Utilities Sector

Privatisation finance: ADDENDUM

Equities

Australasia
Utilities

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Good for the state

This note emphasises the sale proceeds are likely to be higher than expected by the semi-government market, and that the long term benefits to the state could be considerable. The economic benefits of the asset sale and reinvestment plan include the creation of an additional 122,500 full time equivalent jobs, a boost to household income worth $27.8bn (a 3.5% real increase), and a consumption increase of AUD21.4bn (a 3.4% real increase). These benefits would accrue to the NSW state budget over time, including increased payroll taxes, GST and stamp duties. Our earlier published analysis does not attempt to account for these fiscal impacts. NSW revenues have historically averaged 15.6% of GSP.

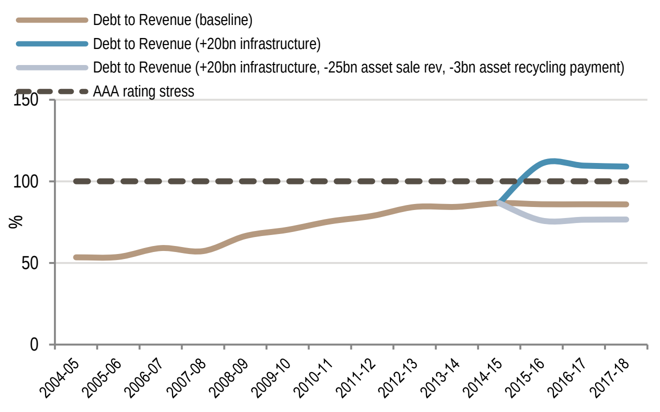
Improving fiscal position

Assuming the sale is completed at $25bn (with an additional $3bn asset recycling payment), and the infrastructure programme costs $20bn, debt would be $8bn lower initially. We expect the semi market would take the asset sale in a positive light over the next few years. The improved fiscal position and associated reduction in net issuance would initially tighten NSWTC's credit spreads to bond. Long bonds and inflation-linked debt would outperform due to the debt structure.

ADDENDUM: Additional benefits to the state

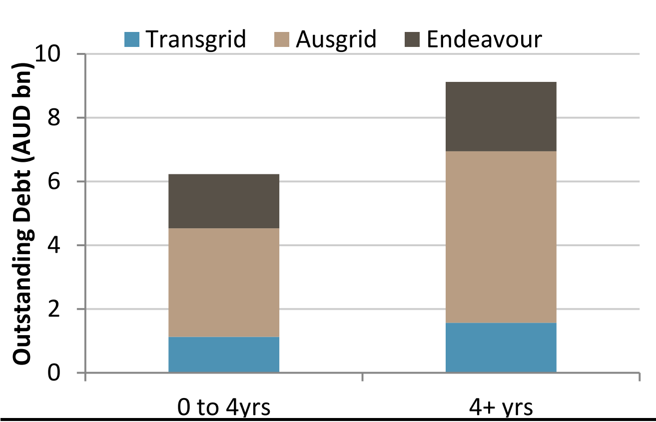
Clients have raised some additional points around the long term lease of NSW's utilities assets. Specifically, we wrote in the note that we did not intend to account for the productivity benefits to NSW budget. Firstly, a report on the economic impact of the infrastructure strategy estimates the productivity benefits are worth 30.9bn to Gross State Product (GSP) by 2035-36 – a real increase of 3.6% over the level of GSP that would occur without the plan. The report stated that part of the forecast increase in GSP was from a more efficient electricity network (as we also note), though mostly from reinvestment in productive infrastructure, which we did not account for.

Figure 1: Fiscal position improves for the first few years



Source: NSW Budget 14-15, UBS estimates

Figure 2: Outstanding debt available for buybacks



Source: NSW Budget 14-15, UBS estimates

It's a $25 bn or even $30 bn transaction that's proposed

Debate continues about the merits or otherwise of privatizing 49% of the wires and poles in NSW ahead of an election to be held on March 28. There are various viewpoints, some ideological ("electricity is an essential service", "privatized companies are more efficient", "the State should NOT be both the owner and regulator of electricity assets") and some financial and economic.

We believe the state's decision to divest utilities assets (which pay a dividend to the state) and replace them with (mostly) transport infrastructure assets (which do not pay dividends) may improve the state's fiscal position in the short term. We stress that this is not a statement on the total economic and social merits of the sale – after all, state governments are run for the benefit of their constituents and not for the pursuit of profit – but it is the financial and economic consequences that are of interest to us.

