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Leading Energy

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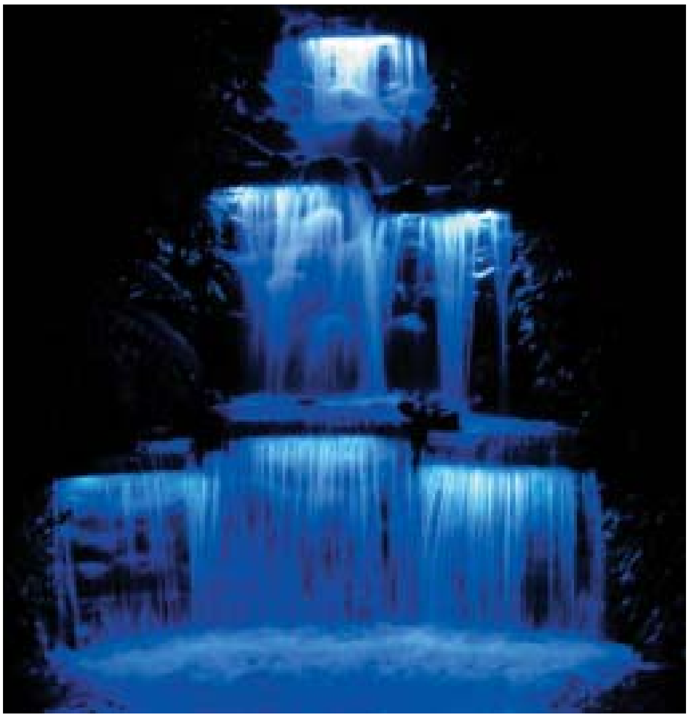
New Zealand Energy Sector Reshuffle

This year has seen a flurry of M&A activity in the New Zealand energy sector. Control in three of New Zealand's largest energy utilities - NGC, Contact Energy and Powerco – has or is about to change hands. In this issue of Leading Energy we look at the motives behind these transactions and what effect this reshuffle could have on the sector.



The economics of New Zealand's energy sector have altered in recent years. The Commerce Commission's Electricity Line Business Targeted Control Regime has limited the opportunity for price increases in the electricity distribution market, while concern over gas shortages and a succession of dry winters has seen electricity prices increase by 6.5% per annum, on average, over the last three years.

In May, the Commerce Commission recommended to the Government that the gas pipeline industry be subject to price regulation, in addition to the light-handed disclosure regime currently in place.

These changes have had different effects on each tier of the market. The major generator-retailers are reporting high profits as power and fuel shortages result in higher electricity prices. In the absence of further consolidation, lines companies can expect little change to profits in the foreseeable future as prices are dictated by the Commission's price threshold regime.

For gas distribution businesses, such as Powerco, Vector and NGC, the Commission's recommendations may have come as a surprise. Nervous investors shaved 4% off the value of Powerco following the Commission's announcement.

Prime Infrastructure Group, a listed Australian infrastructure investment vehicle managed by Babcock & Brown, has now successfully completed a takeover of Powerco. While Prime has signalled no wholesale changes to the business, it is expected to take an active role in charting Powerco's future.

In July, Origin Energy took advantage of distressed seller Edison Mission to acquire a controlling stake in Contact Energy. Origin has since said that it expects further increases in Contact's electricity prices.

Finally, Vector is set to acquire AGL's 66% stake in NGC. This is a logical move for the consumer-owned energy utility, and signals Vector's focus on gas distribution despite the Commission's unfavourable gas pipeline industry recommendation.

Major New Zealand Energy Sector Deals in 2004

Target	Acquirer	Deal Value ($m)	Investment %
Contact Energy	Origin Energy	1,670	51.2%
NGC	Vector	851	66%
Powerco	Prime Infrastructure	1,780[1]	100%

Note 1: Includes all acquired company debt.

