



## Europe energy crunch threatens credit outlook of the UK electric and gas industry as gas prices soar to record highs

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- **The NUS-CRI Agg Forward 1-year PD demonstrates heightened credit risk in the medium term for the UK electric and gas industry<sup>1</sup> due to a record high wholesale gas prices pressuring margins and access to financing**
- **The UK electric and gas industry could face structural headwinds as the energy crisis may accelerate the transition from gas to renewables in power generation**

In the past few months, a [vast majority of European](#) countries have been going through an [energy crisis](#), driven by factors including [reduced gas supply](#) from Russia, a [depleting gas inventory](#), and increasing demand for gas globally as more countries recover from the pandemic. This shortage has driven a rally in the prices of gas across the region, with European gas prices hitting an [all-time high](#). The United Kingdom, in particular, [depends heavily](#) on gas for its power generation and has faced major disruptions in their gas supply chain due to a [shortage of lorry drivers](#), saw its gas and electricity prices increase to be the [most expensive](#) in Europe. Due to the structure of the UK energy market<sup>2</sup>, the dominance of the Big Six<sup>3</sup>, and high input prices, the rest of the UK electric and gas industry - which consists mostly of [small to medium-sized suppliers](#) - has been facing increasing credit risks, as reflected by their increasing NUS-CRI Aggregate (mean) 1-year PD since Jun-2021 (See Figure 1a), in tandem with rising gas prices. In contrast, the credit health of the Big Six has been relatively stable in the last few months, owing to [easier access to capital](#) markets compared to the rest of the industry. However, with the energy crisis potentially expected [to last until 2022](#), the NUS-CRI Aggregate (mean) 1-year Forward PD<sup>4</sup> (See Figure 1b) demonstrates heightened credit risk for UK electric and gas suppliers in the short to medium term, surpassing the BB+ upper bound when referenced to PDiR2.0<sup>5</sup>. Furthermore, the Big Six suppliers also face a worsening outlook in the longer term, with Forward PDs eventually converging due to pressure on their profitability and structural factors such as growing ESG concerns.

<sup>1</sup> NUS CRI's sample for the UK electric and gas industry consists of 18 UK-domiciled electricity and gas suppliers. In this WCB, the UK electric and gas industry refers to the Big Six and 12 UK-listed electricity generators and electricity & gas distributors.

<sup>2</sup> The UK has one of the most deregulated energy markets in the world, which allows easy entrance of new players in the energy market to encourage competition. Although these companies tend to be smaller companies who are [loss-making and heavily indebted](#), investors were attracted to invest in these companies because they grew rapidly. The Big Six held [99%](#) of the total market share in 2013, but it has since decreased to 70% by the end of 2020 owing to the entrance of new players in the electric and gas market.

<sup>3</sup> The [Big Six energy suppliers](#) in the UK are British Gas (subsidiary of British firm Centrica), EDF Energy (subsidiary of French firm Électricité de France), E.ON UK and npower (subsidiaries of German firm E.ON), Scottish Power (subsidiary of Spanish firm Iberdrola), and SSE (subsidiary of British firm OVO Energy). Together these companies hold a combined 70% of the total market share of electricity and gas supply in Great Britain.

