27 December 2017 | Sector Update

Power Sector

***Maintain* POSITIVE**

Overhang removed

INVESTMENT HIGHLIGHTS

- **Base tariff maintained for RP2 (2018-2020) - allowable returns unlikely to have significantly changed as what Tenaga's share price is suggesting**
- **ICPT effectively still in surcharge position albeit lower; Government foots higher electricity bills on behalf of consumers again for 1H18, neutral impact to Tenaga**
- **Market looks to have factored in "worst case" scenario and this development removes a key overhang**
- **Maintain POSITIVE on Power. Top pick is Tenaga (BUY, TP: RM16.80/share).**

Base tariff maintained for RP2. Tenaga announced base tariff has been maintained at 38.53sen/kwh for Regulatory Period 2 (RP2) running from Jan2018 till Dec2020. Meanwhile ICPT for 1H18 is effectively still in a surcharge position of 0.28sen/kwh, though this is a slight easing vs. the effective 1.02sen/kwh surcharge in 2H17. Similar to 2H17 however, the Government has decided to maintain ICPT at a rebate position of 1.52sen/kwh, whereby the effective difference of 1.80sen/kwh vs. the actual surcharge position of 0.28sen/kwh will be borne by the Government on behalf of consumers, ensuring Tenaga's earnings and ultimately, the IBR mechanism is insulated from the Government's decision to subsidise electricity tariff for consumers.

Overhang removed. The development on base tariff is positive, pending further details of actual components making up Tenaga's required revenue for RP2. This is consistent with our previous views on Tenaga's share price overhang on concerns that the RP2 entails a risk of lower regulatory returns for Tenaga's T&D assets. Tenaga's RP1 revenue requirement in determining the base tariff of 38.53sen/kwh consisted of 5 segments (See Exhibit 1), but for ease of discussion we focus on two key components: (1) Allowable returns on regulated assets i.e. T&D assets (2) Generation cost, in particular fuel cost – these consist of several fuel price assumptions e.g. coal, piped gas/LNG, forex rates (See Exhibit xx for RP1 fuel price assumptions in setting the 38.53sen/kwh base tariff).

Absolute returns on regulated assets likely unchanged for RP2. Given our estimate of minimal change in total fuel cost forecast for RP2 (discussed in later paragraphs), there is fair ground to think that allowable returns on regulated assets (in absolute amount) for the RP2 period was also minimally impacted in the RP2 review, for tariffs to be maintained at 38.53sen/kwh. Our previous worst case had been for allowable ROA to drop to 6.5% (from 7.5% in RP1), which would have negatively impacted Tenaga's bottomline by RM485m/annum if calculated based on end-2017 average rate base of RM45b (RM48b at end-2017).

Though we gather that ROA for RP2 is set between 7% - 7.5%, in reality, average asset base for RP2 would also be higher than RP1 as there would be further capex into T&D between 2018 – 2020, which would offset a fall in allowable ROA. Assuming actual allowable ROA for RP2 was set at 7% (a fall of 50bps from RP1's 7.5%), average asset base needs to rise by RM4.6b in RP2 to maintain the absolute return on regulated asset of RM3.5b/annum achieved in RP1. Considering a RM2.5b/annum increase in asset base assumptions in RP1 (i.e..a total increase of RM7.5b over 3 years) , the RM4.6b required increase in RP2 asset base to offset a 50bps fall in ROA to 7% should not be too difficult to achieve.

EXHIBIT 1: REVENUE REQUIREMENT WHICH FORMED BASE TARIFF OF 38.53 SEN/KWH IN RP1

TNB Revenue Requirement for current IBR period (2014-2017)	(RMm)	Demand assumption (GWH)	Base tariff (sen/kwh)
Single buyer revenue requirement	116,273		
System operation requirement	201		
Single buyer operation requirement	849		
Transmission revenue requirement	16,187		
Distribution revenue requirement	36,543		
Total	**170,054**	**441,354**	**38.53**
of which (2014-2017) (RMm):			
Average rate base (RMm)	**44,733**		
1) Transmission revenue requirement			
ROA	***6,706***	***7.5% ROA***	
Depreciation	4,216		
OPEX	3,545		
Regulatory tax	1,720		
Total	**16,187**		
2) Distribution revenue requirement			
ROA	***6,692***	***7.5% ROA***	
Depreciation	9,233		
OPEX	19,361		
Regulatory tax	1,257		
Total	**36,543**		

