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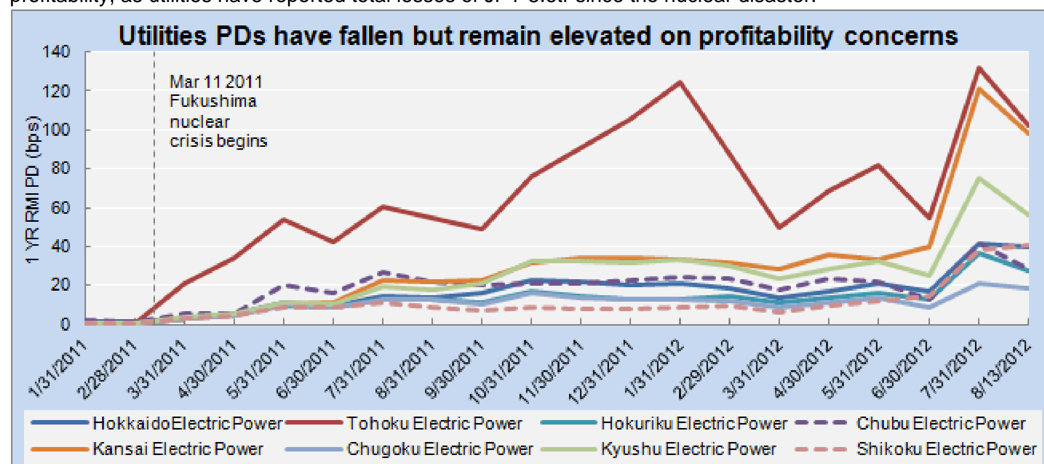
Weekly Credit Brief

Aug 7 - Aug 13 2012

Story of the Week

Japanese nuclear utilities issue new debt as pressure on profits increases

The RMI 1-year probabilities of default (PDs) for Japanese electric utility companies fell slightly last week, after several utilities returned to bond markets for the first time since the Fukushima nuclear crisis in March 2011. However, utilities are paying a very high price to access markets, with yields on recent 5-year bond issuances triple those on Japanese government bonds. Before last year's nuclear crisis, Japanese utilities had been able to price issuances at almost the same price as sovereign debt. Yields on new issuances reflect concerns about profitability, as utilities have reported total losses of JPY 3.6tr since the nuclear disaster.



Overall conditions are likely to remain unfavorable going forward, with revenues under pressure on three major fronts. Increased government intervention, ongoing concerns about the safety of nuclear power in earthquake-prone Japan and the high costs of replacement power sources will likely curtail utilities' profitability. The latter is likely to lead to increased differentiation between firms as Japanese utilities return to bond markets.

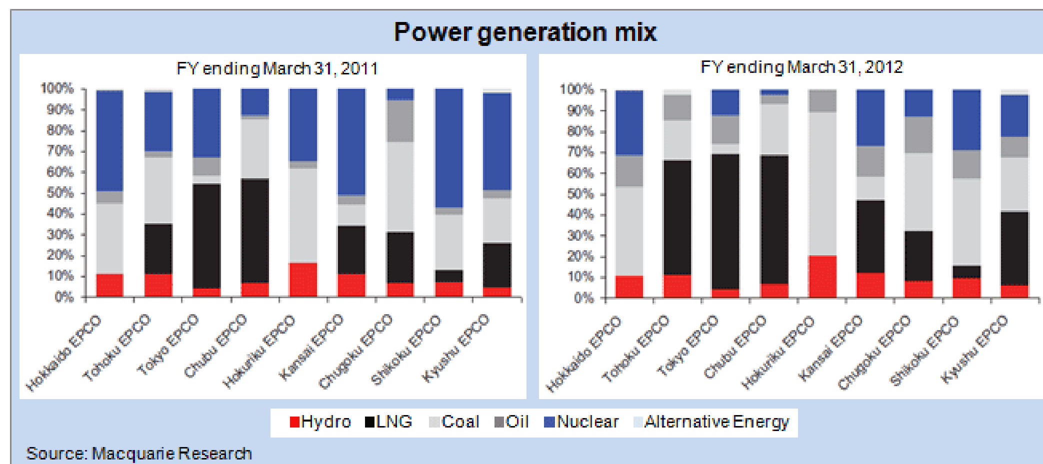
Government intervention: A potential forced breakup of utilities' power generation and transmission networks would significantly impair utilities' profitability. A government panel signed off on a plan in July that will force utilities to spin-off power networks, in order to spur competition in a market with almost the highest electricity costs in the developed world. The changes will eliminate the current power pricing scheme, under which utilities can pass on cost increases to households even if they have only one choice of electricity supplier.

Nuclear safety: Utilities are also under pressure from current government restrictions on the operation of nuclear reactors. All 54 nuclear reactors in Japan were shut down for maintenance following last year's earthquake and tsunami that caused a nuclear emergency at TEPCO's Fukushima Daiichi nuclear plant. Before the shutdowns, Japan derived almost 30% of its electricity from nuclear power. In a positive sign for the industry, the government allowed Kansai Electric Power Company to reactivate two reactors at its Ohi nuclear facility in July. However, the activation of several pressure alarms during the restarts raised concerns about safety.

