Potential liquidity crunch raises credit risk of European utilities as the energy crisis deepens

by Aditi Kamath

- **NUS-CRI Forward PD suggests that the credit health of European utilities may worsen due to soaring gas prices and rising margin calls**
- **European utility giant Fortum OYJ's NUS-CRI Agg (median) 1-year PD skyrockets as losses mount owing to its exposure to Russia, primarily through its German subsidiary, Uniper**

Russia has indefinitely stopped the supply of gas through Nord Stream 1 on Sep 2, 2022, which has signaled a need for European utilities[1] to shrink their dependence on the Russian energy sector. As such, European utilities are set to face a massive liquidity crunch as the rising prices of forward contracts (See Figure 1a), used by them to hedge against volatilities, bring an increased threat of margin calls. In conjunction, pressures are also rising to procure alternative sources of fuel to keep up with increasing energy demand faced across the continent, especially during the upcoming winter months. As seen in Figure 1a, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of European utilities has steadily hovered above BBB+ upper bound, when referenced to PDiR2.0[2], since Mar-2022 when the US imposed sanctions on Russian energy. Although several European governments have established credit lines to provide emergency liquidity to companies that are adversely affected by ballooning gas prices, these come at high costs of around 6-11%. As the market expects the fallout from the energy crisis to be a long-term shock, European utilities potentially face a worsening credit outlook as debt repayment pressure builds, as indicated by the NUS-CRI Agg (median) Forward 1-year PD (Forward PD[3]) rising above BBB- upper bound over the next 3 years (See Figure 1b).

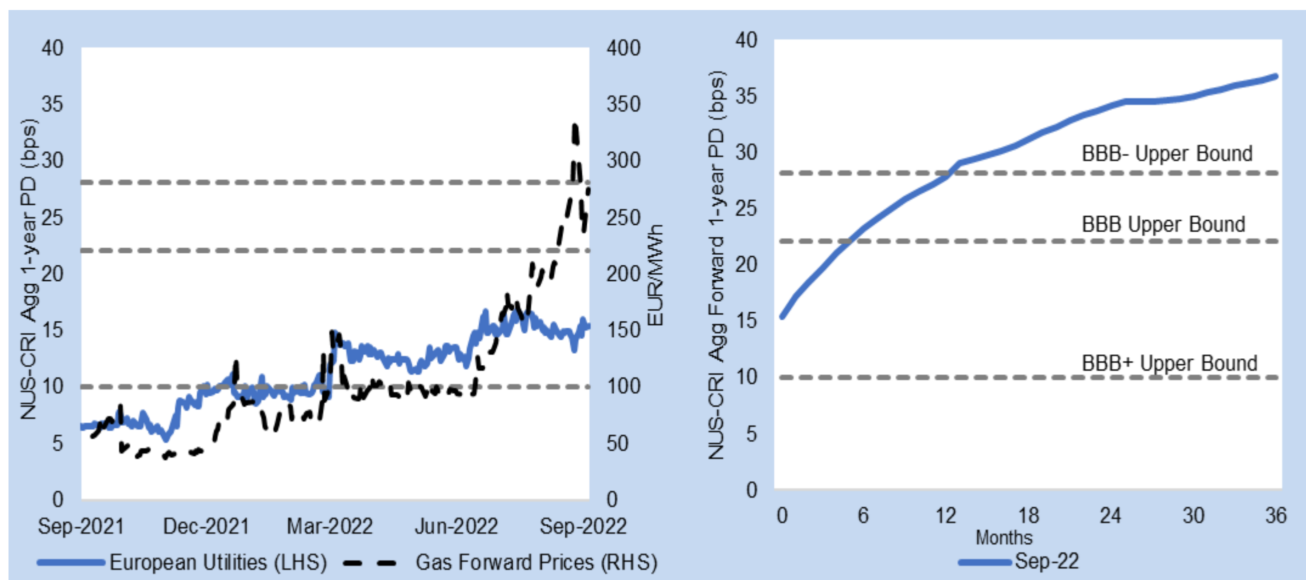

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for European Utilities from Sep-2021 to Sep-2022 with reference to PDiR2.0 bounds; Netherlands TTF Natural Gas Forward Winter 1. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for European Utilities as of Sep-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

[1] "European utilities" refers to all non-renewable utility firms domiciled in Europe, excluding Russia.
[2] 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.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 – this is conditional on the firm's survival in the next 6 months.