Origin Energy Gains Control Of Contact Energy

On 21 July listed Australian company Origin Energy announced it had agreed to acquire Edison Mission's 51.2% shareholding in Contact Energy. With existing investment in upstream exploration activities, Origin will seek to maximise value through higher electricity pricing and a declining supply of natural gas.

Origin is one of two major listed players in the Australian energy market, the other being Australian Gas Light (AGL). Origin has historically grown through securing industrial supply contracts, boosting gas reserves and building co-generation plants. However it also has credentials as a financially savvy investor, making strategic acquisitions to increase its dominance in the market and mitigate its risk.

Origin's stated strategy is one of vertical integration in competitive (i.e. unregulated) energy markets. This is considered to be important due to the inherent risk of non-synchronous price movements in the generation (wholesale) and retail electricity markets. Buying into exploration & production (E&P), electricity generation and retailing, Origin can reduce its exposure to movements in the margin between wholesale and retail electricity prices. Origin also sees benefits in Contact's geographical diversity, reducing its exposure to the Australian market.

Vertical Integration

Funds Employed by Business Segment	Contact	Origin	Origin + 51.2% of Contact
E&P	None	38%	26%
Generation	85%	13%	36%
Transmission	None	6%	4%
Retail	15%	43%	34%

Source: Origin Energy Analyst Briefing 21 July 2004

Contact is New Zealand's largest integrated energy utility, with a major presence in electricity generation and retailing. It has also recently dipped into E&P, procuring exploration permits off the coast of Taranaki which it intends to investigate. Compared to other major generators, Contact has a high reliance on gas to generate electricity (63% of capacity is gas-capable). With the exception of Genesis power, other generators primarily rely on hydro-power, for which there are limited opportunities for of expansion to meet New Zealand's looming "electricity crisis".

Contact is therefore an opportunistic and strategic investment for Origin because of its fit with Origin's existing E&P and LPG investments in New Zealand. This includes a 50% share of the Kupe gas field, which is expected to feature prominently in efforts to find an alternative to New Zealand's dwindling Maui gas field resource. It is unclear at this stage whether Origin will undertake additional E&P directly or through its investment in Contact. A major focus on expensive and uncertain E&P could significantly alter Contact's risk profile, a concern for minority shareholders.

Origin has also signalled that it will continue with tariff increases that have seen New Zealand electricity prices increase by 6.5% per annum, on average, for the last three years. It believes these price increases are necessary due to rising fuel costs and the need to incentivise investment in additional generation.

Origin CEO Grant King expects Contact to outperform analysts' forecasts. Since most analysts have already recognised an expected rise in electricity prices (driven by the cost of gas to fuel generation), this statement could indicate that Contact will aggressively pursue higher prices.

Vector Acquires 66% of NGC

Midway through a highly contested sale process, Vector stole the march on its rivals to secure AGL's 66% stake in NGC. This transaction confirms Vector as a major player in the New Zealand energy sector.

In some respects, NGC was the catalyst for much of the M&A activity in the energy sector this year. In April NGC announced that it was in talks with Vector and Powerco regarding a possible merger. This announcement led Powerco's Majority Shareholders to seek an exit of their investment.

In August, AGL announced its intention to exit its 66% investment in NGC. AGL's decision to exit may have been triggered by a recommendation from the Commerce Commission that certain gas pipeline businesses, including NGC, be subject to price regulation. AGL's strategy is to reduce its reliance on regulated assets.

Shortly after accepting indicative bids in early October, AGL announced it had agreed to sell to Vector. The sale, at $2.91 per share, was above analysts' valuations, however minorities are expected to hold out for a higher offer from VECTOR. NGC shares were trading at $3.15 on 26 November 2004. In order to finance the deal, Vector will issue 24.9% of its share capital in an IPO within the next 12 months. This is expected to raise between $450 million and $500 million. Vector first moved into the gas market when it acquired UnitedNetworks' Auckland gas distribution network in 2002.

NGC has 6,000 kilometres of gas networks, including the North Island transmission network from which other networks source gas for local distribution. It also operates a large energy metering service, and owns 45% and 24% of New Zealand's electricity and gas meters respectively.

