The Impact of the Credit Crunch on Energy Markets

Posted by Gail the Actuary on October 4, 2008 - 10:27am
Topic: Economics/Finance
Tags: credit market, lehman brothers, leverage, natural gas, oil, renewables [list all tags]

The credit crunch is already having an impact on energy markets. New projects are harder to fund. Highly leveraged companies are sometimes finding it necessary to shed assets. Some players are finding themselves to be the indirect casualties of other players, like Lehman, that have already failed. Long term, we will probably see consolidation and lower production than would have been the case without the credit crunch. Of course, if there is a major recession, it is possible that we won't need as high production.

In this post, I have tried to bring together some of the impacts of the credit crunch on the energy industry that are already being felt. If you are seeing other impacts, please make note of them in the comments.

One article seems to suggest that speculators are being driven away from the oil and gas industry, and that more care is being taken with counter-party risk:

Credit crunch slows oil trading

> The OTC markets in oil have not seized up because of credit issues, but liquidity is lower and participants are treading more carefully.
>
> Platts, a unit of the McGraw-Hill Cos. and which provides price assessments in physical oil markets, says derivatives trading, but not physical deals, is slowing down.
>
> "The number of trades and the length of a trading chain are likely to be reduced because of the problems banks are having," said Jorge Montepeque, Platts global director of market reports.
>
> "But the physical oil markets are carrying on because oil has to be moved from producers to consumers.

> They said credit worries were also spurring a shift to clear over-the-counter (OTC) oil trades, such as price swaps, on NYMEX Clearport, which offers clearing for some OTC derivatives. . .

> "People are worried about counterparty risk, so if you don't clear your OTC deal you are simply relying on your counterparty to perform," said Bellew.

More marginal production seems already to be getting squeezed:

[Credit crisis squeezing western juniors]

> For Canada's junior oil and gas companies, the credit crunch comes on top of a helter-skelter commodity price drop that has hit company valuations hard.
>
> As a result, new exploration activity now seems more fraught with risk, especially as Alberta is set to implement a new royalty regime in January that will erode profit margins.
>
> "There's no doubt there's not enough capital around in the market," said Kel Johnston, chief executive officer of Alberta Clipper Inc., a Calgary-based junior oil and gas firm. "I can't see anything other than [drilling] levels dropping off, especially in Alberta."

Newer projects are getting squeezed, especially IPOs.

[Russian IPOs fall dramatically amid credit crisis]

> NEW YORK (MarketWatch) -- Capital raised through initial public offerings in the third quarter by companies from Russia and the former Soviet Union fell to the lowest level since 2004, as the global credit crisis took its toll, the PBN Company said Thursday.
>
> Forty-three companies from the Commonwealth of Independent States (CIS) have postponed or pulled their flotations this year, said PBN, a consultancy with a focus on Russia and the CIS.The CIS consists of former Soviet republics, such as Russia, Ukraine, Belarus, Azerbaijan, Armenia, and Kazakhstan, among others.

The credit crisis is providing buying opportunities for the more cash-rich. The recent decline in prices is forcing the more highly leveraged companies to put properties up for sale, and this is putting downward pressure on sale prices of assets.

[Cash-Rich Oil Firms Snap Up Assets]

> The turmoil on Wall Street is reshaping the U.S. oil industry, forcing debt-laden smaller producers to sell assets and creating opportunities for larger, cash-rich companies that until recently had been criticized by investors for spending too conservatively.
>
> The latest example: Occidental Petroleum Corp., one of the largest independent oil producers, Thursday snapped up the 50% interest it didn't already own in oil and gas fields in Texas and the Rocky Mountains from smaller company Plains Exploration &

> Production Co. The $1.25 billion price tag was nearly 20% less than the $1.55 billion Occidental paid less than a year ago for the first half of the assets.