<sup>4</sup> The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

<sup>5</sup> The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

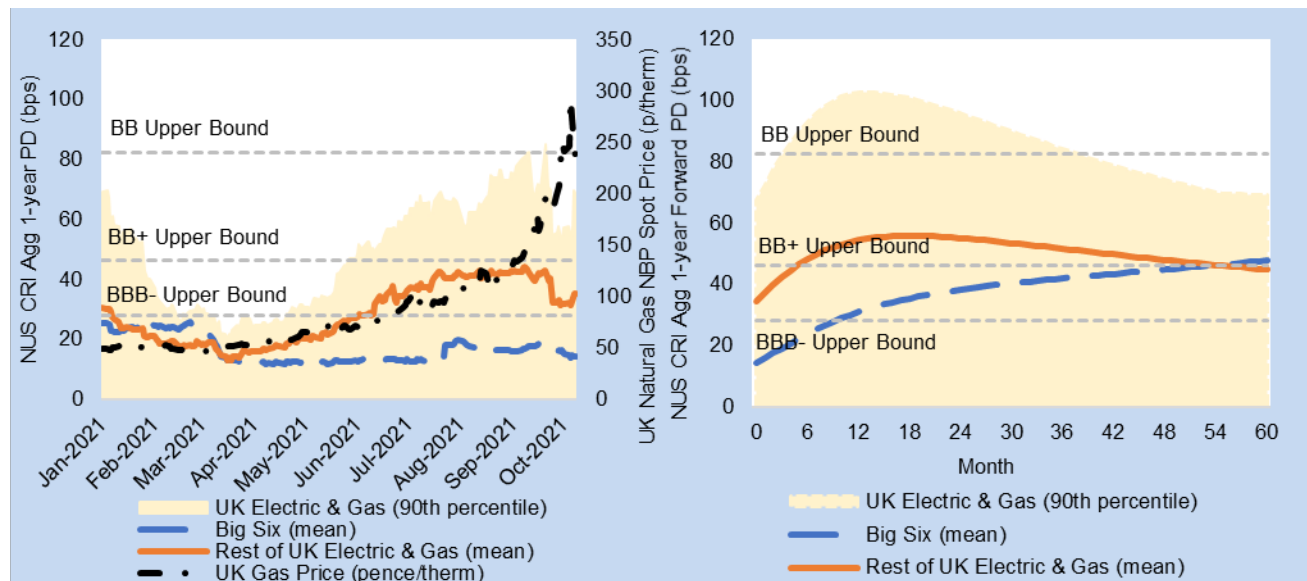


Figure 1a (LHS): NUS-CRI Agg (mean) 1-year PD for the UK electric and gas industry with reference to PDiR2.0 bounds on the primary axis; price of UK natural gas NBP spot price (pence/therm) on the secondary axis. Figure 1b (RHS): NUS-CRI Agg (mean) Forward 1-year PD for the UK electric and gas industry as of Oct-2021. *Source: NUS-CRI*

Since the start of August, [ten power suppliers](#) in the UK have collapsed due to the surge in wholesale gas prices, leaving an estimated [1.7mn customers](#) without a supplier. Unlike the Big Six who can produce their own gas, the rest of the UK electric and gas companies are mainly distributors who [depend heavily](#) on the wholesale gas market to purchase their inventory, which leaves them vulnerable to price shocks in the market, especially those who are [under hedged](#). To make matters worse, Ofgem, the British energy regulator, has set an energy price cap<sup>6</sup> to protect consumers from inflated energy prices. As a result, firms are [unable to pass](#) the increasing cost to customers, leaving them to absorb the losses, consequently depleting their cash flows and thereby worsening their liquidity positions. As demonstrated in Figure 1b, the 90th percentile Forward PD for UK electric and gas sees a spike compared to the Big Six, surpassing the BB upper bound in the short term.

With over [5%](#) of households left without a supplier, Ofgem's 'Supplier of Last Resort'<sup>7</sup> policy could force the remaining electric and gas suppliers to take on unprofitable customers from failed companies. Due to the soaring input prices and the price cap, profit margins for these suppliers have [fallen close to zero](#). With suppliers quoting deals at more than [GBP 700](#) above the latest price cap of [GBP 1,277](#) for each household, the burden of being forced to take on new customers could deteriorate these companies' financial health and may cause them to take on more debt to fund operations and keep liquidity in check. Reflecting the financial strain these suppliers potentially have to take on, UK energy groups have requested an [emergency support package](#) from the government and the establishment of a [bad bank](#) to help them house unprofitable customers.

In addition to the strain on their operations, electric and gas firms are also facing financing headwinds in the current environment as a result of battered investor confidence. Access to financing has proven to be difficult, especially for companies with smaller market shares. Even Bulb Energy, one of the largest power suppliers outside the Big Six with over 6% in domestic market share, has struggled to secure financing due to fears that the company [may not](#) be able to weather the crisis. Furthermore, the UK government has said that it [will not bail out](#) failed companies, leaving the companies to depend on their own finances to weather the crisis, which could leave them severely indebted.

