# Differing supply conditions set to drive convergence in credit outlook of Chinese and European gas distributors

by Valerie Kok

- **Over the past year, Chinese gas distributors' credit risk remained higher than that of global and European gas distributors as showcased by the NUS-CRI Agg 1-year PD**
- **The NUS-CRI Agg Forward 1-year PD shows the converging credit outlook of Chinese and European gas distributors, driven by differing supply conditions**

The global energy crisis in 2021 led to soaring gas prices, however, the impact has been felt differently across various key markets. The NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) indicates that Chinese gas distributors consistently faced higher and more volatile credit risk than their global counterparts, especially when compared to their European counterparts, throughout 2021. Looking forward, however, while the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) suggests a relatively stable credit outlook for Chinese gas distributors, on one hand, it also showcases a worsening credit outlook for European gas distributors (See Figure 1b), with the latter's Forward PD potentially converging with the industry's global median, due to differences in supply and financing conditions, as well as the presence of political tension between Russia, Europe's largest gas supplier, and Ukraine.

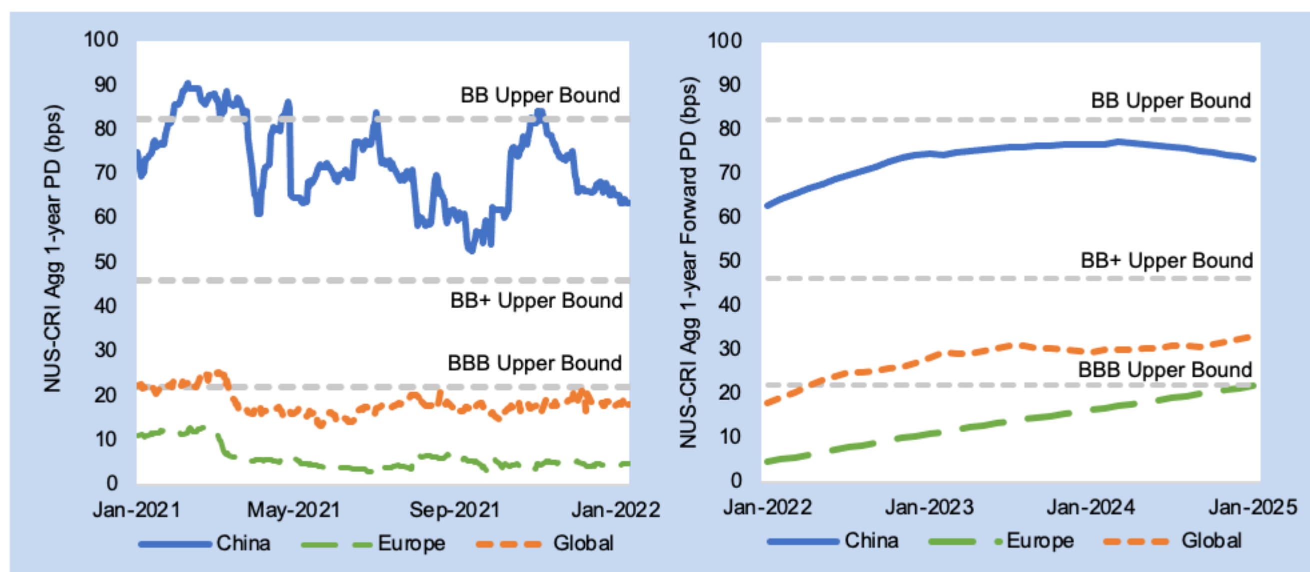


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese, European and global gas distributors from Jan-2021 to Jan-2022 with reference to PDiR2.0[2] bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Chinese, European and global gas distributors as of Jan-2022 with reference to PDiR2.0 bounds. Source: *NUS-CRI*

Gas sales growth in China is likely to have slowed down in H2 2021, owing to rising gas prices as gas procurement costs continue to increase and production growth fails to meet demand, especially during the winter peak season. As seen in Figure 1a, the Agg PD of the Chinese gas distribution industry increased from around 50 bps to a peak of around 80 bps in Oct-2021. The increase in gas distributors' costs and pressure from the Chinese government to purchase more natural gas to secure enough fuel at heightened costs have led to falling profit margins, from 10.7% in Q2 2021 to 5.5% in Q3 2021. Many Chinese gas distributors, especially those

[1] 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.

