19 September 2018 | Sector Update

Power Sector

***Maintain* POSITIVE**

MESI Reform 2.0

INVESTMENT HIGHLIGHTS

- **MESI Reform 2.0 in the works**
- **To reactivate MyPower to design and implement reform**
- **Key objective to introduce more market-based competition, future proof industry and empower consumers**
- **Parts of the value chain could be opened up, not ruling out carbon tax**
- **Maintain POSITIVE on Power. Top picks are Tenaga (TP: RM16.90), YTL Power (TP: RM1.55) and YTL Corp (TP: RM1.55)**

We attended CEPSI 2018 opening yesterday, where MESTECC (Ministry of Environment, Energy, Science, Technology and Climate Change) Minister YB Yeo Bee Yin, gave a speech. A key takeaway from her speech was that **MESTECC** plans to embark on a new reform program for the Malaysian Electricity Supply Industry (MESI) under MESI Reform 2.0.

3 key objectives of MESI Reform 2.0:

1. Increase industry efficiency e.g. greater utilization of market-based competition throughout the value chain, reducing Government intervention, increasing transparency, adoption of more cost-reflective and time-based tariff, targeted subsidies (the Mnister also announced an new e-Kasih subsidy program), increase cross border trade.

2. Future proof industry, structure, regulations & key processes
Introduce market-based competition, adoption of new technologies, promotion of Renewable Energy, energy efficiency initiatives - ultimately these initiatives are aimed at adding value to consumers and to improve energy security of the nation.

3. Empower consumers
Ensuring consumers have a choice by incentivizing changes in consumption patterns, to facilitate active participation of consumers in the power sector as a producer of power (we think this could be along the lines of FiT),

MyPower to design and implement reform. At the end of MESI Reform 2.0, MESTECC hopes the outcome is a green, efficient, transparent, market-based, sustainable power industry. To kick-start the reform, Ministry will reactivate the Malaysia program office for power/electricity reform; an independent company limited by guarantee, but unlike other agencies, the agency will only have a life of 36-mth to design and drive implementation of MESI Reform 2.0.

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Our initial thoughts:
YB Yeo Bee Yin's speech emphasized two things repeatedly – decarbonisation and market-based competition.

Breaking up Tenaga's IBR revenue requirement/tariff. Tenaga's regulated business accounts for of its annual profit with the bulk of the rest coming from generation. It is important to note that the majority of Tenaga's profit element for its regulated business sits under: (1) Transmission revenue requirement (2) Distribution revenue requirement. T&D accounts for 21% of tariff (See Exhibit 1) and an estimated 42% of transmission revenue requirement and 18% of distribution revenue requirement consist of Tenaga's profit element i.e. its return on regulated assets. Other components of tariff/revenue requirement are largely cost pass-through.