Source: EC, MIDFR

Government to foot higher tariffs again for 1H18. The second important element of the base tariff setting is generation cost; of which one of the single largest component is fuel cost. The tariff setting factors in base fuel price and forex assumptions (among others) in setting the base tariff. The assumptions in base tariff setting therefore would take a mid-term perspective rather than reflecting the immediate current price levels. However, unlike allowable returns setting, there is more flexibility in fuel cost assumptions in base tariff setting in a sense, as any deviation against actual fuel price or forex incurred is allowed to be adjusted and reflected every half yearly via the ICPT mechanism. An ICPT under-recovery means Tenaga is incurring higher generation cost than what was forecasted under the IBR tariff setting while and over-recovery means Tenaga is incurring less than forecasted fuel cost.

How are base tariffs maintained despite higher fuel price? Although the exact details on fuel price assumptions for RP2 have not been released, we can roughly simulate the impact of higher coal price and higher USD assumptions against RP1 fuel cost forecast. Several possible reasons why base rates can be maintained despite higher fuel price now: **(1) Coal mix assumption is higher for RP2 at 57%** (this is based on EC's approved generation mix) till 2020 vs. ~45% assumed in RP1. Coal is a cheaper generation fuel at 13sen/kwh vs. gas+LNG cost of 17sen/kwh based on FY17 numbers **(2) Bloomberg's 3-year coal price forecast is USD70/tonne vs. circa USD87.50/tonne for RP1**, although the USD is a lot more expensive now around RM4.00:USD vs. RP1's RM3.14:USD assumption. As we mentioned earlier, base tariff setting takes into account a mid-term view rather than immediate prices and deviations are passed on via ICPT **(3) Lower market priced LNG take-up** given higher coal mix in the generation. We estimate that take-up of market priced LNG reduces to just 3% from up to 24% under RP1, which assumes coal mix of just 45%. Market price LNG stands at RM32/mmbtu vs. subsidised piped gas of RM22.70/mmbtu.

EXHIBIT 2: POSSIBLY LITTLE CHANGE IN FUEL COST VS RP1

Fuel cost (RMm)	**RP1**	**Possible RP2 Scenario**	***Comment***
Gas	5,548	8,286	
LNG	4,811	377	
Coal	6,167	7,959	
Distillate	189	189	
Oil	173	173	
Total fuel cost	**16,888**	**16,983**	*Minimal change in total fuel cost assumption*
Total generation (GWh) *assumption*			
Gas & LNG	**61,227**	**47,889**	
Coal	**50,076**	**63,414**	
Distillate	228	228	
Oil	353	353	
Hydro	5,116	5,116	
Total	**117,000**	**117,000**	*These are our assumption for simulation purposes*
Generation mix			
Gas & LNG	55.0%	43.0%	
Coal	**45.0%**	**57.0%**	*Higher coal mix in RP2*
Distillate	0.2%	0.2%	
Oil	0.3%	0.3%	
GAS			
Daily avg gas vol (mmscfd)	1,316	1,030	
Avg LNG price (RM/mmbtu)	41.68	**35.00**	*Lower LNG market price*
Total LNG consumed (mmbtu)	115,430,384	10,770,994	
Total LNG consumed (mmscf)	115,430	10,771	
LNG consumed per day (mmscfd)	316	30	
LNG consumed per day (mmscfd) as % of total gas consumption	**24%**	**3%**	
Subsidised gas price (RM/mmbtu) 1H	**15.20**	**22.70**	*Higher piped gas price in-line with gradual subsidy rollback*
Total gas consumption (mmscfd)	480,430	375,771	
Total piped gas consumption (mmscfd)	**365,000**	**365,000**	
COAL			
Coal price (CIF) (USD/MT)	**87.50**	**70.00**	
Coal price (CIF) (RM/MT)	274.8	280.0	
Average USD:MYR	**3.14**	**4.00**	
Coal consumption (mt)	22,446,597	28,425,364	