[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.

which are state-owned[3], often incur such losses from importing costly natural gas and selling to domestic consumers at lower fixed rates, thus hurting their profit margins. While Chinese gas distributors' Agg PD fluctuated throughout 2021, their credit risk was consistently much higher than that of global gas distributors. This is especially witnessed when comparing Chinese distributors' higher leverage (See Figure 2a) and weaker liquidity levels (See Figure 2b) with their European counterparts.

Meanwhile, a strong push for the replacement of coal in the industrial sector, as highlighted by a guideline by the China State Council, could lead to stronger gas consumption volume growth, positively impacting profit margins for Chinese gas distributors. Furthermore, as China strives to reach its carbon-neutral target where natural gas is set to play an important role, gas sales are likely to have vast room for expansion above current levels. Its share in China's energy mix is expected to increase from around 10% in 2020 to 13-15% by 2025. Gas distributors[4] that can best ride on government policies during the energy transformation process are likely to benefit the most.

At the same time, efforts to boost domestic production, debottleneck infrastructure, and diversify import sources could ensure a long-term stable gas supply for Chinese gas distributors and help mitigate the upward pressure on costs. For example, efforts by the government to increase gas supply domestically have led to the opening up of main gas transmission infrastructure[5] in recent years. Enhanced access to these types infrastructure has also benefited gas distributors who can diversify their gas resources and thus reduce costs. Therefore, underpinned by the boosted domestic production and increasing imports from Russia, overall gas supply in China is expected to expand consistently in the future.

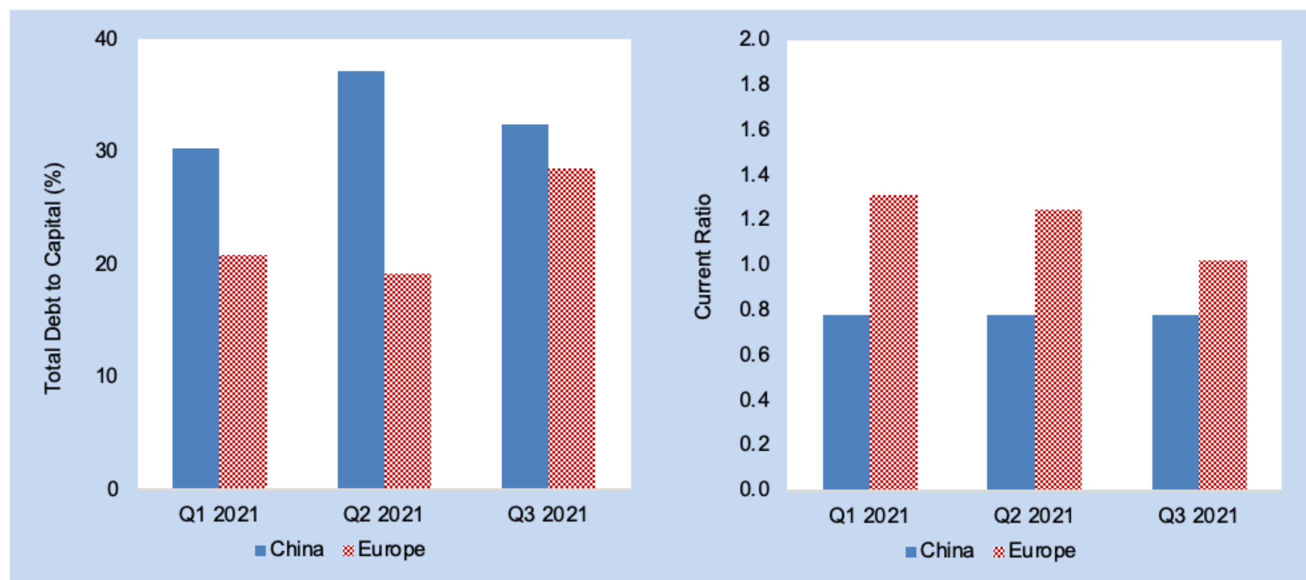


Figure 2a (LHS): Total debt to capital (%) of Chinese and European gas distributors. Figure 2b (RHS): Current ratio for Chinese and European gas distributors. *Source: Bloomberg*