The sale would not result in higher transmission or distribution prices to consumers in the foreseeable future. Those prices are set by the regulator and the evidence to date, based on benchmarking studies by the AER and before them the Grattan Institute, is that the NSW networks have been the least efficient in Australia. So much so that the AER allowances are based on 40% less opex than Ausgrid currently spends.

One reason why network unit prices have risen generally, not just in NSW, is because volumes have fallen, but as a monopoly the network is entitled to earn the same return on capital. That is one of the main attractions of the business. The volume fall is but one example of the ongoing changes in electricity production, distribution and consumption. PV, storage, time of use meters can be owned by consumers, retailers, or networks. Even in the traditional centralised system changes impacting volume, connection and demand based pricing models are all impacting this sector as it's dragged, willy nilly, into the 21st century. The State Govt is part of the regulator, via its participation in the SCER and through that to the AEMC. Should it also be the owner?

The lease program capital benefit to NSW is likely to be >$25bn

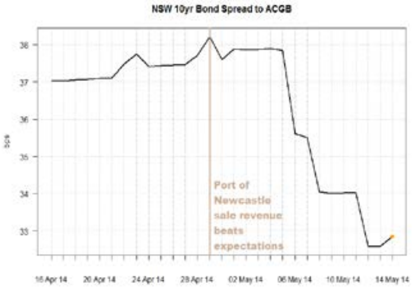
We calculate this is made up of:

1. Proceeds received for selling/leasing the equity of 100% of Transgrid and 50.4% of the equity in Ausgrid and Endeavour.
2. Increased borrowing capacity equivalent to 100% of the debt of Transgrid, Ausgrid and Endeavour. We estimate, with one caveat, that this alone is about A$15 bn. The caveat is that that there will be less income from the assets that have been sold to service remaining debt.
3. Funds that are received from the Federal Government under its State infrastructure recycled program, about A$3bn.

An estimate of the proceeds. For simplicity we have assumed the buyers would pay 1.2X estimated FY16 Regulated asset value [RAB] as proposed by the regulator in draft decisions handed down in November 2014.

In this case, semi-government investors would see such the sale outcome as a positive factor for owning NSWTC debt. Semi investors have been anticipating sale proceeds of ~20bn (including the asset recycling payment from the Commonwealth). The sale of the Port of Newcastle for 1.7bn in April 2014 (around 50% larger than market expectations) assisted NSW's credit spread contraction of 5bps to bond over the following two weeks.

Figure 3: Revenue expectation beat



Source: Bloomberg, UBS

Figure 4: Proceeds and implied exit ebitda multiples, sales price based on 1.2X FY16E RAB

		Transgrid	Ausgrid	Endeavour	Total
Dividends paid 2014	$m	179	381	178	738
Tax equivalents	$m	105	167	77	349
Total	$m	284	548	255	1087
Implied cut to dividends from regulatory resets	$m	-39	-275	-72	-386
Implied 2016 dividends	$m	139	106	106	351
State share from minority interest post sale of 2016 div	$m		53	53	105
Notional Proforma tax 2016 post sale,post regulation cut	$m	88	49	46	184
Equity sold (100% Transgrid, 50.4% Ausgrid & Endeavour)	$bn	5.2	4.8	1.1	11.1
Debt removed (100% of each asset)	$bn	2.7	8.7	3.8	15.2
Federal asset recycling grants (15% of equity sold)	$bn				3.8
Total benefit	**$bn**	**7.9**	**13.5**	**4.9**	**30.0**
Minority Equity retained	$bn		4.7	1.1	5.8
Enterprise value	$bn	7.9	18.2	6.0	
Rab 2016	$bn	6.6	15.1	6.0	
FY14 Regulatory revenue	$m	910.8	2350	1000	4261
Regulator's FY16 draft revenue	$m	770	1576	736	3082
Company revised 2016 proposed revenue	$m	939	2338	1059	4336
Average	$m	855	1957	898	3709
Decline in revenue from 2014	$m	56	393	103	552
2014 ebitda	$m	723	1927	770	3420
Reduction for loss of revenue (no cost mitigation)	$m	-56	-393	-103	-552
Adjusted 2016 ebitda	$m	667	1534	668	2868
Implied FY16 ebitda multiple on sale	$m	11.9	11.8	9.0	

Source: UBSe

Proceeds from the asset sale should be more than sufficient to cover outstanding debt. Debt held against the electricity assets would most likely be bought back by the state soon after the transactions were completed (though some securities may be left outstanding to finance other state borrowing). It is unclear whether the remaining funds (~10bn) would be used to temporarily reduce issuance, or placed in an investment fund that would be gradually drawn down to finance future expenditure.