Compared to the Big Six, other electric and gas suppliers may have limited access to the bond market for financing, hence they rely on traditional bank lending to expand and finance their operations. However, with soaring gas prices [fuelling inflation concerns](#), which is expected to climb to [double](#) the Bank of England's target, the British central bank may hike interest rates [sooner than expected](#), potentially impacting the borrowing cost for the industry. Additionally, the Big Six are also facing financing headwinds, as the YTM's on their bonds have risen since the start of the crisis in Aug-2021 in the UK (See Figure 2a). With the high gas prices potentially

<sup>6</sup> The [energy price cap](#) is the maximum amount an energy supplier can charge customers paying standard variable rate energy tariffs (SVTs) per kWh of gas and electricity per year. The energy price cap does not apply to those with a fixed-rate energy tariff. The price cap is reviewed in February and August each year and takes effect on 1 October and 1 April respectively.

<sup>7</sup> The ['Supplier of Last Resort'](#) process is when Ofgem ensures that when an energy supplier fails, a household's energy supply won't be disrupted as they will be directed to another gas or electricity firm.

[persisting into the winter](#), the elevated borrowing costs, coupled with thinning margins, could increase pressure on their debt repayment capabilities, especially as close to 20% of current outstanding bonds are due within the next 3 years (See Figure 2b).

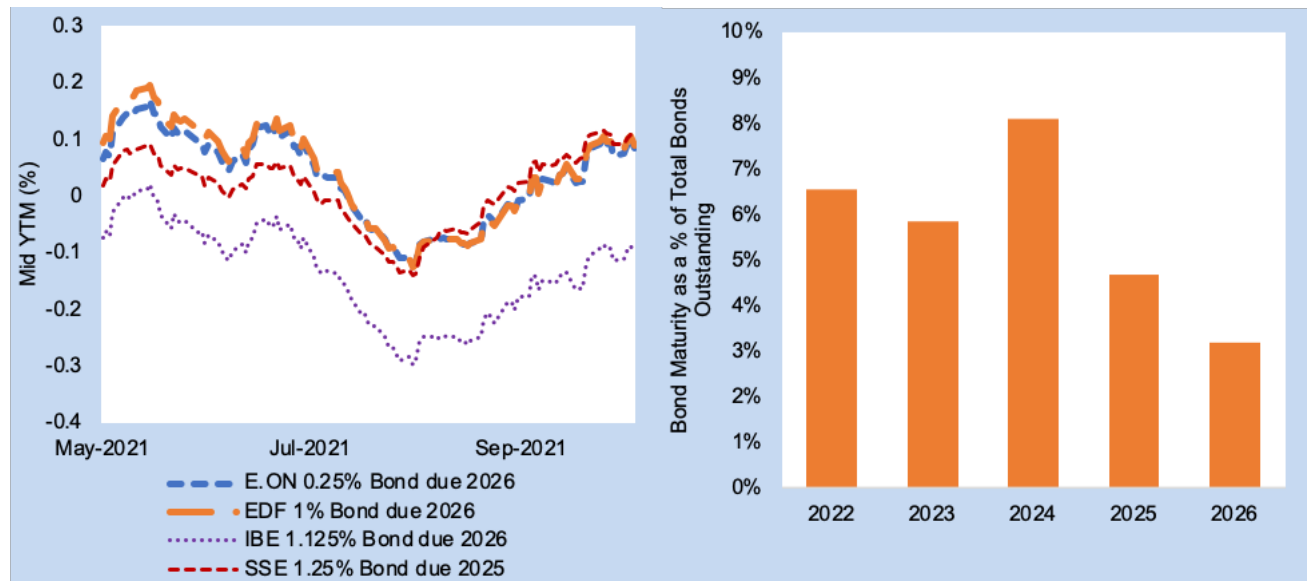


Figure 2a (LHS): Mid-Yield to Maturity (YTM) of Big Six bonds with similar coupon rates maturing in 2025 and 2026. Figure 2b (RHS): Bond maturity as a percentage of total outstanding bonds of the Big Six by year. *Source: Bloomberg*

In the longer term, a major structural headwind jeopardizing the outlook of UK energy companies is increasing ESG concerns. Over the past decade, the cost of capital to finance fossil fuel businesses has [increased significantly](#). Although the loan spreads<sup>8</sup> on gas-powered plants have [risen moderately by 7%](#) in the same period, it is likely that from now on, borrowing costs will [jump higher](#) given that Europe and the UK have committed to phasing out carbon emissions in the next few decades.