On the other hand, European gas demand in 2021 rebounded strongly on the back of post-pandemic economic recovery, while gas production continued declining as many countries shut down production fields and imports became unexpectedly tight, leading to the gas price spike. Consequently, European gas distributors face a worsening credit outlook. Over the past year, European gas prices have surged more than 400%, due to strong demand domestically and from Asia, as well as the simultaneous drop in supply from Russia, which accounts for more than a third of the EU's gas supplies. The unprecedented rise in gas prices has resulted in a sudden need for financing by companies due to swelling liabilities on futures contracts, and could potentially trigger a liquidity crisis for gas distributors. Uniper, one of Europe's largest energy companies, was forced to seek EUR 10bn in new credit lines in Jan-2022, while RWE has also sought extra financing on expectations of volatile gas prices throughout 2022. The elevated credit risk faced by European companies is reflected in the upward sloping Forward PD for European gas distributors in Figure 1b.

[3] State-owned enterprises are more likely to incur losses due to government imposed price caps as they may be more likely to ensure adequate levels of gas supplies for consumer use.
[4] For example, China Gas has adopted an aggressive strategy in pushing clean energy into rural areas, where the government has rolled out a coal-to-gas conversion program, through its LPG smart microgrid business. Business diversification is also seen in city gas distributors, who are expanding into integrated energy development and offering value-added services to customers. These segments are expected to expand by a CAGR of 12% in the next four years.
[5] The China Oil and Gas Pipeline Network (PipeChina), involving the majority of China's midstream infrastructure, is expected to be extended to other regions and achieve full national coverage.

Heightened political tensions between Russia and Ukraine could push gas prices even higher. This could negatively impact the profitability of gas distributors should they be forced to sell power at a discounted price to protect consumers, especially if it is government-stipulated. For example, Electricite de France, the country's biggest utility company, is expected to take a EUR 7.7bn hit on its revenue after the French government forced a price cap on gas. As European households are estimated to pay an average of 54% more for energy in 2022 as compared to 2020, potential price caps that could be imposed on the industry could severely dampen their profit margins.

However, in spite of increasing dependence on gas as the region phases out the usage of coal, European gas distributors are unlikely to benefit significantly from this increase in demand due to falling supply, which has led to greater dependency on imports. The region's natural gas production is in a long-term decline and inventory has depleted. To add to their woes, unlike China, new investments in gas in Europe have been more limited, due to disagreements over the use of gas as a transitional green energy source. This has left the region largely dependent on Russia, which has limited supplies to Europe in 2021 and has a growth strategy focused on exports to Asia, especially China. Thus, although European gas distributors currently demonstrate better financial health than their Chinese counterparts, their growing external dependence on gas supply will only leave them vulnerable to global gas market volatilities and weigh on their future credit quality.

**Credit News**

**Wall Street's big banks are set to tap the corporate bond**

**Jan 16.** Analysts expect Wall Street's biggest banks to borrow USD 24bn to USD 32bn from the corporate bond market after announcing their quarterly earnings reports before the Fed raises borrowing costs. Bond prices could be affected by earnings reports of major companies such as United Airlines and Netflix, the latter of which has about USD 16bn of bonds potentially eligible for Bloomberg's high-grade indexes. Currently, investors are hedging against inflation and rising rates by favoring shorter-term bonds and leveraged loans. Lower-rated high-yield bonds are especially attractive to investors in a rising-rate environment due to their lower correlation to interest rates. (Bloomberg)

**Companies raise USD 100bn on global debt market in brisk start to 2022**

**Jan 11.** In the first week of 2022, companies raised more than USD 100bn on the global bond market as finance chiefs tried to lock in lower borrowing rates before benchmark interest rates increase. The corporate bond issuance market has been dominated by financial issuers, especially foreign institutions raising funds in US markets. However, US debt and equity markets have experienced significant volatility since the Federal Reserve signaled that interest rates could rise sooner and faster than expected. For example, the tech-heavy Nasdaq Composite has decreased about 8% from its November high. As for debt markets, investors canceled some orders for new bond deals when the Fed released its December meeting minutes. US corporate borrowing costs have already risen, with the average yield on investment-grade bonds marginally rising from 2.36% to 2.55% in 2022. As a result, companies have also been encouraged to issue bonds before borrowing costs jump soon. (FT)

