Brazilian Utilities

MP1304: Unwelcome Risks Overshadow Long-Overdue Changes

Our First-Read Leads to Downside Risks for DisCos and Increased ERPs for the Sector

On October 28, the rapporteur of MP1304 disclosed the report in which it details the initial proposals for an ample sector reform that aims to tackle a multiple range of relevant topics all at once. Overall the report adds risks to the sector in two ways: i) the first and most obvious is by hampering the economics of DisCos in a theme that has already been discussed and overcome (there is NPV downside for EQTL, NEOE and ENGI) and ii) several items in the report are still vague and bring more questions than answers and make it a harder task to predict the economic impacts of these measures for listed companies (especially GenCos). Naturally, this is part of a political process that has many steps, and we do not expect that the text remains as is after the process is concluded. Overall, we expect negative reactions for listed DisCos with SUDAM/SUDENE exposure, marginally negative performance for AURE (as price action in Oct 28th's trading session already reflected part of the frustration) and mixed performances for the rest of the coverage, with an obvious increase in ERPs for the sector as whole while uncertainties increase.

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An unwanted easter egg for DisCos: The initial text for MP1304 is proposing (we recall this is a provisional measure and not a bill of law which could bring judicial implications) that ANEEL should capture the SUDAM/SUDENE fiscal benefits DisCos currently have (effective tax rate of 15.25% until 2038 vs. 34% -> an average 2.0p.p. reduction in ROIC during the period). Our view is that incentives are the compass of policy making. In that sense, we argue that the incentives to reduce tariffs by hampering regulatory returns of DisCos seem to be an ineffective way as there is an increased goodwill to be perceived as providers of increased quality and services by end-consumers, especially when social tariffs are now covering a relevant part of the population (making them less sensible to growing tariffs). Additionally, as this wasn't a topic of discussion even with congressmen that worked closely on the initial draft, we see there will be an ample debate on the theme in the coming days. The report will be discussed at 11am on Oct 29 and we will be able to gauge the initial thermometer of where the members of the commission stand. Running our models with an eventual capture of these benefits we estimate potential NPV reductions of 5%, 12% and 11% for EQTL, ENGI and NEOE respectively. Although we believe ultimately the odds of this passing are lower than that of not passing, the ERP for DisCos will increase once again and eventually spillover to the rest of the sector while investors increase their skepticism on future economics for DisCos.

Are the overall elements brought forward bringing potential downside to energy prices in the mid/short-term? We believe so. While LT LCOEs are having upward pressures, we see potential mid and short-term changes as downside risks to power prices. LCOEs might sustain LT power prices upwards, but increased BESS penetration and more inflexible capacity will invariably reduce intraday volatility, reducing modulation gains for HPPs and potentially reducing risk-aversion in the pricing models. It will be important to keep track on how these themes evolve over time. For now, what is certain, is that uncertainty of prospective economics for generators is on the rise and risk premiums should reflect such uncertainty. We discuss other read-throughs in the following pages of the report.

Modest solutions for utility scale renewables: The report brings a solution for past curtailments related to reliability and electrical restrictions, proposing the reimbursement of all values related to these cuts from Sep/23 to date. We estimate this will have a modest positive impact in some of the companies we cover (notably AURE has ~2% of its market cap to reimbursed from this topic according to XPe calculations). Other forward-looking solutions for curtailment were left out and the rapporteur was very clear on stating that energetic curtailment is a risk that belongs to the entrepreneur. However, we do highlight that second-level measures such as increased economics for BESS and the slowdown of GD (at least for now) could help soften blow for renewables by preventing energetic curtailment to continue its accelerated growth and smoothen the increasing modulation costs due to high intra-day spot price volatility. These elements are still hard to measure but could bring some economic relief. All in, curtailment solutions for renewables were far from what the market had recently created in terms of expectations, and we therefore expect a potential continuous negative performance for AURE shares in the next couple of days while investors digest the entirety of the report.