A comparative table of listed regulated utilities' trading multiples and valuation metrics is shown below.

As a result of the sale the NSW Government would lose the dividends that the businesses had been providing, the income tax equivalents, and also the capital growth they would have provided.

What is unclear is how dividends or payments from the 49.6% stake in Ausgrid and Endeavour would be paid up to the State. In the private sector this is often by way of shareholder loans or repayment of loans made by a trust to an operating company.

Tax

The Government owned wires and poles businesses do not pay income tax to the Commonwealth. While in public hands, they make a notional "tax equivalent" transfer to state governments.

To the extent that the privatized entities do pay tax, and we are not overly optimistic on that score, the Commonwealth government would receive a benefit. This would be partly offset by the asset recycling infrastructure benefit equal to 15% of the sales value.

The 15% payment is based on new infrastructure spending financed by the sale of an asset on the state's balance sheet. New infrastructure spending proposals amount to a 20bn programme, so on current plans the asset recycling payment is worth $3bn to the state.

Use of proceeds

The State Government has made it quite clear that the proceeds would be put into providing State infrastructure, the vast majority of which would not produce any income directly for the State.

As such we expect the State's financial position would be worse off over the long run. The only way this would not be true would be if the associated boost to the State's GDP was sufficient to raise revenue by enough to offset the lost income.

Figure 5: Proposed use of funds, great for NSW but not much income to State

Urban public transport	$m	$m
Sydney Rapid Transit	7000	
Sydney's Rail Future 2 Upgrades	1000	
Parramatta Light Rail	600	
Bus Rapid Transit	300	
Total		8900
Urban roads		
WestConnex northern and southern extensions; Western Harbour Tunnel	1100	
Pinch Points & Clearways	400	
Smart Motorways	400	
Gateway to the South	300	
Traffic Management Upgrades	200	
Total		2400
Regional roads (and rail)		
Regional Road Freight Corridor	2000	
Regional Growth Roads	1000	
Fixing Country Roads	500	
Fixing Country Rail	400	
Bridges for the Bush	200	
Total		4100
Non transport infrastructure		
Regional Water Security and Supply Fund	1000	
Future Focused Schools	700	
Regional Schools Renewal program	300	
Hospitals	1000	
Culture and Arts	600	
Sports Stadia	600	
Regional Environment and Tourism Fund	300	
Total		4500
Total		19900

Source: NSDW Govt reports

Considerations for the state's credit quality

Judged in isolation, it is an open question whether the poles and wires divestment would improve or weaken the credit quality of the state. If we were to assume that both the state and a private corporation were able to extract the same revenues from the assets, then the debate turns into a matter of the sale price and the appropriate long term discount rate.

However, we argue that the sale is more nuanced – the potential revenues of the assets may differ between public or private hands. In nearly all asset transactions the buyer believes they can do a better job than the seller.

There is an increasing awareness that advances in technology are changing the way that electricity is produced, distributed and consumed. In this context it's worth recalling that it was only in the mid 1990s that we saw the breakup of the electricity sector, from a vertically integrated, not for profit, State Monopoly into three separate sectors, generation, distribution and transmission and retailing. Generation and retailing were made to be competitive and distribution was regulated as having monopoly characteristics.

It's becoming very clear now that electricity production and distribution is going to be a different business in the future and the current model will need to adapt.