More importantly, this energy crisis has highlighted the importance of the transition to [renewables for power generation](#) in the UK, due in part to reducing its [exposure to volatile](#) gas prices in the future. UK lawmakers have called on the Bank of England to [penalize fossil fuel](#) financing in a bid to achieve net-zero emissions by 2050, impacting loan costs for energy suppliers, which could be more costly in the future. This could pressure the UK electricity market, which still generates [38%](#) of its power from natural gas, to pivot operations away from the fuel. However, the transition to renewables requires significant upfront capital expenditure, and since the cost of capital for renewables technologies is [more sensitive](#) to fluctuations compared to that of fossil fuels, electric and gas firms without the capabilities to finance the initial investments may be forced out of the market in the long run.

Currently, Ofgem is scheduled to review the energy price cap in Apr-2022, but that might be too late for the suppliers at risk of collapsing [in the near future](#). Even though inflationary pressure on gas prices has eased since Russia hinted that it would [increase the supply](#) of the commodity in the market, it remains uncertain whether the shortage will ease before winter, as Russia's biggest supplier Gazprom has said that its own inventories [have been running low](#). If energy suppliers were to fail altogether at the same time, the outcome could prove to be difficult on the UK electric and gas market as the larger firms may have already [exhausted their capacity](#) to take on unprofitable customers.

<sup>8</sup> [Loan spreads](#) are spreads over the benchmark interest rate that reflect the riskiness of the company or project that is being lent to. Banks apply a higher spread to riskier loans, as there is a greater probability that the borrower will default and not pay them back.

## Credit News

### Evergrande contagion may trigger wave of defaults for developers

**Oct 8.** A wave of defaults may be triggered next year should Evergrande's debt crisis impede access to funding and market conditions don't ease for heavily indebted developers. Fears of contagion risks were fueled by the unexpected default of Fantasia Holdings Group Co., sending the yields on Chinese dollar junk bonds to 16.9%, the highest in nearly a decade. The yield rise is indiscriminate, making it almost impossible for developers to refinance maturing debt, leading to a spate of missed payments across the industry. Missed payments by developers constituted 36% of this year's record CNY 175bn in onshore corporate bond defaults. Furthermore, developers are facing a weaker housing market that could reduce revenue. In September, combined contracted sales by China's top 100 real estate companies fell 36% YoY to CNY 759.6bn. ([Bloomberg](#))

### How Evergrande grew and grew, despite years of red flags

**Oct 8.** The red flags are abounding on China Evergrande Group's route to default. Asset sales, financial injections, or a government bailout might help Evergrande avoid defaulting on its debt, but the latter is doubtful. Over the last decade, Evergrande has been the subject of several financial research papers. Evergrande has partners in China's local governments, which rely on land sales for revenue. Investors' confidence in Evergrande remained high because many assumed Beijing would bail it out to avoid upsetting the housing market and incurring homeowner losses. However, last year, Beijing made it apparent that Evergrande had borrowed too much, citing concern about excessive debt levels and confidence in their ability to manage the property market's indebtedness ([WSJ](#))

### New Junk-Bond ETFs are born of Fed moral hazard

**Oct 7.** The newly launched BondBloxx Investment Management LLC aims to run seven ETFs that break down the HY debt market by sector, despite the negative impact on the HY bond ETFs due to the pandemic. Hence, it may seem that the new ETFs could face higher risk during the next credit crunch. However, if policy response is anything to go by, the market may not experience another severe credit squeeze. As bond ETFs took a beating in 2020, the Fed introduced its Secondary Market Corporate Credit Facility, which allowed it to buy investment-grade corporate bonds and ETFs tracking that market. This facility was later extended to ETFs tracking US high yield corporate bonds. Hence, in this new environment of growth and Fed support, it is hard to think that niche HY ETFs would face any trouble. The resultant new ETFs are born out of a moral hazard, and their investors will have to contend with any related consequences. ([Bloomberg](#))

