

New Zealand Equity Monthly June 2021

20 July 2021

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Overview and prospects for New Zealand's electricity generators

This month, we take a look at the current state and prospects of New Zealand's five main electricity generators/retail providers. Almost all the electricity in New Zealand is generated by five companies: Genesis Energy, Contact Energy, Meridian Energy, Mercury Energy and Trustpower. All five are also the dominant suppliers to the retail market and are collectively known as "gentailers" (generators and retailers).

The gentailer sector has traditionally been relatively stable and predictable, but it has experienced a significant amount of turbulence over the past 18 months. The first source of turbulence was the prospect of the Tiwai Point Aluminium Smelter, a major consumer of electricity, closing down. Turbulence was also caused by Blackrock's Clean Energy ETF, which was buying Meridian and Contact shares from October 2020. As a result, the share prices of these two stocks almost doubled in about four months, before pulling back in February 2021 after the ETF announced a change of methodology which saw the two companies significantly down-weighted.

Calm eventually returned to the gentailer sector following the decision that Tiwai would remain in operation until 2024 and as ETFs ceased dominating share price performance. However, the sector is currently facing new challenges, notably a drop in hydro lake levels and reduced natural gas availability. Lake levels have recently been around 70% of historical averages amid a dry spell (although South Island lake levels have improved of late), and production at the country's largest gas field, Pohokura, has been declining steadily since May 2020. Both factors have pushed up wholesale prices. Spot electricity prices are between NZD 250 - 300 per megawatt hour (Mwh) at present, much higher than historical levels of between NZD 70 to 90 per Mwh.

Wholesale prices are expected to remain elevated for as long as gas availability issues persist. However, they are likely to normalize in time, as new renewable generation comes online. Looking at future supply/demand dynamics, the potential closure of Tiwai in 2024 remains a risk to the demand front, although this is expected to be partly offset by the retirement of thermal generation, in addition to new demand sources. Three key potential sources of demand being eyed by the sector are 1) the switch in the energy source for dairy boilers in New Zealand's South Island to electricity from coal, 2) data centres and 3) green hydrogen production. Green hydrogen, in particular, presents a large opportunity given the demand likely to come from countries such as Japan and South Korea.

From a valuation perspective, the gentailer sector has historically exhibited strong relationship with interest rates. Gentailer stocks traded at relatively stable spreads to government bond yields prior to the pandemic. This relationship was disturbed momentarily by the spread of COVID-19, speculation over Tiwai and ETF-related developments. However, we are starting to see some stability return to the yield spreads recently.

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