Asset light

01/01/2002

A quiet year for the Australian electricity sector has ended with a surprising announcement from the New South Wales government heralding a possible sale of trading rights in a market once closed to the private sector. As long as the move meets no serious political opposition and as long as the government is able to put detailed information memoranda together quickly enough, bankers say that six or seven sizeable deals could reach financial close as a result of the government initiative as soon as July or August 2002.

The state government calls the document it issued on Friday 14 December a risk management discussion paper for the New South Wales electricity industry, the chief aim being to reduce the risks associated with participating in the wholesale electricity market, which the government describes as the most volatile commodity market in the world.

Industry observers stress this is not tantamount to privatization. ?The government says it is committed to retaining the state's physical generation, distribution, transmission and retail assets, but will sell some of the risks and revenue streams associated with those assets,? says Mark Schneider, associate director in National Australia Bank's project finance team, which is following developments closely. The sale will focus solely on the wholesale side of the electricity market. A$2.5 billion of wholesale electricity is traded in New South Wales annually.

As long as the idea generates sufficient interest the government will sell rights to trade output from the state's generating business for a period of between three and five years. Bankers say the government is keeping the contract periods relatively short to allow arrangements to be reviewed, reformed or reversed if they prove unsatisfactory. Private companies will bid for the energy or trading rights and, if successful, will win control of how the electricity is bid into the electricity pool and how the trading is conducted. The New South Wales Treasury is the department running the sale process.

According to Schneider, the government would set a reserve price for the trading rights to cover the costs of electricity production and delivery and, in the words of the discussion paper itself, ?to ensure that the public sector's anticipated earnings from trading, adjusted for the reduction in risk, are met.?

The government will offer trading rights associated with the four corporatised energy retailers in New South Wales: Energy Australia whose franchise extends from Sydney to Newcastle along the coast, Integral energy, whose area of coverage is western metropolitan Sydney extending south and Country Energy which covers much of the remaining country areas. The fourth is Australian Inland energy & Water which runs retail operations for the west of the state.

Under the government's plans the new retail trader would be obliged to offer an energy price for the contestable customers. Each government retailer would purchase its electricity exclusively from their retail trader at the energy price. The government retailer would remain responsible for supplying franchise customers under the Electricity Tariff Equalization Fund agreements and would continue to be responsible for customer services such as sales, marketing and billing.

On the generating side, the amount of generating output that could come under private sector control as a result of the government initiative is substantial, says Schneider. Of the three government-owned generating companies in New South Wales, Macquarie Generation and Delta have 4,500MW of capacity each. Eraring Energy has about 2,000MW of capacity. One financier speculates that wholesale trading rights for the two largest generation companies could be sold at well above A$1 billion ($500 million).

The government envisages that contracts will be set up between the generating companies and the private sector traders which would give the traders the exclusive rights to determine when and how the capacity of each government trader would be traded in Australia's National Electricity market.

Market sources say each trader would determine the output of the government generator through their bids to the National Electricity Market Management Company. If, for whatever reason a generation trader defaults on fees owned to a government generating company, trading rights would revert back to the government generator.

According to Mary Reemst, executive director at Macquarie's project finance department, there will be no upfront payments for the retail or trading rights. However the discussion document says that the private sector traders would pay a fee, agreed up front, in return for trading rights over the life of a three to five year contract. Fees would not be linked to the private sector's actual trading performance, says another financier. Traders will still be liable for the government's fee even if they make significant trading losses.

Good news for project finance bankers is the fact that the ?assets' being sold-off do lend themselves to project financings in much the same way as physical assets would, says Jeremy Hasnip, director in Westpac's power & telecoms industry unit. Banks are already alerting their clients about the potential opportunity.

The government is inviting all interested parties who read the broad, 10 page discussion document to comment on the proposals. As long as no major problems arise at this preliminary stage, formal expressions of interest will then be sought with tender documents expected to be released in May. Term sheets will be sent out with the expression of interest documents.

Will a sufficient number of energy companies be interested in buying into the government's scheme? Hasnip thinks they will. ?There are a number of companies operating in the Australian market who have been successful in building up integrated positions here, such as TXU Corporation. They are highly likely to want to build on these positions with a complimentary stake in the New South Wales market,? says the banker.

