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Malta: Energy Sector Overhaul Should Decrease Fiscal Vulnerabilities and Increase Competitiveness

The Government of Malta (A3 negative) is in the process of reforming its energy sector, with the aim of lowering energy costs for the entire island economy and returning the loss-making, state-owned energy company, Enemalta (unrated), to financial health. Although the plan is still in its infancy, any gradual steps are likely to help reduce Malta's exposure to the sector's contingent liabilities and attract greater investment to diversify the economy away from its tourism base.

» The first stage in this reform initiative involves a shift in the country's energy mix to significantly reduce its electricity generation costs and introduce a conservative approach to reserve power and renewable sources. The government's plan envisions diversifying energy sources through an interconnector linking the grid to mainland Europe through Sicily, and gradually shifting production away from fuel-oil generation towards a cheaper, cleaner, gas-powered energy matrix.

» The second stage involves tackling inefficiencies and restructuring Enemalta's debt. As a result of its exposure to oil prices and operational inefficiencies, Enemalta posted losses in 2011 and 2012. These efforts have yielded tangible progress, with more substantial results likely to come.

» We do note, however, that the planned reforms are ambitious and there are risks to its successful implementation. For instance, the building of new infrastructure relies on the interest of private partners, adding a degree of uncertainty as to whether a suitable partner may be identified. Moreover, Enemalta's financial health could be jeopardised by a premature cut in tariffs should anticipated savings be delayed. Nonetheless, we believe that the sovereign will benefit from a less volatile Enemalta and a more resilient energy sector that is likely to attract greater investment to the country as input costs fall.

RATINGS

Malta

	Foreign Currency	Local Currency
Gov. Bond Rating	A3	A3
Country Ceiling	A1	A1
Bank Deposit Ceiling	A1	A1

KEY INDICATORS

	2012	2013F	2014F
Real GDP (% Y/Y)	0.8	1.3	2.0
Current Account (% GDP)	0.2	0.7	0.5
Fiscal Balance (% GDP)	-3.3	-3.1	-3.0
Gov. Debt (% of GDP)	71.3	73.5	74.2

Haver, Eurostat, Moody's

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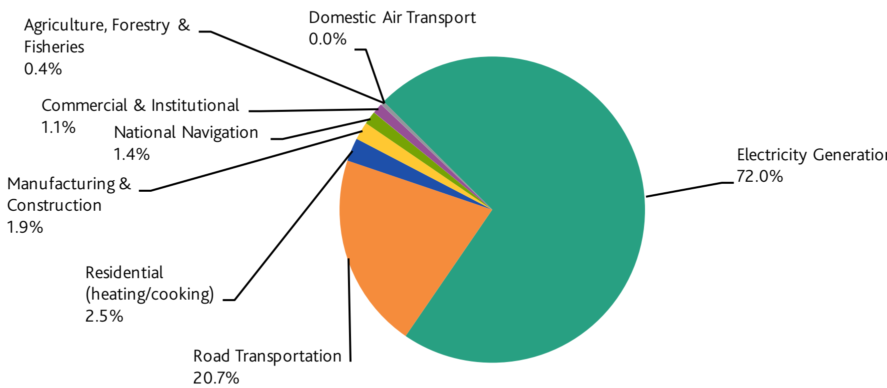
Reforming Malta's Energy Sector

Step 1: A shift of the energy matrix...

Malta is entirely dependent on energy imports, chiefly oil, and 70% of primary energy imports consumed in the inland market (i.e., not for aviation or bunkering) are used for electricity generation (see Exhibit 1). Fuel constitutes 73% of the costs of providing electricity to final consumers. Given the country's geographic limitations, the viability of developing renewable energy sources is limited and very costly. As such, Enemalta, Malta's only generator, distributor and supplier of electricity, is exposed to fluctuations in oil prices, and the cost of generating electricity rises in tandem with oil price movements.

EXHIBIT 1

Primary energy imports consumed in the inland market in 2011 by percentage



Source: 2012 National Energy Programme

The new Labour government that took office in March 2013 has made energy reform a policy priority. A key pillar of its strategy rests on lowering the cost of electricity generation by reducing the dependence on oil imports and diversifying the energy matrix.

...to significantly reduce electricity generation costs...

The authorities hope to build on the progress that Enemalta has already made in installing modern diesel-fired generators that operate with greater efficiency, which has cut the cost of fuel to generate electricity to 11 cents/unit, from 17-18 cents. The company expects to generate €36 million in savings from the diesel-run power plant.

The diversification strategy also entails shifting production towards natural gas power generation. The government seeks to build a new gas-fired power plant, to be operational by 2015. The plant, as well as the infrastructure needed to receive and store the gas, are to be financed through public private partnerships (PPPs). The authorities expect the private partner to build, own, and operate the new plant, as well as supplying gas to the existing ones. Under the plan, Enemalta would lease properties to the independent producers and buy energy from them. The government issued a call for tender in April 2013, with a 15 September deadline. The authorities expect the generation cost from the gas-fired plant to be less than 10 cents/unit, including the cost of capital.