Most utility firms are facing the brunt of high input costs driven by limited supply[4] amid growing demand for electricity. Natural gas intensive utilities are one of the worst hit as their crucial source of gas, Russia, plugs supply - causing gas prices to nearly quadruple since last year. Generally, European utilities hedge against volatilities in the gas market through forward contracts, however, following the surge in gas prices, they expect a surge in margin costs if current high prices sustain. Natural gas forward prices have skyrocketed since Jun-2022 (when Russia first curtailed the supply of gas) and utility firms now require close to EUR 1.5tn[5] in highly liquid assets to meet these margin calls, consequently restricting free cash reserves which could have otherwise been utilized to defray operating costs or repay short term liabilities. As retail consumers' real disposable incomes and institutional customers' margins get squeezed by prevailing inflationary pressures, utilities may also witness a higher portion of credit sales turning bad, potentially aggravating their liquidity profile further. Furthermore, heightened interest rates, following ECB's and BoE's hawkish moves, drive refinancing costs higher, adding pressure on European utilities, especially as they expect around a quarter of their borrowings to mature over the next three years.

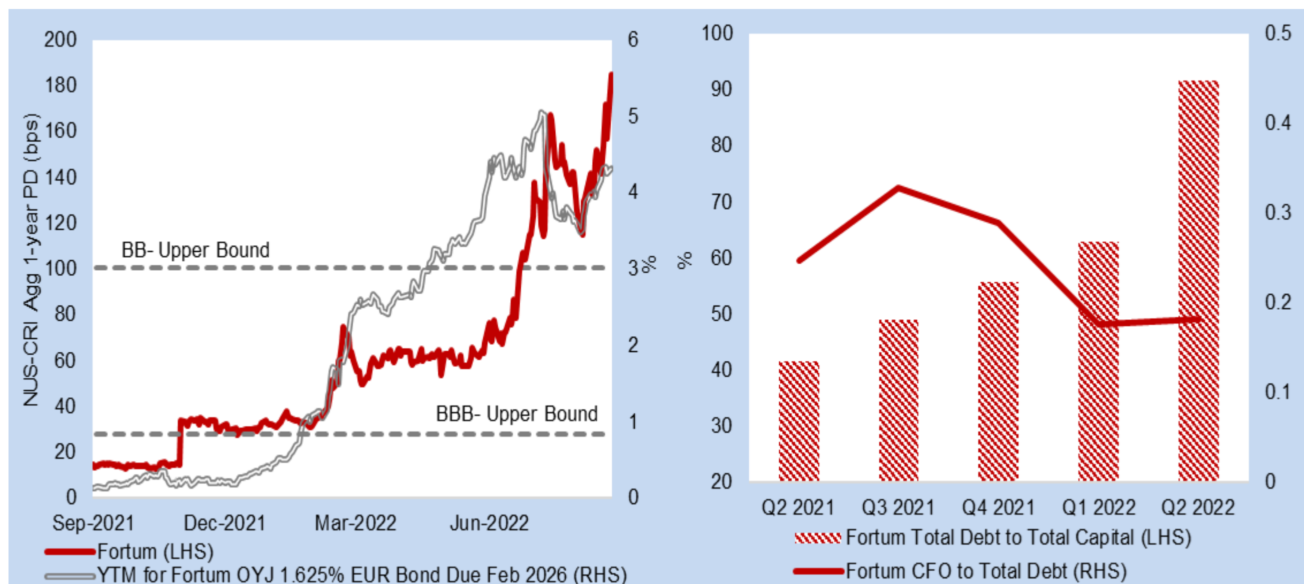

Figure 2a (LHS): NUS-CRI 1-year PD for Fortum from Sep-2021 to Sep-2022 with reference to PDiR2.0 bounds; Mid Yield to Maturity for Fortum OYJ 1.625% EUR Bond Due Feb 2026. Figure 2b (RHS): Total Debt to Total Capital and CFO to Total Debt ratios for Fortum. *Source: NUS-CRI, Bloomberg*