Pausing GD growth? Another proposal that might face some political backlash is the inclusion of a charge for new GD assets of R$200/MWh that are coming online between the date of the report and Dec/28. This might create an important deceleration in GD capacity additions in the period that could bring some ST relief in growing energetic curtailment pressures. There is no clear economic impact for the listed companies we cover, but we highlight risks of businesses related to the supply chain of solar panel sales in Brazil could suffer with choppier waters in the next couple of years.

The start of a new era for BESS in Brazil? One important topic to keep a close eye on are the provisions regarding BESS. The possibility to exempt BESS components of import tariffs in the future (although a R$1bn exemption cap is set for 2026) is transformational in terms of economic viability and some sector experts estimate that without import tariffs, BESS could be ~30-40% cheaper than alternative fossil solutions, with a quicker time-to-market and optimal ramp requirements for Brazil's current needs. Additionally, Senator Braga mentioned in an interview after the session today, that DisCos could eventually develop BESS within their concessions to help modulate local GD loads more efficiently. This proposal could quickly increase BESS penetration in Brazil's matrix and significantly reduce intraday spot price volatility and therefore ST prices (downside risks for Axia and names with exposure to power pirces?). It is still hard to gauge what could be the full potential for BESS capacity, but in our recent IoC report we have estimated a potential of up to ~20GW of BESS capacity based on current electricity being curtailed during peak production hours.

ELET's privatization bill inflexible thermal plants and SHPs revival, a positive for ENEV? After being dormant for the last couple of years, the report revives the debate on adding more inflexible thermal capacity into the grid (that reduces the correlation of power attribute to power prices) at an expensive cost to be allocated to consumers in detriment of creating more flexible thermal capacity, adherent to the system's current needs. With a total of 4.25GW of inflexible thermal (50% inflexibility from 70% previously) this could add ~2% of base production to the matrix, increasing curtailment, GSF and marginal expansion costs to the system. However, if the requirements remain, we believe players such as ENEV could benefit from this measure as it has existing footprint in specific regions that are being addressed by the report. The requirements for inflexible capacity will have to meet technical criteria set by the ministry, as well as operational startup requirements have been delayed, which could be seen as an alternative to delay the need for such capacity in the future.

CMIG, CPFE, AURE, EGIE and LIGT could benefit from the possibility of a concession renewal with no competition for HPPs? An interesting topic that was added is the possibility of concession renewals for HPPs >50MW that had their concessions contracts signed prior to Dec/2003. Out of the listed name we cover, this could be especially important to LIGT (the bulk of Light's generation portfolio fits this), CPFE (a relevant part of CPFE's HPPs have concession contracts signed before 2003), AURE (AES' HPPs and most of AURE's HPPs via JVs have contracts signed between 2000-03), EGIE and CMIG (through HPP Emborcação), and the report also clearly outlines that any residual values related to these assets should have the replacement cost methodology applied to measure what amounts are owed.

LCOE's on the rise? Allocating Reserve Capacity or adding BESS requirements to new renewable capacity lead to the same path. The provision that establishes that new capacity that does not provide "firming" to the system will be allocated with Reserve Capacity Charges are clearly a beneficial economic signal to align energy attribute to economics. The report also allows the possibility of adding BESS with renewable capacity as an alternative. Either way, by adding "firming" costs to renewables we should see more aligned economic signals that will be reflected in much higher LCOEs in the long run, while we will probably see limited capacity additions in the mid/short-term given challenging economics.

Additionally, new renewable assets will not be able to benefit from incentivized energy spreads (which we also see as a positive and already incorporate in our LCOE build-up). Lastly, self-production rules are getting stricter, with a minimum required stake of 30% and reduced charges will only be applied to on-site consumption (e.g. consumption in a location different of the production site will bear some additional charges compared to the actual framework), reducing the structural spread of ~R$90-100/MWh of lower regulatory charges for Self-Producers.