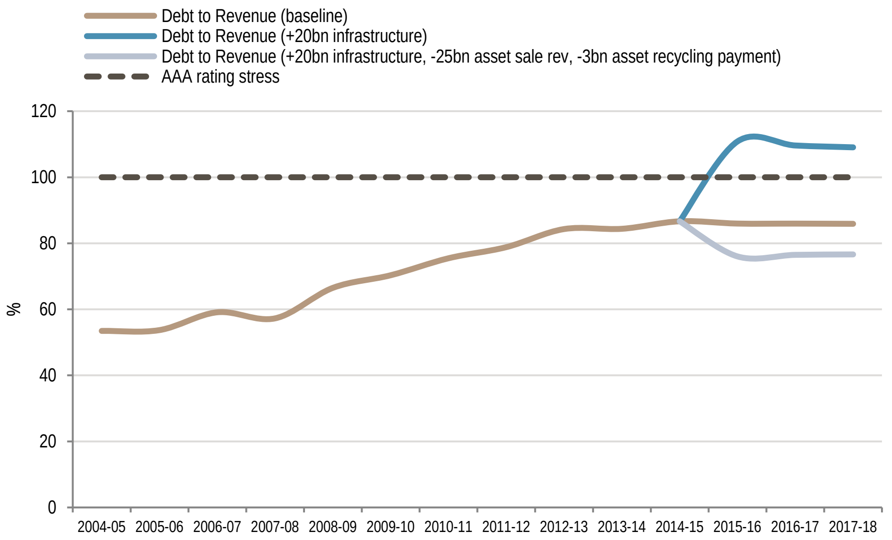
Specifically, consider solar PV and storage. Are these better owned by the household, by the network or by the retailer? If one million houses put solar and storage on their roofs at $20 k each, that's $20 bn of investment. There are plenty of arguments that the storage would be more economic at street level. Storage has the potential to greatly increase overall capacity utilization of the network to the general benefit of society. If the networks want to own this segment of the market they will need to be dynamic, develop plans early. We see absolutely no evidence of this occurring in NSW at present. Networks could emerge much more dominant from this technology change, or they could become the enemy of the people with opaque, out of date pricing structures. It needs management to navigate through this and share price signals to let management know when they are right and when they are wrong. Some in the private sector will surely get it wrong, but the market will let them know fairly quickly.

Another example is meters. It's very clear that communicating time of use meters are coming to NSW, just as they have in Victoria. The only question is who is going to own them. In Victoria the meters and the ongoing software investment are owned by the networks. Here in NSW the networks have explicitly rejected the need for communicating meters in their latest regulatory proposals and yet the retailers have well developed plans to introduce them as soon as the AEMC approves the rule change. At a stroke the networks will lose a nice piece of business. We suspect a privately owned network would not allow this to happen so easily.

Two separate decisions, but linked by design

The next question is – should we consider the government's infrastructure plan separately to the poles and wires divestment? The 20bn investment plan could be funded via debt issuance, though it would undoubtedly result in a ratings downgrade, which would increase the state's cost of borrowing (by ~0.10% per of new issuance). A comparable infrastructure investment in transport infrastructure may also have been required in the long run, even if the poles and wires lease had not occurred.

Figure 6: AAA would be lost if funding 20bn of infrastructure with no recycling



Source: NSW Budget 14-15, UBS estimates

Yet since the state's infrastructure spending plans are contingent on the divestment of the utilities assets – the Premier has made it clear that there is no acceptable alternative means to fund the government's ambitious infrastructure plan – we should consider the two policies in tandem.

The benefits to the state's budget position entail:

1. The asset sale proceeds (we estimate at 25bn)
2. The asset recycling payment from the Commonwealth (we estimate at 3bn)
3. Dividend flows from assets built under the new infrastructure programme

The costs entail:

1. The infrastructure spend (estimated by the NSW government at 20bn)
2. Foregone dividend flows from the utilities assets
3. Foregone income tax equivalent payments to the state government
4. Any recurring subsidies required to fund the new infrastructure

Impacts on NSWTC's debt performance

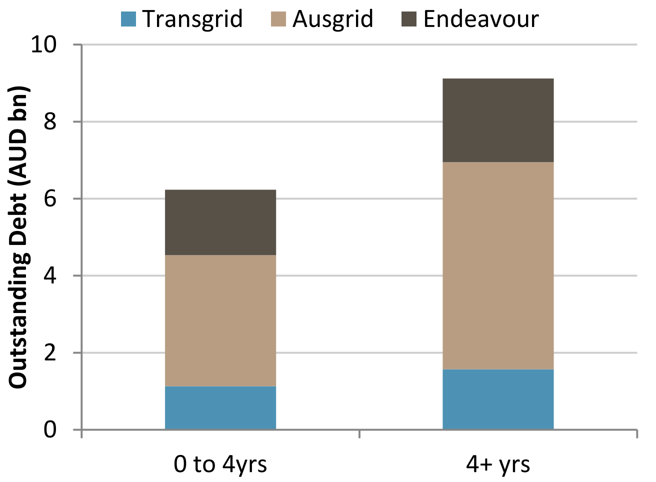
The improved fiscal position and associated reduction in net issuance would initially tighten NSWTC's credit spreads to bond – bringing its spreads in line with TCV. We expect the initial market reaction would move NSW ~4bps tighter to 10yr government bonds.

