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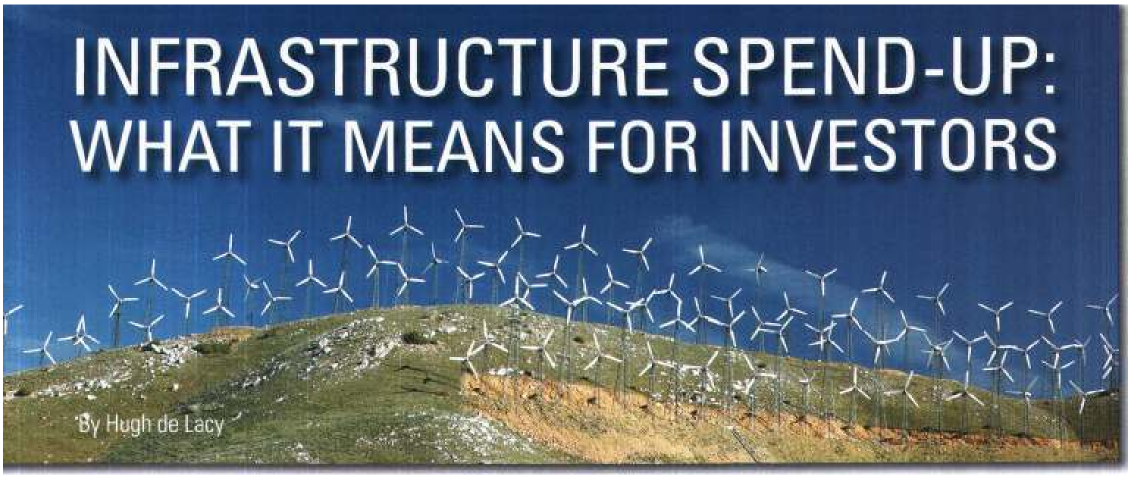
INFRASTRUCTURE SPEND-UP: WHAT IT MEANS FOR INVESTORS



By Hugh de Lacy

As an election looms, it seems clear both main parties are committed to huge expenditure on infrastructure for both political and economic reasons

Infrastructure stocks – especially those in the energy and transport sectors - could be the haven of investment growth as New Zealand battles its way through the global credit crisis sparked by the United States sub-prime mortgage meltdown.

Already strongly supported by both major political parties, infrastructure is a logical area of potential government-driven economic stimulus to help haul the country out of the mire created by the collapse of major global finance groups, and desperation measures by the US government to prop up others.

The most obvious effect of the crisis on New Zealand looks like being a shortage – and resultant high interest rates – of development capital, something that can be offset by direct injections of government money into infrastructure.

Within days of the Lehman Brothers and AIG dramas in the US, New Zealand economic forecaster Berl was in fact calling for a big government infrastructure spending programme to cushion local industry from the fallout.

And the chances are that the November 8 general election will spark something of a bidding war between the Labour-led incumbent government and opposition National Party over which can promise the bigger spend-up.

Both parties are already committed to substantial infrastructural programmes, especially in energy and transport, and the Wall Street crisis is almost certain to have a government of either persuasion reaching defensively for the cheque book.

And there's plenty to spend the money on across all four categories – energy, transport, water reticulation and telecommunications – as a recent government infrastructure stock-take demonstrated.

Last year the Ministry of Economic Development (MED) published the findings of a study, announced in the 2003 Budget and carried out mostly by PriceWaterhouseCoopers (PWC), into the state of the nation's infrastructure that concluded it's "in reasonable condition."

"Subject to an ongoing appropriate level of investment, [infrastructure] should not pose a barrier to the Government's growth and sustainable development objectives.

"But, notwithstanding the overall positive message, there are significant local and sector-specific issues [that] may have significant impacts, both locally and nationally," the PWC report said.

These issues included land transport, specifically Auckland's roads and deferred maintenance on the rail network.

The second area of concern was with water and waste-water, especially in terms of security of potable

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water supplies in drought-prone areas, supply and waste-water treatment in smaller communities with large tourism-driven seasonal population fluctuations, and competing demands for water from the agriculture and commercial/industrial sectors.

The third issue PWC noted was electricity generation and certainty of supply during dry periods.

Whichever major party gets to form a government after November 8, it'll not be lacking infrastructural projects on which to spend money to keep unemployment low and to drive the economy out of the current technical recession.

And with the Government's fiscal position sound and debt low, it can afford to run substantial deficits, even bigger than the $3b projected over the next four years.

National has promised to increase Labour's infrastructure spend by $750m a year despite cutting taxes, and it hopes to limit debt by involving the private sector on a dollar-for-dollar basis that could take the total infrastructure spend to $12b a year.

Labour too is promising greater private sector involvement by way of public-private partnerships, something it has talked about for years but has seemed reluctant to put into place.

Local authorities will also be a source of capital for infrastructure developments: last year they had revenues of $6.23b, up by $405m on the previous year, and spent $6.07b with an operating surplus up $434m.