### The pandemic's over for big banks. Now comes the hard part.

**Oct 10.** The pandemic boom concealed lackluster growth in banks' lending businesses and temporarily swelled trading revenue. Now, profits are expected to plateau, exposing weaknesses in banks' core businesses. S&P 500 banks are expected to report aggregate profits of about USD 31bn, up 20% from a year ago but down 20% from Q2 2021, while profits are expected to hold steady in Q4 2021. Loan growth has been slow to recover, with total loans at US banks up only 1% since the end of June. Meanwhile, near-zero interest rates continue to depress lending profits, as the net interest margin fell to a new low in Q2. On the other hand, stock-trading revenue remains above pre-pandemic levels, though fixed-income revenue is expected to tumble. However, Global mergers and underwriting volumes remain high, especially for IPOs and high-yield bonds. ([WSJ](#))

### Chinese property bonds hammered by weak September sales and a surprise default

**Oct 6.** The price of dozens of dollar bonds sold by Chinese real-estate businesses dropped, reflecting growing investor skepticism following the failure of Fantasia Holdings Group Co. to repay USD 206mn in dollar bonds due Monday. After beleaguered property giant Evergrande ran out of cash and was forced to halt building on some of its unfinished residential projects, developers' sales numbers for September revealed a drastic reduction in home-buyer interest. The numbers reflect China's broader efforts to control

the housing market, while Evergrande's issues may have made Chinese citizens less inclined to buy new homes. Fantasia's default was the key catalyst for the recent downturn. Its default was a surprise because the developer had assured that it had no liquidity concerns and had sufficient cash to repay a five-year dollar bond issued in 2016. Some market investors speculated that Fantasia had decided not to repay the company's offshore debt, raising concerns about whether other developers follow suit to save money or give onshore creditors priority ([WSJ](#))

**For Indian junk bonds, it's love in the time of Evergrande** ([Bloomberg Quint](#))

**Municipal-bond fund investor pullback signals weakening market** ([Bloomberg](#))

**Debt-burdened alarm firm tests credit market with 10% junk yield** ([Bloomberg](#))

### **Regulatory Updates**

#### **BOE officials double down on signals of an imminent rate hike**

**Oct 11.** Two Bank of England officials, Michael Saunders and BOE Governor Andrew Bailey have indicated that an interest rate hike is imminent in order to curb inflation, with one of them warning households that a rate hike may come significantly earlier than expected. BOE policymakers have historically resorted to indicating their views at least one meeting prior to the impending move. High energy prices, disrupted supply chains, and wage increases have stoked inflation, undermining the BOE's view that inflation will be transitory. The central bank said that it expects inflation to exceed 4% in the last quarter, higher than double its target. Investors have forecasted a rate hike in mid-2022 with the benchmark rate at 0.75%. ([Bloomberg](#))

#### **JPMorgan's seal of approval gives huge boost to Libor's replacement**

**Oct 6.** JPMorgan's new loan offering tied to the Secured Overnight Financing Rate (SOFR) could encourage other lenders in the USD 1.2tn leveraged loan market to embrace SOFR, the rate regulators want as the US replacement for Libor. Real estate lending company Walker & Dunlop Inc. raised a USD 600mn leveraged loan deal led by JPMorgan. Investors are closely watching two elements of this loan: First, the company is using a "credit spread adjustment" of 10 basis points, which is lower than adjustments provided by regulators to assist with the transition. Second, the loan has a 50-basis-point floor, which means even if SOFR is below 0.5%, investors still get paid at least half a percentage point in interest, in addition to the spread. Ultimately, how JPMorgan markets this deal and how investors receive it could pave the way for future SOFR loans. ([Bloomberg](#))

**Fed's Daly says Covid pushing prices up but impact should fade** ([Bloomberg](#))

**ECB said to study new bond-buying plan for when crisis tool ends** ([Bloomberg](#))