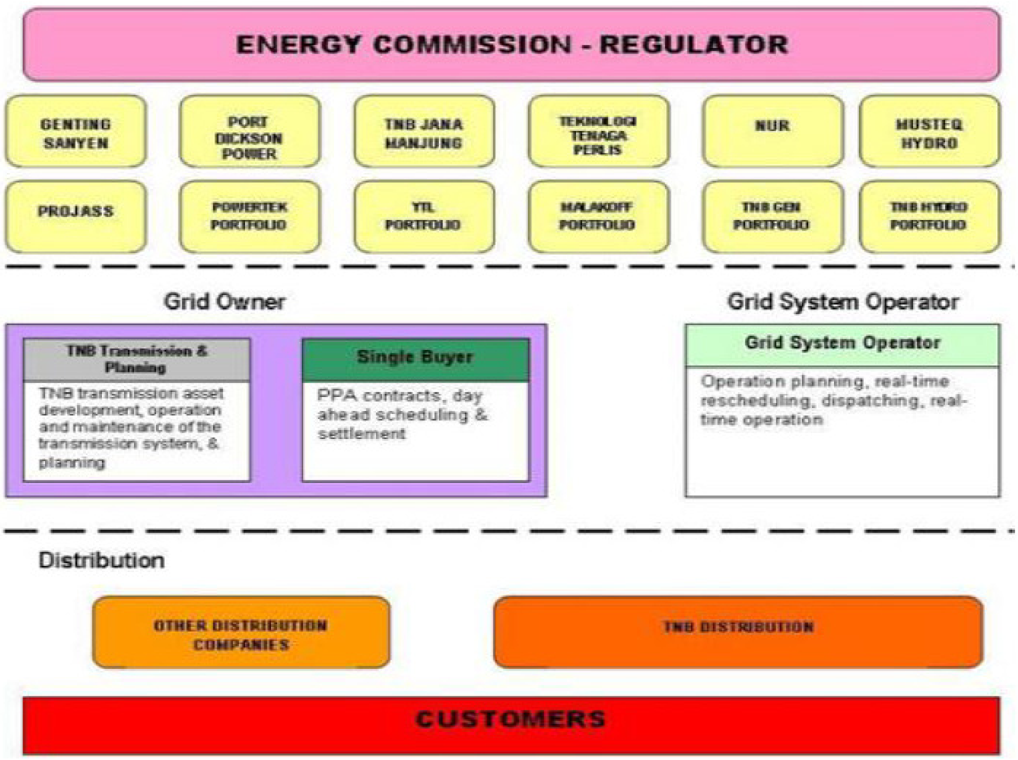
EXHIBIT 1: TARIFF BREAKDOWN

Component (sen/kwh)	RP2
Single Buyer Generation	27.05
Transmission	**4.03**
Distribution	**7.15**
Customer Services	0.96
Single Buyer Operation	0.19
Grid system operations	0.06
Total	**39.45**

Source: ST, MIDF

Opening up parts of the value chain? There is always the possibility of opening up parts of the existing value chain to market-based competition e.g. electricity wholesaling and retailing. Under the current Single Buyer model, Tenaga is the single wholesaler of electricity from the IPPs/generation sector. A gradual transition to an open wholesale system could create higher competition in the generation sector. Separation of the single buyer role off Tenaga could essentially eliminate fuel risk (ICPT risk) from the equation for Tenaga. Under the IBR, capacity payments and energy payments to IPPs account for the bulk of Single Buyer Generation revenue requirement, which in turn accounts for 69% of the base tariff of 39.5sen/kwh and is largely a cost pass through.

EXHIBIT 2: CURRENT SINGLE BUYER MODEL



Source: ST, MIDF

Existing PPAs are gradually expiring. The bulk of current generation capacity (25GW) is tied to long-term PPAs with more than half expiring in 2030-2040. However, there could be partial liberalization by allowing direct to market sale by new RE generators or even IPPs that have reached PPA expiry e.g. YTL's Pasir Gudang plant, particularly to meet peak load requirement. An estimated 6.5GW of PPAs are scheduled to expire gradually from next year up till 2027.

Opening up other REs to open bidding? Solar is already opened up to bidding under the Large Scale Solar (LSS) scheme, but the rest of the REs are still supported by Feed-in-Tariff (FiT). Solar accounts for 68% of Malaysia's RE capacity while biogas/biomass account for the 2nd largest portion at 24%. The latter is still under the FiT program and we see possibilities of this sector being opened up similar to solar. Biogas/biomass is a more reliable RE in with high availability factor (provided a firm feedstock supply is in place for the plant). The addition of storage capacity could improve reliability of solar but this means additional cost.

Introduction of carbon tax? The introduction of a carbon tax is a possibility as part of the "de-carbonisation" initiative. This may even eliminate the burden for high voltage users (e.g. manufacturers) to subsidise RE via the current FiT surcharge as collection of carbon tax from fossil fuel producers can be used to subsidise RE. The inclusion of "carbon cost" could increase the attractiveness of RE sources and accelerate its development.

Affordability over RE push. The push to expand RE still remains (though with a lower target of 18% by 2030) vs. the earlier target of 20% by 2025. However, the Minister highlighted that affordability takes precedence over RE targets that it has set. The Minister also believes that RE will eventually reach grid parity driven by technology development.

Maintain POSITIVE on the power sector. Tenaga (BUY, TP: RM16.90) remains our top sector pick. Key catalysts: (1) Solid dividend yields of 4.6% (+ve spread against 10yr MGS of 4.04%) while valuations are cheap at 12x FY18F earnings, a substantial discount to the market's 16x-17x. (2) Peaking capex suggests room for dividend upside (3) Possible monetisation of backbone fibre asset via partners.

YTL Power (BUY, TP: RM1.55). YTL Power is one of the few local proxies to lucrative overseas power plant projects. Despite higher finance cost over the next few years, dividend yields are generous at ~4% (even at just 50% payout ratio) while valuations are at a discount to the market's 16x-17x. Key potential 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) Potential divestment of mobile broadband business from any potential partnership.

Hafriz Hezry
hafriz.hezry@midf.com.my
03-2173 8392

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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.