They may be less inclined to go into deficit to fund capital spending than central government, but their contribution to civil construction is always significant.

The stock market investor is also spoiled for infrastructure investment choice, except perhaps in the water and waste-water treatment sectors.

Opportunities in the four infrastructure sectors include:

Energy

Electricity shortages in four of the nine years Labour has been in power make public spending in this sector a priority for both parties.

Labour has cited annual electricity demand growth of 1.5%, though National's estimate is closer to the historic level of 2.2% - and where Labour sees a need

for 145mW of new generation a year through to 2020, National sees the need for 210mW.

The energy sector is dominated by state-owned enterprises which have grown rich on prices boosted by the repeated shortages, and they're all committed to new generation projects, mostly windpower and geothermal.

Hanging over the sector is the Government's 10-year ban on new coal and gas generation, which National has promised to scrap, and the impact of its Kyoto Protocol emissions trading scheme (ETS) which was passed into law in early September.

A cluster of new generation projects, most of them in windpower, is due to come on-stream over the next few years, but the rush to develop security of supply means more will follow, especially if the thermal ban is lifted.

The country is enormously rich in energy resources, by far the biggest being the 11 billion tonnes of lignite coal sitting untapped below the farms of Otago and Southland while the Government has used the thermal ban to pursue its goal of having 90% of the country's power coming from renewable sources by 2020.

However the most immediate problem in the sector is not generation, but transmission.

The two-way street by which electricity passes between the two main islands is severely congested, with supplies from the North Island to the South at one stage this winter jeopardised by a single power pylon buckling.

Upgrading the 500mW high-voltage direct current line between the islands to as much as 1400mW is likely to take at least three years, and the South Island generators and transmitters are scrapping with their North Island counterparts over who should pick up the $1+b tab.

The Government has also promised to spend $1b on household insulation, which should give a fillip to the myriad of small insulation companies presently eking out a living in that area.

Public companies that will benefit from the

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generation and transmission spend-up include Contact Energy (mid-September share-price about 860c), Trustpower (820c), Horizon Energy Distribution (340c) and wind turbine maker Windflow Technology (330c).

Transport

This is the second sector looking forward to major investment, both immediate and on the horizon, to offset the surge in global oil prices that reached $US147/barrel this year before mercifully falling back to under $US100.

Investment will also be aimed at easing congestion on the roads and stimulating rail and sea-borne traffic.

On the horizon is self-sufficiency in diesel priced around $1/litre if state-owned collier Solid Energy and privateer L&M Group are allowed to go ahead with their plans to build gasification plants – each costing around $6b – to convert the southern lignite coals to transport fuels.

The present coal-shy Government has been ducking the implications of using lignite, of which there's enough to supply all the country's transport fuel needs for centuries, but as Solid Energy and L&M firm their gasification plans up, public pressure for cheap fuel is likely to brush government objections aside.

Certainly a National government would support the two companies' plans, as well as continuing the present government's energetic pursuit of overseas oil explorers to tap into the dozen or so largely unexplored petroleum basins that surround the country.

The roading spend looks likely to be boosted by public-private partnerships whichever party wins the election, with Auckland's $2b Waterview motorway the first to be funded that way.

National has also given its backing to tolls on a cluster of other major projects, including a second Auckland Harbour crossing, State Highway One north of Auckland, the South Waikato expressway and Wellington's Transmission Gully.

OnTrack, the state-owned rail network controller, is planning to spend hundreds of millions making rail more competitive with road transport, while planning has begun – but as yet no major funding allocated – to help coastal shipping acquire a bigger share of commercial traffic.

Listed companies that will benefit from the resultant spend-up include Fletcher Construction (trading at 727c/share in mid-September), Opus International (163c), and Steel and Tube (336c).

Water

For the first time in the country's history water has become a relatively scarce commodity – at least to the degree that water metering may soon become as standard a feature of commercial and household life as electricity monitoring.

Agriculture is making a grab for irrigation sources, but in the short term the infrastructural spend will be on improving local water supplies and waste-water management.

The construction and building supply firms look like being the main beneficiaries of the push to ensure that especially the tourist-focussed communities can boast potable water and non-polluting waste-management during their seasonal peaks.

Telecommunications

This is a sector also due for major spending as both the Government and opposition have pledged to get broadband access extended to the farms, rural communities and small towns that generate most of the country's export income.

National has pledged $1b for this programme, building on the failure of the present government to achieve its own targets in this area.

A variety of technology supply companies, many of them small and most unlisted, will benefit from this largesse but, aside from having to commit a sizeable chunk of their own capital to such developments, Telstra (mid-September share price about 500c) and Telecom (285c) will ultimately be among the beneficiaries.

Overall, infrastructure is an area that will attract a tremendous inflow of funds just as other sectors are turning down. That makes the blue chip investments in infrastructure and energy well worth considering for their defensive qualities at a time of economic risk.

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