How Risky are the Electricity Generator-Retailers?

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With the public listing of Mighty River Power approaching fast, many potential investors will be asking themselves just how risky are the electricity generator-retailers. The sale of up to 49% of the shares in Mighty River Power is on the table and the partial floats of the other state-owned generator-retailers, Meridian Energy and Genesis Energy are due to follow soon after.

One common trap is to think of the electricity generator-retailers as utilities. Utilities, such as the electricity lines and gas network companies, are typically low-risk businesses offering investors stable and often regulated returns.

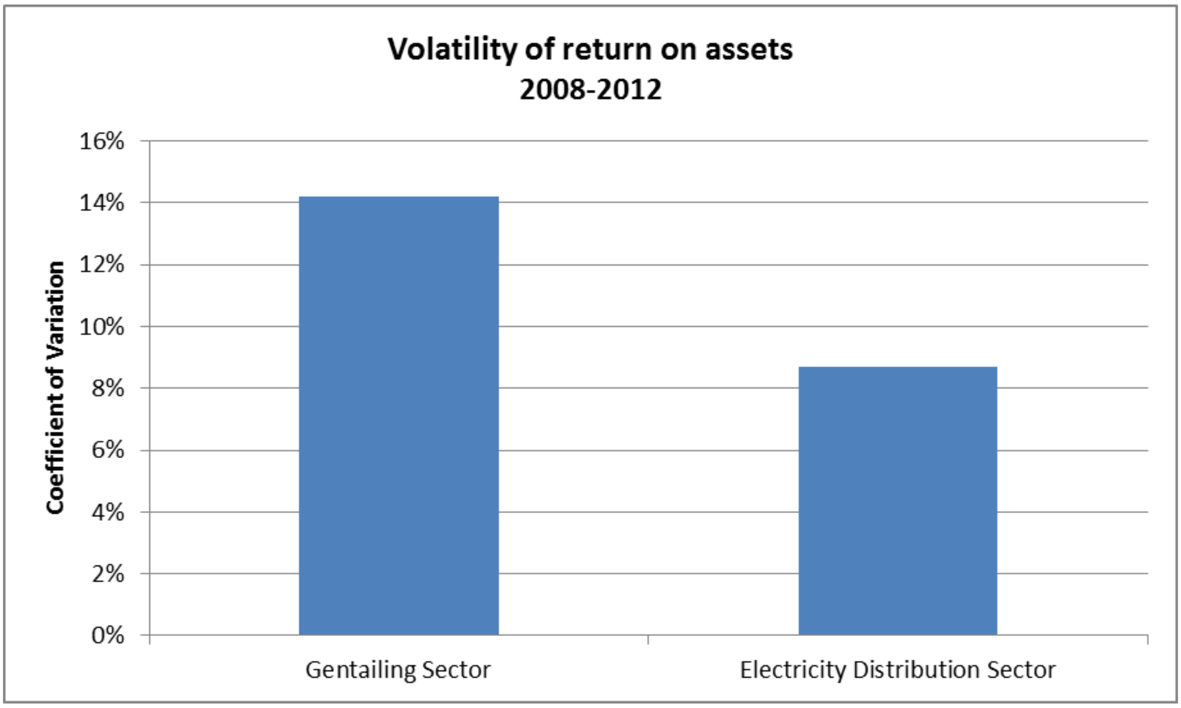
The electricity generation and retailing market, however, is a risky business and companies can, and do, get into financial difficulty if the risks they face aren't managed well. Revenue and earnings volatility comes with the territory in a market where almost 60% of generation comes from hydro power. As this year's drought highlights, it is very difficult if not impossible to forecast the rain.

Despite the 80 years of data the electricity companies have on historical water inflows, history provides only a vague indicator at best about the future timing and volume of inflows. On top of this, New Zealand's hydro generation lakes don't have a great deal of storage capacity. As a result there is a lot of uncertainty around arguably the most important thing in the business: the fuel supply.

Electricity demand can be volatile too, as highlighted by the current uncertainties around the Tiwai Point aluminium smelter. Further the retail market is becoming increasingly competitive, as witnessed by the increase in customer switching.

The large electricity generators devote considerable efforts and talent to managing the risks they face. The measures they use include integrating into the retail market, owning a mix of generating plant so they are not reliant on a single fuel source, and entering financial hedges through the ASX futures electricity market and bilateral ("over the counter") forward trades with each other.