Another credit related sale was the purchase of Constellation Energy by Warren Buffet's Warren Buffet's Mid-American Energy Holdings. About this we read:

Constellation in Quick Deal With Buffett

> Constellation's shares had fallen 70 percent since July 31 as investor concerns increased over the liquidity needs of the company's energy-trading business, which was growing until this year. That business relies heavily on financing that has all but disappeared with the turmoil in the financial markets.
>
> Investor and lender confidence was damaged by chief executive Mayo A. Shattuck III's August disclosure that Constellation had dramatically underestimated the collateral it would need to put up if its credit rating were downgraded. Then late last month, the company took several steps to raise capital, selling off some natural gas reserves. That appears to have been too little, too late.

Then there are the indirect problems, coming from the failures of other organizations. For example, the state of Georgia formed the Georgia Municipal Gas Authority in 1987, to help communities get better prices in natural gas. This authority formed Main Street gas corporation, to enter into prepaid gas contracts on behalf of communities. These contracts were entered into with Lehman Brothers, J. P. Morgan, and Merrill Lynch. Now Lehman has defaulted on its contracts, and Main Street and the communities it represents will need to go looking for more natural gas, probably at higher prices. Tax exempt bonds were used to purchase this gas which has "gone missing". One hopes the contracts with J. P. Morgan and Merrill Lynch will hold up better.

Lehman failure leaves natural gas supplier searching

> Main Street, an affiliate of the Municipal Gas Authority of Georgia, lost a $709 million, 30-year gas supply contract.
>
> The contract was with a subsidiary of Lehman Brothers, the investment bank which collapsed last week.
>
> Main Street now has to find new gas to replace the low-priced supplies that Lehman was supposed to deliver in Georgia and Florida.
>
> The new gas will almost certainly cost more.

We also have the next layer, a gas marketer, failing as well. In Thursday's Atlanta Journal Constitution, we read:

Catalyst Energy Files for Bankruptcy

> De Aguero said his company's bankruptcy stems directly from the meltdown on Wall Street.
>
> "We are all aware of what's happening with the macro economy," he said. "And it's gone down into the midmarket and now Main Street."
>
> "It's very common. It's going on all over the country right now."
>
> Catalyst's credit line and gas supply contracts were both with Constellation Energy, the nation's largest independent energy marketer. Constellation was a trading partner of Lehman Brothers. Its stock price collapsed after Lehman Brothers' demise two weeks ago. Constellation announced it was selling itself to Warren Buffett's Mid American Holdings for a cheap discount a few days later.
>
> Constellation cut off Catalyst late last week, leaving the marketer scrambling for credit in a market that isn't giving any.
>
> "The illiquid credit markets have exacerbated the issue," de Aguero said.

The credit crisis can expect to cut back in investment in alternatives. Where an investment is made, it is likely to be made by the larger, better funded organizations.

Credit Crisis May Delay Biofuels Development

> LONDON, Sept 29 (Reuters) - A global pull-back from bank lending may dent the commercialisation of biofuel technologies to replace conventional gasoline, said the chief executive of U.S. cellulosic ethanol firm BlueFire Ethanol.
>
> A credit crisis which claimed more bank victims on Monday has raised project finance costs and made ambitious targets to replace fossil fuels with renewable energy sources look less achievable. . .
>
> The credit crisis could slow that transition both through more costly finance and by diverting subsidies from renewables, which are often more expensive than conventional fossil fuels.

Credit Crisis Could Lead to Consolidation in Renewables Industry

> A clamp down on the credit market will make it difficult for renewable energy developers to finance new projects, putting utility companies in a strong position to increase their share of the renewables pie, according to a Reuters report.
>
> Utilities have large supplies of cash, and even if they have to borrow, they can do so more cheaply as government-regulated businesses, an analyst at Raymond James & Associates notes.

> "The big projects being built by big utilities don't need to borrow from banks for short-term loans," said JP Morgan analyst Chris Rogers. "But if banks don't lend to each other they certainly won't lend to small project start-ups."

Let us know what you are seeing as well.