Next steps for MP1304: A hearing is scheduled for October 29 in the morning for the members of the commission to discuss the contents, we believe it will be an important thermometer to gauge what will be the most relevant debates by policymakers. Once the commission is concluded, the contents of what has been discussed moves to Congress and afterwards the Senate. Lastly, the bill goes to the President for any potential vetoes.

Figure 01: Potential NPV Impact on DisCos

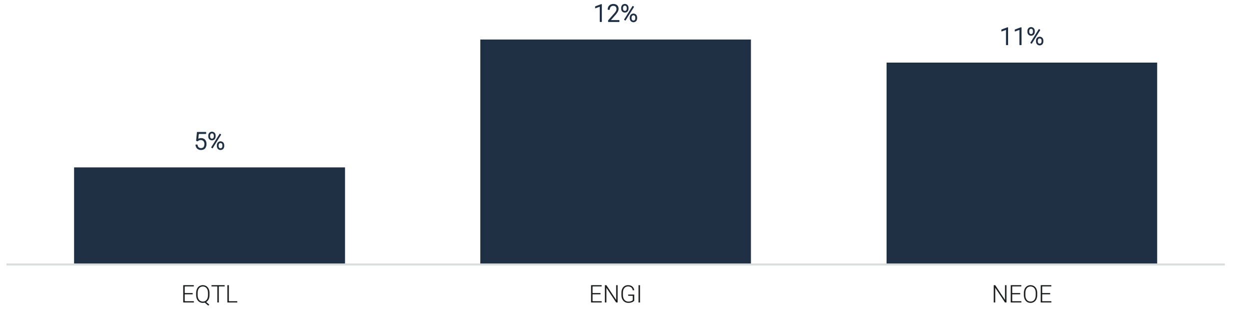
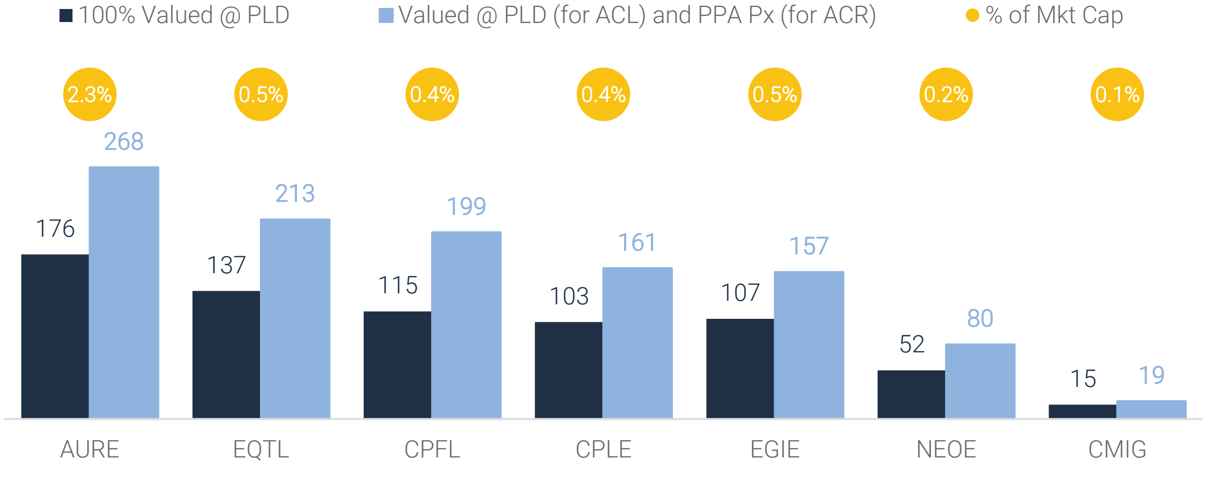


Figure 02: Potential Reimbursement for Reliability and Electrical Curtailments Accumulated Since Sep'23 (R$mn)



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