Source: EC, MIDFR

Government to foot ICPT surcharge again for 1H18. Even under the new fuel price assumptions in RP2 base tariff, 1H18 ICPT is still effectively in a surcharge position of 0.28sen/kwh. This means actual fuel cost incurred is higher than the revised forecasts under RP2, which factors in a longer-term view on fuel prices. However, the Government had decided to maintain the ICPT rebate of 1.52sen/kwh, whereby the total differential of 1.80sen/kwh (i.e. 1.52sen rebate plus 0.28sen surcharge) will be subsidised by the Government. Several sources of fund: (1) Remaining PPA fund estimated at RM300m, (2) Khazanah received dividends of ~RM1b (RM0.61sen/share) for Tenaga's FY17 based on its 28% stake – this a doubling in Tenaga's earnings payout to 50% vs. historical ~25%, (3) Crude oil price has performed better than expected – 2017 Govt. assumption of USD55/barrel vs. actual USD60/barrel - this should have incrementally benefitted Government coffers. It was reported that every USD1/barrel deviation vs. the base assumption impacts Govt. tax revenues by USD100m (RM410m). The decision whether to continue subsidising consumers beyond 1H18 lie with the Government, but the fact that Tenaga has been kept neutral from the Government's subsidy decision in the past 2 ICPT reviews is positive in keeping the IBR mechanism intact and ensuring Tenaga's earnings stability. Should the Government decide to discontinue subsidising tariffs for consumers, Tenaga has the right to pass on the ICPT surcharge (or rebates) to consumers directly.

EXHIBIT 3: FUEL PRICE ASSUMPTIONS IN RP1 VS. POSSIBLE RP2 SCENARIO

1st IBR Period Fuel Price assumptions (2014-2017)	Unit cost	Possible RP2 assumptions
Piped Gas (RM/mmbtu) up to a maximum of 1000 mmscfd	15.20	22.70
Coal (USD/tonne) (CIF) (CV:5500kcal/kg)	87.50	70.00
LNG (RM/mmbtu)	41.68	35.00
USD:RM	3.14	4.00

Source: EC, MIDFR

We maintain POSITIVE on the power sector. Tenaga (BUY, TP: RM16.80) remains our top sector pick. Key catalysts: Key catalysts: (1) Dividend catalyst on the back of an under-geared balance sheet and capital optimisation exercise (2) Overseas expansion provides scope for stronger growth in the mid-term (3) Strong earnings visibility post-ICPT implementation (4) At just 12x FY18F PE Tenaga trades at a discount to sector average of 13x and the index's 16x-17x. Tenaga is a liquid proxy to the GDP growth and trade upcycle.

We recently upgraded YTL Corp to BUY (TP: RM1.40/share) as we think the market has more than priced in the cut in dividends for YTL's recent FY17. Even after lowering payout assumptions to 50%, dividend yields at current price are attractive at 4%. We see a revival of YTL's long overlooked construction unit with a possible more than doubling in order book as a strong catalyst in the next 12 months. Among key catalysts to look out for: (1) Gemas-JB rail project (2) Commencement of Tanjung Jati power plant construction; estimated RM4b construction value (3) Construction of two new luxury hotels – Marriot and Edition Sentral - under YTL Land, (4) KL-Singapore High Speed Rail project awards.

YTL Power (NEUTRAL, TP: RM1.20/share): While new projects are expected to contribute meaningfully, these entail gestation period up till FY19F-21F: (1) COD of Tanjung Jati plant in FY21F (2) COD of Jordan shale power plant in FY21F. Earnings drag from its Singapore operations is likely to persist, while capex cycle is likely to re-accelerate in anticipation of new power projects in Indonesia (Tanjung Jati) and Jordan.

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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.