…and a conservative approach to reserve power and renewable sources

Enemalta is also in the process of building an interconnector that will link the Maltese grid to Europe via Sicily. This will enable Enemalta to broaden its energy mix and make it less vulnerable to fluctuations in oil prices. Access to the European grid will also allow Enemalta to benefit from the more competitive prices associated with a larger market.

As the new diesel generators have come online, the authorities have relegated the less efficient, fuel oil-fired Marsa power plant as a reserve provider of energy, should electricity demand spike or the supply be interrupted for any reason, highlighting the prudent transition strategy. The interconnector is expected to be finalised by the end of 2014, at which point Enemalta will decommission the Marsa power plant.

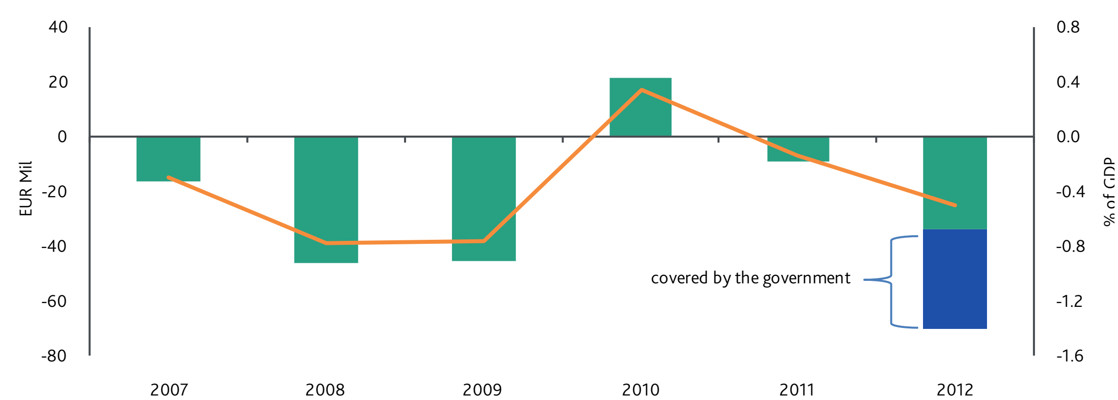
The government is also aiming to increase the proportion of energy from renewable sources to 10% by 2020 from less than 1% currently in order to meet EU targets. Large wind farms projects have been ruled out due to the large investment that would be required, while photovoltaic power and slower water heater projects have met more success. Although their contribution to the energy mix remains small, we believe that a gradual increase in renewable generation decreases the risk that elevated costs due to rapid investment in these sources could result in higher outlays for Enemalta, and potentially, the sovereign.

Step 2: Tackling inefficiencies and restructuring Enemalta's debt…

In order to avoid jeopardising the economic recovery following the 2008-09 global financial crisis and in the context of adverse economic conditions prevailing in Europe, the government prevented Enemalta from passing increased electricity-generation costs on to final consumers. Despite its efforts to hedge against fuel price hikes, the measures resulted in losses for the company (see Exhibit 2). A return to profitability followed lower oil prices in 2010, but inefficiencies and a lack of tariff adjustments resulted in losses once again in 2011-12. Enemalta's losses have contributed to volatility in the government's fiscal accounts given the need for reinvestment and capital support.

EXHIBIT 2

Enemalta's Financial Performance (Profits and Losses*)



*2008 covers 15-month period from September 2007 to December 2008 as the corporation changed its financial year end from 30 Sept to 31 Dec. Data for 2012 is an estimated provided by the authorities.

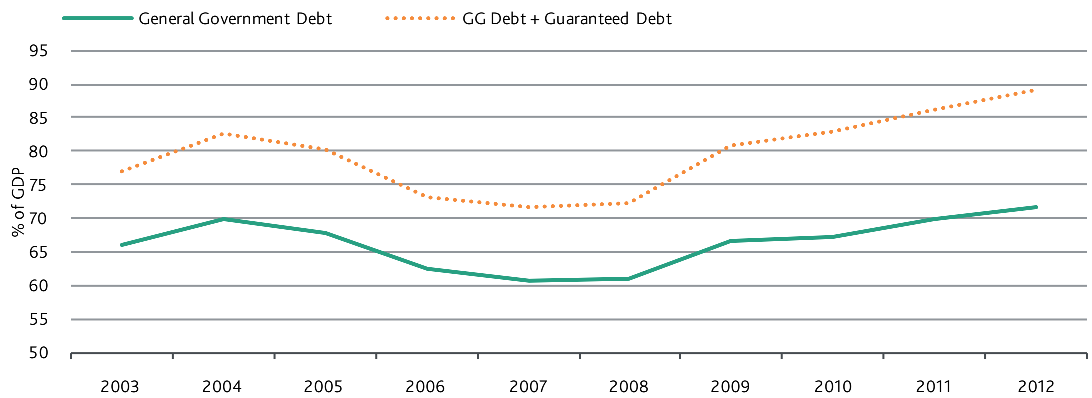
Source: Enemalta Financial Statements

Enemalta estimates that revenue losses resulting from theft and non-technical losses (such as unbilled consumption due to metering and invoicing issues) amount to about 7%. Losses resulting from technical deficiencies in distribution total roughly 5%.