Amongst a rising number of utility firms under pressure, the Finish utility giant Fortum OYJ stands out due to its high exposure to Russian gas through its German subsidiary, Uniper, and also, its ownership in Russian power units which may be subject to write-downs. The company reported its second consecutive quarterly loss of EUR 7.4bn after absorbing losses from Uniper and writing off nearly EUR 2.1bn in Q1 2022 due to a fall in the value of assets in its Russian operations. Faced with inflated costs, a lag to procure inputs, and Russian operations making up nearly 20% of the Group's operating profits, another bleak outlook is expected for the company's performance in Q3 2022. Fortum's operating cash flow-to-total debt has fallen drastically along with an upswing in its total debt to total capital ratio (See Figure 2b), signaling heightened repayment pressures as approximately 50%[6] of its debt is set to mature by 2023. Financing through bond issuance has also become costly, with its bond yields skyrocketing since the start of the year (See Figure 2a). With collateral ties rising to approximately EUR 5bn in Aug-2022, and the company's deteriorating cash flow position, the company may be compelled to avail of additional short-term financing to meet operational needs. Therefore, the Finnish government has set aside EUR 2.35bn in emergency funds should the company require additional short-term financing, however it comes with a lofty interest of 14.2% which could further add to its debt burden.

Numerous other European utilities, such as Axpo and VNG, have also crumbled under pressure from the inability to maintain required liquidity and have sought external financing. As such, several governments have extended credit lines as safety nets to absorb losses and tide through the liquidity crunch. However, this may not be an adequate measure as the curtailed supply of gas is expected to keep prices high for another few years, requiring massive capital expenditure to restructure away from gas-intensive generation. As per the recent emergency energy meeting on Sep 09, 2022, the EU energy ministers are likely to propose a cap on imported gas prices to limit the worsening of the European utilities' already battered margins. Such action, however, might divert supply, threatening gas security in Europe and hence, could prolong the energy crisis in Europe.

[4] Along with Russian gas shortage, the industry also faces a slowdown in hydro, and French nuclear power generation along with an environmental reluctance to return to coal power generation.
[5] This value is estimated by Equinor ASA, a Norwegian state owned energy company, and the sample does not include utilities in Britain.
[6] Data from Bloomberg.

As Europe does not expect the Russian gas supply to restart anytime soon, European utilities would likely need more capital investments to phase out their dependence on Russian gas. Under the current liquidity constraints, the industry may require to take on additional financing or risk a prolonged energy crisis. Countries such as Finland, Sweden, Switzerland, and Austria have already established credit lines to support their energy firms and numerous other countries are set to follow suit. Government interventions, such as imposing windfall taxes, safety nets and incentivizing lower energy consumption, could potentially stabilize the gas market and ameliorate the long-term credit health of European utilities. However, governments' financing facilities might add further pressure to the longer term leverage profile and impose repayment pressures when these debts mature, potentially worsening their credit risk outlook as showcased by the rising term structure of the Forward PD in Figure 1b.