But the sell-off isn't likely to generate the same frenzied excitement that the sale of Victoria's energy assets did. ?We are into the third or fourth phase of energy sector deregulation in Australia and the honeymoon period is definitely over. The private sector recognizes that it paid over the odds for assets in Victoria which have not performed that well since,? says an anonymous Sydney banker.

As Project Finance observed in its report on the Australian power market in August 2000 (pp30-31), equity interest in the Australian electricity industry is much less than it was three years ago.

Amongst the reasons for the diminished interest in Australian power assets is the fact that international power companies, particularly in the US and Europe, have shifted the focus of their investment strategies back into their home markets at the expense of Asian investment opportunities.

Schneider believes that most of the interest will be in the generating rather than retail trading rights. Nevertheless, there are industry players (Enron was amongst them) who consider their competitive advantage to be retail trading know-how rather than power station operating skills. These trading companies will be glad for an opportunity to buy retail trading positions without being lumbered with a physical power station.

As far as the financial community is concerned the state government's move could have been better timed, coming so close on the heels of the Enron collapse. ?Enron was criticized in hindsight for being an asset light company. In a sense, what the New South Wales government is doing is inviting companies to follow the same route because they will get trading rights without the assets behind them,? says the Sydney based financier.

US electricity giant TXU, another player in the Australian market, is already slimming down its asset base and monetising its gas and electricity networks. According to market sources, the company has split its Australian businesses into unregulated and regulated segments and is in the process of bringing institutional equity investors into the regulated half. ?TXU's management can see that the returns they are getting on the regulated parts are quite modest ? they don't see the point in keeping cash tied up in it,? says one Sydney-based utilities analyst.

Macquarie Bank is one investor seeking to acquire a 60% equity holding in the regulated TXU business in Victoria ? called TXU networks ? reportedly for $450 million. Specifically, the purchase would be by Macquarie Essentials Infrastructure Group, which has a planned share market listing in early 2002 and could take place within six months.

Australia Gas Light (AGL), which is another company interested in the New South Wales plans, is following the same strategy as TXU. However, AGL's job will be harder. Like TXU, AGL plans to monetise its high-yield, low growth network assets through a so-called NetCo spin-off. The move is making the finance community nervous because AGL is already light on physical assets ? it has next to nothing in the way of generating assets. And while its retail business is strong, taking away the network business would leave a core that is almost pure retail trading. ?Given what happened with Enron, and the fact that AGL lost lots of money mis-hedging its New Zealand operations, people are rightly nervous about AGL's plans,? the analyst adds.

Given these moves by two of the most likely bidders for the New South Wales electricity rights, some sources say the banking community will react cautiously to financing requests. Reemst, however, believes that comparisons with Enron aren't particularly appropriate. ?Companies who buy the rights won't get the physical assets but they will have a much closer connection to the physical supply than Enron typically had in its businesses,? she says.

Market observers don't rule out the possibility of a full-scale privatization of electricity companies in New South Wales, but they believe that such an outcome is unlikely while political opposition remains strong. ?Privatization is a contentious issue,? says one energy analyst. He adds: ?New South Wales's current premier came out in favour of privatization about three years ago at an annual Labour Party convention but he backed away from the idea because of intense opposition amongst the party rank and file.?

New South Wales's decision to sell-off five year trading rights could in fact make a privatization less likely over the same time period because of the problems of having one private company running a power station and another owning the retail or generating rights to the same asset.

Sales of the generation and retail trading rights will be partly contingent on the implementation of full retail contestability, which is now scheduled for January 2002, having been delayed for about a year.

Since the sale does not comprise the sell-off of any of the corporatised electricity companies in the state, political opposition to the government's plans is expected to be light. ?The government has been careful to explain that there isn't going to be a change of ownership and there won't be any adverse effects on jobs,? says Hasnip, ?it's actually a pretty good way to get the private sector involved with minimal political aggravation.? Observers think New South Wales's approach could eventually become a template for Queensland, but not for Western Australia, which continues to be a regulated market.