In 2012, Enemalta's total debt reached more than €830 million (12% of GDP), of which 85% is guaranteed by the government. This has increased the sovereign's contingent liabilities, weakening its fiscal position (see Exhibit 3). As of end-2012, guarantees to Enemalta represented about 50% of the government's total guarantees.

EXHIBIT 3

Government and Government-guaranteed Debt*



*Includes guarantees to other publicly-owned enterprises such as Airmalta
Source: Central Bank of Malta

Given the company's fragile financial position, the outgoing Parliament approved a plan in December 2012 to restructure Enemalta's debt in order to smooth out its repayments on outstanding obligations and better align them with cash flows from tariff income. As part of the transaction, the company sold assets to a Special Purpose Vehicle, refinanced its loans from the proceeds and leased the assets back at a rent of about €20 million a year, which is equivalent to the capital and interest payments due on the refinanced loans.

The restructuring enabled Enemalta to spread out €318.5 million in loan repayments over 25 years in place of three bullet repayments due in 2011, 2015 and 2018. While the transaction gave the company room to continue its operations, it did not resolve its longer-term solvency issues.

…have so far yielded tangible progress, with more substantial results likely to come

In order to curb technical and non-technical losses, the authorities have embarked on a campaign to install new remotely read meters to better identify sources of electricity loss and theft. As of June 2013, a total of 88,000 smart meters had been installed, up from 44,000 in March. The government's target is to have 130,000 smart meters in place by the end of the year.[1]

The initiative has increased Enemalta's cash flows by €5 million a month and management sees potential for boosting revenue collected by €140 million overall. Important elements in this strategy involve an ongoing cost-reduction exercise, settling and resolving a number of locked and past-due accounts, greater billing efficiency, and the benefits derived from the PPPs, savings from the new generation engines, the interconnector and potential sale of non-strategic assets which could generate nearly €75 million.

[1] The total population of Malta is approximately 400,000.

In addition, the government recently announced that it had signed a Memorandum of Understanding with the China Power Investments Corporation (CPIC), one of the five largest state-owned electricity producers in China. As part of the agreement, Shanghai Electric Power, a subsidiary of CPIC will become a minority shareholder in Enemalta, providing the Maltese utility company with a cash injection that will improve its financial position. Enemalta and CPIC also plan to set up a joint venture to produce photo-voltaic units for sale in Malta and across the EU, which would help Malta reach its renewable energy production targets, while providing China with a foothold in the European solar energy market.

Another initiative between both parties is the setting up of a Energy Service Centre that will cater for the maintenance and service of energy production plants in Southern Europe, Turkey, the Gulf and Africa, a venture that is likely to further boost economic activity in Malta.

Successful implementation would be credit positive, yet risks remain

Overall, the authorities believe that by 2014, Enemalta should register an underlying loss of approximately €17 million, excluding the sale of plant assets to a private partner which would result in a shift to profitability for the year. By 2015, forecasts envision the company producing a small profit of just under €4 million, reducing the need for budgetary support and containing further contingent liabilities that weaken the sovereign's fiscal position.

Moreover, the government expects that cost reductions stemming from the overhaul of the sector will allow Enemalta to reduce tariffs by 25% for households by 2014 and for industrial consumers by 2015. The reduction would be beneficial for the entire economy, as it would increase households' purchasing power and improve the economy's competitiveness.

Malta already benefits from a well-educated, English-speaking labour force with high technical skills that attracts investment from business-service providers and electronic components manufacturers. We believe that lower energy costs would be a boost to both industries and could attract greater investments to help diversify the economy away from its tourism base.

Nevertheless, we note that the energy reform agenda is ambitious and there are risks to its successful implementation. The building of new infrastructure relies on the interest of private partners, adding a degree of uncertainty as to whether a suitable partner may be identified. The financing of the interconnector project also relies on EU funding, which is subject to restrictions and conditionalities. Although two new interconnectors are expected to be put in service between Sicily and the mainland between 2014 and 2017, Sicily's current interconnector to Italy is already congested, and the planned Maltese interconnector could further strain the neighbouring island's grid.

Enemalta's financial health could be jeopardised by a premature cut in tariffs should any roadblocks delay the anticipated savings. However, we believe that the authorities remain committed to the successful implementation of these measures. Even if progress on the agenda does not meet the authorities' ambitious targets, any gradual steps taken through the end of 2014 would have a beneficial impact on a long-standing vulnerability to Malta's credit profile.

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