Credit News

China overtakes US with USD 306bn corporate credit boom

Sep 08. The effect of the diverging monetary policies of the PBOC and the Fed in addressing inflationary pressures has become more visible in the debt market. With the Fed aggressively hiking interest rates, US corporate bond sales have contracted by about 40% to an 11-year low in Sept-2022. On the other hand, PBOC's effort to keep funding costs low to support its economy, along with the recent waves of default by Chinese developers that have made foreign debt less attractive, has motivated Chinese firms to issue yuan-denominated debt. This also means that because of the weakening currency, they would have to issue more bonds, in terms of volume. (Bloomberg)

Europe bonds slide as ECB removes cap on government deposits

Sep 08. Following the 75bps hike in policy rates, ECB also temporarily removed the 0% cap on interest on government deposits for the first time in a decade. The ECB expects that the move would prevent a sudden and significant outflow of capital from public funds to short-term debt, especially as demand for high-quality assets increases. In effect, asset-swap spreads have eased as yields on German bonds jumped to 1.33% after a selloff. The massive rate hike earlier had failed to support the EUR which had traded down as much as 0.8% against the USD. (Bloomberg)

Junk-loan defaults worry Wall Street investors

Sep 06. As the Fed commits to monetary policy tightening, junk-rated companies are facing higher pressures from increasing borrowing costs. As a sign of increasing financial pressures, defaults on leveraged loans increased to USD 6bn in August, the highest since Oct 2020. Investors worry that as the economy slows down the stress in junk-rated debt signals a potential credit crunch in the near future. With the central bank committed to increasing rates, it is expected that the refinancing pressures would squeeze companies that went on a borrowing spree during the pandemic. According to data by Leveraged Commentary & Data, new loan sales currently stand at USD 334bn YTD as compared to USD 532bn in 2021 for the same period. (WSJ)

Bond markets are showing turnaround signs in emerging Asia

Sep 08. An improvement in signals on local inflation and foreign inflow measures is helping ready the emerging Asia bond market for a rally once the Federal Reserve turns less hawkish. With realized inflation in countries such as South Korea, Thailand, and the Philippines below estimates, and with initial signs that foreign capital is flowing into sovereign bonds, the negative impact of the Fed's aggressive rate hike on Asian bonds could be lower. An index following emerging Asia bonds dropped only 1.6% so far in Q3 2022, compared to 6% in Q2 2022. This slowdown in sell-off demonstrates that local economic dynamics are beginning to play a more significant role in Asian market movements compared to the market reacting to moves made by the US Fed. (Bloomberg)

China bank lending sees slow recovery due to cautious households

Sep 09. Benefitting from the Chinese central bank's push, credit growth saw a recovery in August. However, with household borrowing muted and an increase in shadow banking, the demand for loans remains weak. The government and the central bank have stepped up efforts to increase credit growth and improve investor sentiments by engaging in rate cuts and debt issuances. These efforts are yet to bear fruits as the economy continues to reel under the weight of the property crisis and pandemic related restrictions. (Bloomberg)

Bond issuance spree as U.S. companies rush before more rate hikes (Reuters)

Banks try to offload USD 15bn of Citrix buyout debt to 'gun-shy' investors (FT)

China debt sees portfolio outflows despite nascent recovery for EM in August - IIF (Reuters)

Regulatory Updates

ECB to start talks on shrinking its balance sheet

Sep 09. ECB aims to start talks in early October on reducing its balance sheet. This could in turn increase pressure on the already thin budgets of governments in the south of Europe. There remain doubts on how long the Eurozone can maintain its EUR 5tn debt portfolio. According to inside sources, the ECB is likely to decide by the end of 2022 to reduce the amount of maturing debt the institution replaces. The proposed quantitative tightening is likely to come into action going into 2023. (FT)

China central bank to cut FX reserve ratio to help limit yuan weakness

Sep 06. The PBOC seeks to slow down the yuan's depreciation by reducing the level of foreign exchange reserves that financial institutions hold. The central bank will reduce the reserve requirement ratio from 8% to 6% starting 15th Sep 2022. The reduction will increase dollar liquidity. As of July, the reserves stood at USD 953.7bn. The reduced requirement would free up around USD 19bn which is not a substantial amount compared to cross-border receipts. (BT)

ECB ramps up scrutiny of banks' response to energy crisis (Bloomberg)

India cracks down on illegal loan apps, RBI to prepare whitelist (Bloomberg)

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