIVE previously). Our **NEUTRAL call on Tenaga is maintained** at **unchanged TP of RM14.40/share**, following strong share price recovery in the past 4 months. The implications of the sector reform on Tenaga is not major in the near-term, but Tenaga is expected to experience increased competition in the generation space in the longer-run.

Maintain BUY on YTL Power. Our SOP-based TP remains unchanged at RM0.88/share. YTLP could potentially stage a comeback into the domestic power sector riding on NEDA+ (which allows the re-entry of expired IPPs into the system) as well as an entry into the retail segment. The stock is trading at undemanding PER of 9x, while dividend yields are solid at 7%-8%. Key catalysts: (1) Financial close of Tg. Jati power plant (2) Completion of 45% owned Jordan shale power plant mid-CY20F (3) Consolidation in Singapore power generation sector, (4) Gradual expiry of LNG supply contracts for Singapore power, (5) Accelerated breakeven of mobile broadband business from any potential partnership. Key risks to our call are a cut in dividend payout, a delay in commissioning of the Jordan power plant and further deterioration of the Singapore power sector.

Maintain BUY on Ranhill at unchanged TP of RM1.45. Key catalysts: (1) Progress in 1150MW Kedah CCGT power export to Thailand (2) Scheduled rate hike for Johor water (3) Johor water-sewerage integration (4) RM500m NRW-reduction contract wins (5) Successful bid for Large Scale Solar (LSS) 3.

PEER COMPARISON TABLE

		Shr Price	PE (x)		P/BV	ROE	Div Yield	Target	Total
Companies	**Rating**	**(RM)**	**FY19**	**FY20**	**(x)**	**(%)**	**(%)**	**Price (RM)**	**Upside (%)**
Tenaga	Neutral	13.60	13.8	13.3	1.4	9.1	3.7	14.40	9.6
Ranhill	Buy	1.28	17.0	14.6	0.7	14.4	4.1	1.45	17.4
YTL Power *	Buy	0.72	10.8	9.0	0.5	4.3	6.9	0.88	29.2
YTL Corp*	Neutral	0.97	38.8	23.3	0.7	3.1	3.0	1.03	9.2

*Source: Company MIDFR *FY20/FY21*

MIDF RESEARCH is part of MIDF Amanah Investment Bank Berhad (23878 - X).
(Bank Pelaburan)
(A Participating Organisation of Bursa Malaysia Securities Berhad)

DISCLOSURES AND DISCLAIMER

MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.