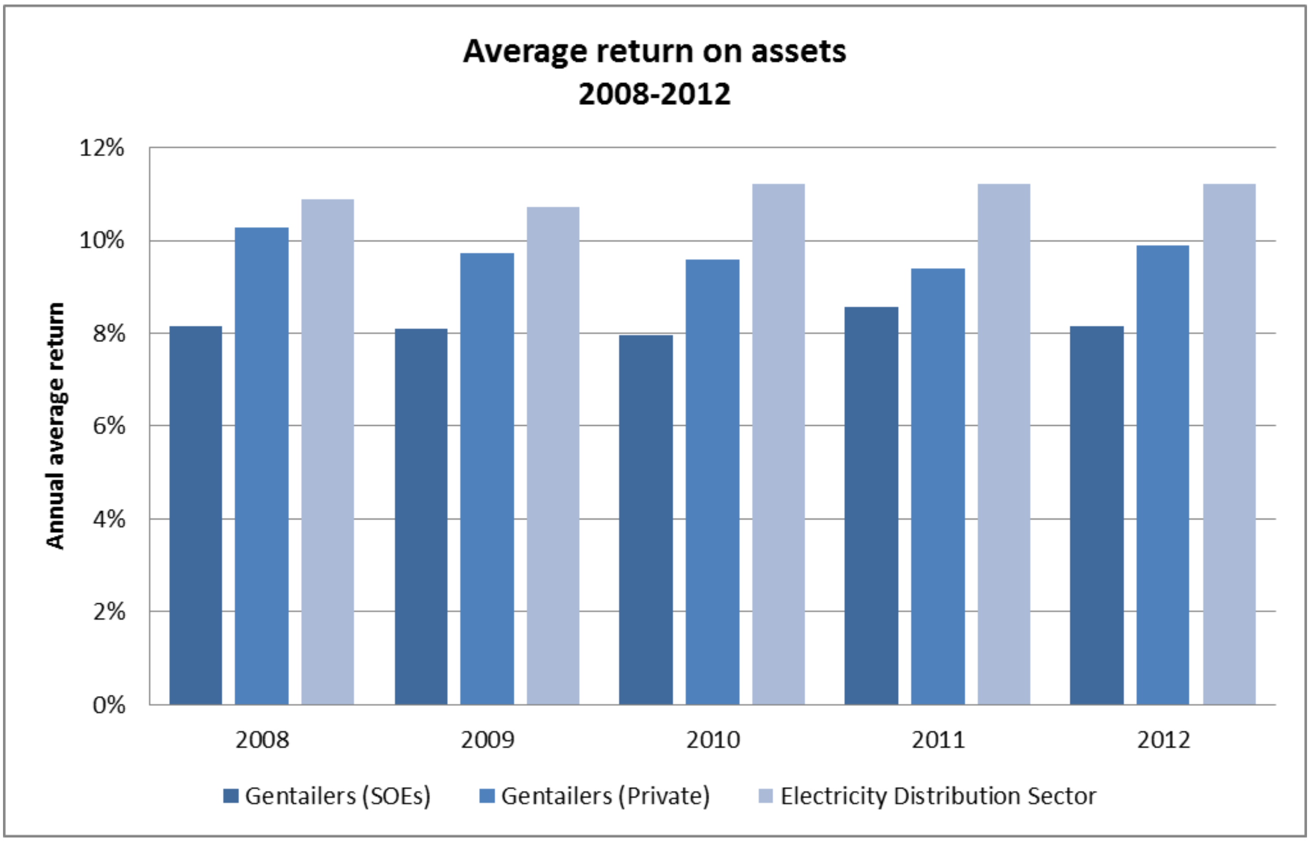
Despite these measures, the electricity generator-retailers come with plenty of risk when compared with the electricity lines companies like national grid owner Transpower and the local distribution companies Vector, Powerco and Orion. As the first graph below highlights, the volatility of the earnings of the generator-retailers over the last five years has been almost twice that of the electricity lines companies.



The coefficient of variation is a measure of volatility that allows for the differing sizes of the companies.

The relative riskiness of the generator-retailers is probably not surprising given the nature of the industry. A further important question is whether the greater risk is compensated by higher average returns? Somewhat surprisingly perhaps, the answer over the last five years has been no, as measured by average returns on assets. As the second figure below illustrates, the average return on assets for the generator-retailers has been below that of the electricity distributors in each of the past five years.

The apparent anomaly may be explained, at least in part by the current state ownership of three of the five main generator-retailers. As the graph below illustrates, the average return on assets for the SOEs (Mighty River Power, Meridian and Genesis) has been below that of the two publicly listed generator-retailers, Contact Energy and Trust Power, in each of the past five years.



The average annual return is measured as pre-tax, pre-interest return on average total assets over the year.

Further (and although the graphs don't show it), the average volatility across the five years for the three SOEs has on average been higher than it has been for Contact and TrustPower.

Overall, whether we look at return on assets, return on equity or the volatility of these returns, from 2008 to 2012 the major lines companies have out-performed the generator-retailers. And amongst the generator-retailers, Contact and TrustPower have out-performed the three SOEs.

That is not to suggest that buying shares in the upcoming asset sales is necessarily a bad idea though: far from it. The evidence is compelling that the financial performance of the SOEs is likely to improve noticeably once they are listed. Further, governments have tended to offer shares in privatised companies at a discount, thus providing a good return to the initial investors. Overseas this "day-one" return has often been huge, averaging over 30%, while in New Zealand the premium has been more modest, averaging around 10% for the three previous government-led initial public offerings (IPOs) of Auckland Airport, Capital Properties and Contact Energy.

When considering whether to invest in the forthcoming floats of the electricity generator retailers, the important thing is that potential investors are aware of the risks the companies face. While the electricity generators-retailers devote considerable efforts to manage their risks, the evidence suggests it would be a mistake to think of them as low-risk utilities.

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For further reading on the evidence that public listing is likely to improve the financial performance of the SOEs see:

http://www.tdb.co.nz/documents/presentations/210311-The-Mixed-Ownership-Model.pdf

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