Prior to Vector acquiring control, NGC indicated that it was "seeking to identify mutually beneficial growth opportunities with other energy-infrastructure companies". With a relatively sparse gas network in New Zealand and the potential for synergies between NGC and Vector there is now plenty of scope to achieve this goal.

Prime Infrastructure Acquires Powerco

With PricewaterhouseCoopers as lead sale advisor, the Majority Shareholders have exited their investment in Powerco. Prime Infrastructure Group, the successful bidder for their stake, has now moved to compulsorily acquire all of the equity in Powerco. Prime has signalled that its strategy for Powerco is to maintain the status quo. However, the implications of a strong and ambitious new owner need to be considered.

In late April, Powerco's Majority Shareholders - comprising New Plymouth District Council, Taranaki Electricity Trust and Powerco Wanganui Trust - advised the market that they were seeking to exit their investment. Following a contestable sale process led by PricewaterhouseCoopers, Prime Infrastructure Group secured the Majority Shareholders' acceptances and successfully made a full takeover offer for Powerco.

Faced with some reinvestment risk with respect to the sale proceeds, the Majority Shareholders expressed an interest in non-cash consideration. Consequently, Prime's offer comprised a mix of cash and unsecured, convertible securities known as SPARCS (Subordinated Perpetual Adjusting Reset Convertible Securities).

Following a Takeovers Panel exemption that allowed overseas shareholders to obtain full cash consideration, rather than a mix of cash and SPARCS, a significant number of shareholders sought to move offshore to secure a full cash payout. Prime consequently adjusted its offer to contribute more cash.

PricewaterhouseCoopers separately arranged an underwriting facility to absorb any additional SPARCS that might be received by the Majority Shareholders. This facility was not utilised as the Majority Shareholders received the intended proportion of cash from Prime.

During the sale process concerns were raised in the media that Powerco's new Australian owner might seek to maximise its return by cutting costs, with a resulting fall in the quality and reliability of service to consumers. The same concerns were raised regarding Prime's upkeep of Powerco's distribution assets. While it is important to consider such matters, Prime's proven track record as an infrastructure investment company should assuage these concerns.

Prime is the long-term lessor of the Dalrymple Bay Coal Terminal, in Queensland. Since acquiring this lease, Prime has completed an expansion of the terminal, increasing its capacity by 22%. In its 2003 Annual Report, Prime said:

"Part of Prime Infrastructure's success will be its ability to … enhance the value of existing assets"

Regarding quality of service, the Electricity Lines Business quality threshold regime penalises any lines company that fails to provide a high level of service to consumers, principally measured by periods of interruption to service.

Prime's ownership could also provide Powerco with the funds to expand. Powerco is currently developing a gas network in Tasmania, with partial funding from the Tasmanian government. Developments such as this could be self-funded (i.e. on Powerco's own initiative) with the backing of Powerco's new parent, not to mention the backing of Prime's managing entity, Babcock & Brown.

Prime is acquisitive, with a preference for regulated assets with stable cash flows. Babcock & Brown has recently completed an IPO in Australia in which it raised $550 million, giving it a market capitalisation of $1.6 billion. Through Prime, Babcock & Brown will undoubtedly see an opportunity to participate in developments in the New Zealand energy sector. This may include development of New Zealand's gas transmission infrastructure, a core area of expertise for Powerco.

Prime CEO, Chris Chapman, has indicated that Prime views Powerco as a strategic investment. In his acquisition statement, Mr Chapman said that Prime is "supportive of Powerco's business plan and growth ambitions".

Powerco Transaction Multiples

	Year Ended 31 March 2004 (A)	Year Ended 31 March 2005 (E)
EV / EBITDA	9.4	9.1
EV / EBIT	14.5	13.7

Source: Bloomberg

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Cover image: Festival of Lights photographed by Richard Hale.

Inside image: Rural Mount Taranaki photographed by by Steve Hart.

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