Since the asset lease funds would be received upfront, whereas new infrastructure spending would occur gradually, the reduced supply of NSWTC debt would improve its performance for a few years. Notwithstanding, once the new infrastructure plan had been fully funded in subsequent years, outstanding debt would have returned to be close to its prior projection. At this point, the worsened fiscal position of the state should marginally deteriorate spreads compared to a counterfactual where the state never leased its utilities assets, nor incurred the $20bn infrastructure plan.

The maturity distribution of the poles and wires debt is slightly longer than that of NSWTC's distribution of debt, and so should support a credit curve flattening. Fixed rate securities would benefit more than floating – less than 10% of their liabilities are held in floating rate debt.

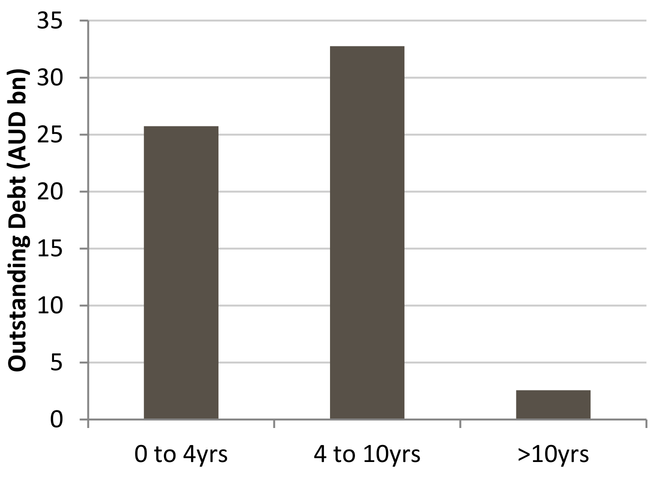
The buyback would benefit NSWTC's inflation-linked bonds more than its nominal bonds, given that electricity assets have a disproportionate share of the state's CPI-linked borrowing. We estimate that around two thirds of outstanding debt for these assets has been issued in the form of inflation-linked securities, equivalent to a third of outstanding inflation-linked debt.

Figure 7: Outstanding debt available for buybacks, per state owned entity (nominal & inflation-linked)



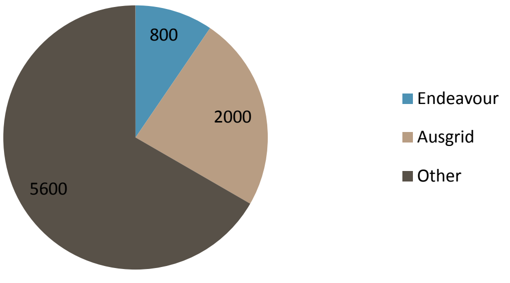
Source: Transgrid Annual Reports, Ausgrid Annual Reports, Endeavour Annual Reports, UBS estimates

Figure 8: Slightly longer than NSWTC's overall distribution of debt



Source: Transgrid Annual Reports, Ausgrid Annual Reports, Endeavour Annual Reports, UBS estimates

Figure 9: NSWTC Inflation-linked liabilities (approx. market value), by state owned entity, AUDm



Source: Ausgrid Annual Reports, Endeavour Annual Reports, UBS estimates

Opinion polls and betting odds favour re-election

Opinion polls and betting odds both continue to allow a presumption that the Coalition will win a lower house majority and retain Government. As compared with our last reading a month ago, the odds have tightened marginally but the opinion polls we follow are not much changed.

Opinion polls, reported on face value, are biased toward the LNP, and we expect the result will be closer than the polls (and in turn the bookmakers) are predicting. Opinion polling companies are projecting a two party preferred lead of 8% (54% to 46%) to the incumbent government. Yet note that the polling companies only collect first preference voting intentions, and then assume the preference flows of the 2011 election recur at the 2015 election. Preference flows provided an unusually large benefit to the LNP in 2011, due to below average preference flows to the NSW Labor party. These considerations notwithstanding, our base case is that the LNP win the lower house, and will have sufficient seats to negotiate a sale through the Senate with the minor parties.

Figure 10: Poll result indicators

	Bookmakers			Opinion Polls (Two Party Preferred)	
NSW	Coalition	Labor		Coalition	Labor
Sportsbet	87%	13%	Newspoll	54%	46%
Centrebet	90%	10%	Morgans	n/a	n/a
Ladbrokes	86%	14%	Galaxy	54%	46%
Average	**87%**	**13%**		**54%**	**46%**

Source: Sportsbet, Centrebet, Ladbrokes, Newspoll, Galaxy

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Buy	FSR is > 6% above the MRA.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 December 2014.
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