

A Bright Spark for Investors in the Energy Sector

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The television images of the smoldering exposed reactor core in Japan have focused everyone's minds again on the inherent dangers of nuclear energy. Nuclear power stations supply 6 percent of the world's energy and account for 13.5 percent of all electricity generation. If the cautious and efficient Japanese can't make nuclear power safe, then who can?

In the short term, commodity prices have been upstaged by uranium's dramatic dive in price, while conventional fuels — including gas and coal, but also renewables such as carbon dioxide credits — have received a huge boost.

In the longer term, Fukushima has reopened the whole debate on whether nuclear power is worth the risk of an accident. Germany has idled one-third of its nuclear capacity, and Gazprom is suddenly once more a darling of the investment community.

At this point it looks likely that the West is cold to the idea of building new nuclear reactors, but the East is much more positive. Prime Minister Vladimir Putin put it plainly: “It is impossible to speak about a global energy balance without the nuclear power industry,” pointing out that nuclear power accounts for 16 percent of the country’s power generation and more than 80 percent in France. Hungary, Kazakhstan, Ukraine, Serbia and Belarus followed Putin’s lead, saying they would push ahead with plans to build new nuclear power stations.

And here is the rub. Normally the utilities sector is one of the least exciting in the investors’ universe. Wading through the huge reports that the sector’s analysts churn out is guaranteed to put any fund manager to sleep. Almost everywhere, utilities look like a sector with no hope. They are squeezed by regulators, rising fuel costs, environmental demands and the post-crisis poverty of the consumer. Now, to make matters worse, regulations and prices will only increase further after the Fukushima disaster.

But not so in the emerging markets. With double-digit growth rates and dilapidated infrastructure hindering further development, the question of energy is an issue of national security. Nuclear power is an acceptable solution to their problems.

There is one country where utilities — despite their sleepy image — are among the most dynamic sectors and profits are growing by increasing demand and liberalization. It is not China, which has an insatiable thirst for energy. It is not the developed world, where pricing power and returns on equity are capped. It is Russia, one of the richest energy countries in the world.

What do you do if you need \$500 billion of investment? Turn to the state for support? The trouble is there is a long line of Russian companies in the infrastructural sectors that are also looking to the state for multibillion-dollar investments.

Anatoly Chubais, former head of Unified Energy System, went through the utilities sector like a storm, cutting red tape and slashing rules to transform it into a state-of-the-art investment opportunity while sweetening the deal to entice investors.

The competition meant that the state could assign premium valuations, and the cream of the international power companies were pulled into what is arguably the last really big power privatization that will ever happen.

Russian power sector reform was probably the most ambitious the world has ever seen. Privatization of the generation companies have raised tens of billions of dollars of investment, including from global energy giants such as Germany’s E.On, Italy’s Enel and Finland’s Fortum.

Russia copied the British liberalized wholesale power market model, which runs on the marginal pricing principle. At any time, the most expensive generator delivering power to the grid sets the price for everyone else. It is a good principle if you are an efficient generator, since the most inefficient generator always sets the price. And most of Britain’s power companies are making a good living out of it. Moreover, every generator in the sector is motivated to improve efficiency as fast as possible to add significantly to its bottom line.

But in Russia, in addition to selling electricity, all newly built generators also receive extra cash from the state with the so-called guaranteed capacity payment. Companies can earn back up to 90 percent of their investment over 10 years with a 13 percent rate of return, effectively doubling their profitability. No wonder that the “spark spread” — the difference between the price of a kilowatt-hour of electricity and the cost of fuel needed to produce it — on the newly built Russian power stations is double that in Britain.

Putting aside some of the recent snags associated with the government’s desire to hold the tariff growth down, the utilities reform is nearly completed, and most of the associated risk is already behind us.

But investors are still largely ignoring the sector, which trades at very low valuations. For example, you can buy into E.On’s business in Russia, which is expected to generate more than double the average EBITDA margin of E.On’s worldwide business, at half the valuation levels of the parent company.

Likewise, investors can buy a piece of a Russian energy distribution company at half its regulated asset base levels, while in other countries similar companies trade at above these levels.

In Russia, this is nothing short of a miracle given that the government is known for its inability to implement its good ideas. But perhaps there is where the real surprise lies. Japan has a reputation for modernity and technological prowess, but Fukushima, built 38 years ago, is one of the world’s oldest nuclear power stations. It was supposed to be decommissioned this year, but the cash-strapped government had just extended its license for another decade before the earthquake hit.

In contrast, despite Russia’s reputation for backwardness, its nuclear power stations, built 19 years ago, are some of the world’s youngest. Here, too, the conventional wisdom has been turned on its head.

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