**Treasury market gets reprieve as 'bond-bearish euphoria' pauses**

**Jan 13**. After a brutal selloff that kicked off this year, longer-maturity Treasuries attracted buyers back this week, extending a reprieve to a market worried by rising inflation and the Fed's move toward tighter monetary policy. While yields rose slightly on Friday, the 10-year yield is still set for the first weekly drop in a month. This week's steadying marks a welcome respite after a dismal start to the year for Treasuries, as investors are increasingly convinced that the Fed will start raising rates in March and begin winding down its balance sheet in H2. The yield pullback reflects the view the market repriced too much too quickly given the uncertain outlook, as well as the still-loose monetary policy. (Bloomberg)

**Negative-yielding debt total tumbles to USD 10tn as bond prices drop**

**Jan 14.** The withdrawal of pandemic-era stimulus has pushed negative-yielding debt globally down to USD 10tn for the first time since Apr-2020. Global government bond prices have dropped since the beginning of this year as investors prepare for central banks to raise interest rates and stop asset purchases. Bond yields have in turn risen to the highest level since before the pandemic took hold in many markets. At the end of 2020, sub-zero yield debt mushroomed to USD 18.4tn, as central banks bought up a large scale of sovereign bonds to support the market. The value of negative-yielding debt fell below USD 10tn on Jan 7 and remained below that level until Jan 12. A sell-off in US Treasury, which began in Dec-2020, has contributed to the dwindling global pile of negative debt as major bond markets are inclined to move in unison. (FT)

**Early rate hikers hit jackpot as local bonds trounce dollar debt**

**Jan 17.** To curb inflation, Emerging-market central banks have gone on raising interest rates last year, especially in Latin America. As a result, rate premiums in developing countries have been raised, making emerging-market assets more attractive. For example, the index of debt issued by developing nations denominated in their individual currencies has achieved about a 1% return over the past three months, while a similar gauge of USD-denominated emerging market bonds has fallen 2.8% over the same period. Moreover, improving economic conditions amidst global recovery have also attracted investors all around the world to buy emerging-market bonds. (Bloomberg)

**Bond market forecasts bad economic news** (WSJ)

**Green debt market faces a rare default** (Bloomberg)

**Crisis impacts major developer country garden** (Bloomberg)

**Regulatory Updates**

**China cuts policy interest rate for first time since April 2020**

**Jan 17.** To guide borrowing costs lower and encourage credit supply amidst robust economic headwinds and housing slump, the People's Bank of China lowered the one-year policy loans rate by 10bps to 2.85% for the first time since Apr-2020. As a result, a significant decrease in borrowing costs has been triggered across different asset classes. For example, the 10-year government yield fell 2bps to 2.78%, and the overnight repo rate, which measures short-term interbank funding costs, fell 6bps. Furthermore, such policy puts China further apart from global central banks such as the Federal Reserve, which are seeking to hike interest rates to curb surging inflation. (Bloomberg)

**BOJ's future path could start to emerge during Kuroda's last lap**

**Jan 17.** Haruhiko Kuroda begins his last full year as the governor of Bank of Japan amidst the public dissatisfaction with rising prices which may affect BOJ's direction after he leaves or in the following months. For the first time in over seven years, the central bank is likely to discuss changing its insistence that downward risks to prices outweigh upward factors during a 2-day meeting beginning Monday. While almost 80% of economists expect BOJ will take no action this year to address inflation or a weaker yen, others see potential government displeasure in an election year contributing to a tail risk scenario for action. The cocktail of higher prices, elections, and new board members of BOJ, could trigger a spike in speculation of BOJ's policy rate moves. (Bloomberg)

**Taiwan central bank chief repeats stance on rates-housing link** (Bloomberg)

**Another two central banks joined rate hiking club this week** (Bloomberg)

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Contributing Editors: Yao Xuan, Raghav Mathur