Moreover, the discovery of suspected geological fault lines under the Ohi reactor, and reactors owned by Hokiriku Electric Power Company have increased market concerns that more problems may become apparent as government scrutiny continues. The government is likely to continue to face pressure to keep nuclear plants closed, with opinion polls showing around 70% of the population want to completely remove nuclear power from Japan. The most nuclear dependent utilities, including the Kansai, Hokkaido and Shikoku Electric Power companies are likely to be the first to be allowed to restart other reactors.

Replacement power costs: Utilities have replaced part of the generating capacity lost to nuclear shutdowns with crude oil and LNG based thermal generation, or coal-fired power. Japanese utilities reported combined quarterly losses of JPY 268bn for the quarter ending June 2012, as fuel costs surged following the nuclear shutdown. As operators return to credit markets, replacement power sources and previous dependencies on nuclear power are likely to be seen as the key differentiating factors between Japanese utilities. Reflecting this, companies with a

higher historical dependence on nuclear power have relatively higher RMI PDs.



Moreover, operators which have replaced nuclear power with more expensive LNG or crude oil instead of cheaper coal have comparatively higher RMI PDs. For example, the Tohoku, Kansai and Kyushu Electric Power companies have increased their dependence on LNG and oil relative to other power companies, and have some of the highest RMI PDs among Japanese utilities. These factors are reflected in recent debt issuances, with the predominantly coal-fired Hokuriku Electric Power Company issuing 10-year bonds last week to yield 40bps over Japanese government bonds. Shorter-dated issuances by the Tohoku, Kansai and Kyushu Electric Power companies yielded similar or higher rates.

Note: Tokyo Electric Power Company (TEPCO) has been excluded from RMI PD graphs due to scaling reasons, as it was the only company whose reactors were directly affected by the earthquake and tsunami. Readers can find the RMI PD for TEPCO at rmicri.org

Sources:
Japanese investors re-embrace nuclear power (IFR)
Japan's utilities lose USD 46bn as end of era nears (Bloomberg)
Japan starts debate on power deregulation (FT)

In the News
New tactics boost bank profits **Aug 12.** A number of European banks have repurchased their own long-term debt from investors in recent months, boosting profits and capital ratios through related accounting gains. Lenders including Société Générale, Commerzbank, Intesa Sanpaolo, Banco Santander and several Portuguese banks have taken similar steps as the European debt crisis has made it harder to raise capital through traditional measures. However, such moves could reduce banks access to low-cost, long-term funding, and make banks more dependent on lifeline funding from the ECB. Analysts believe the buybacks will lead to further usage of ECB funds, which may deter private investors. Issuance of debt with maturities over 18 months by European banks has reached USD 400bn so far this year, down from USD 645bn in the same period in 2011. (WSJ)
India central bank deputy says corporate debt restructuring skewed **Aug 11.** The Deputy Governor of the Reserve Bank of India K.C Chakrabarty said that domestic corporate debt restructuring (CDR) processes heavily favored large state-owned banks and larger corporate borrowers. Mr Chakrabarty said larger corporates have better access to CDR processes through hired consultants, and creditors are usually represented by large state-owned banks, creating biases in CDR negotiations. Corporate loan restructurings in India surged 156% YoY in the financial year ending March 2012, as economic growth slowed. Mr Chakrabarty voiced concern that banks are pushing borrowers to restructure their debts only in order to avoid the increase in lenders' non-performing assets that result from defaults, rather than restructuring for the benefit of both borrower and lender. (Reuters, The Hindu Business Line)
Asian corporate CDS index lowest in world; US junk bond stress at record low **Aug 9.** The Market iTraxx Asia index of credit-default swaps (CDS) fell below other similar regional CDS indices for the first time in a year last week, with resilient Chinese GDP growth supporting regional

fundamentals. The current monetary policy of the People's Bank of China is expected to support Chinese economic expansion. Elsewhere in credit markets, Moody's Investors Service said its North American Speculative-Grade Liquidity-Stress index fell to a record low of 3.1% in July, as demand for yield and ongoing near zero interest rates lend support to the liquidity profiles of speculative grade credits. Overall yields on junk bonds fell to 7.45% last week, close to record lows. However, analysts continue to pinpoint the European debt crisis as the primary risk to Asian corporates and the US junk bond market. (Bloomberg, Bloomberg)

Fitch sees pressure on Malaysia's credit profile from public finances

Aug 9. Fitch Ratings said the Malaysian government will have to reduce its heavy dependence on revenues from petroleum sales and implement a Goods and Services Tax (GST), to address structural weaknesses in public finances. Extensive consumer subsidies and a relatively high public debt stock create negative fiscal pressures. Despite current high oil prices, extensive subsidies and limited investment in the industry weigh upon oil-linked revenues. The introduction of a GST has been long discussed but is yet to be implemented; Fitch believes it is necessary to counter declines in non-oil revenues. However, measures to address public finance weaknesses will be limited until after a general election due before June 2013. (The Malaysian Reserve)

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