Fall 2010 Review

The US Recovery is Coming—But When and How High?

INTRODUCTION

Our economy is far better than one year ago, but there's still wide disagreement about how fast a full recovery will appear, and its impact on the energy business over the next several years. And, most forecasters see low natural gas and power prices ahead, with no specific recovery date. International crude prices are a totally different matter, with full price recovery soon seen by many.

Note that some economists are seeing the possibility of a faltering of the recovery and a meltdown in sectors like commercial real estate and municipal finance. We'll take the more optimistic view, but caution is certainly appropriate.

Few people are expecting the days of 2005-2007 to return in the same fashion. That was the apex of easy capital and limited regulatory oversight.

Capital access is easing, but many regulatory/political questions remain.

Hedging rules, the role that banks can play in trading, the continuation of Federal support for renewables, how the EPA will handle carbon emissions—all are in play.

What we gather from our sources is that 2011 will still be a transition year. It will take until 2012 for many firms to understand enough about the business climate to launch any new initiatives or grow in a significant way.

In addition, by 2012 the financial services sectors that support the energy business should be on their way to recovery and will provide more and more of the requisite financing.

Global Energy Markets

Asian markets in energy are in much better shape than either the US or Europe, and companies there are expanding significantly. It's a bit like the 90's in the US when the energy sector was growing sharply in all sectors. The difference is that the US growth then was driven principally by the forces of de-regulation. Growth in global markets is driven by pure demand.

There is an impact on US energy markets from the global scene, of course. Not only do global crude markets impact the US, but LNG markets worldwide are becoming more tightly linked to US natural gas markets.

Key Players Are Placing Their Bets

The most interesting part of the energy business sector in the US is the divergence of opinion. Some firms are optimistic, take the long view, or see a competitive advantage and are moving ahead. Other firms are still in a consolidation or wait-and-see phase.

A good example of is the solar renewables market. Despite the perilous state of federal subsidies that fuel this business, firms are rapidly moving into this space. Their optimism is fed by the utilities' need to respond to state renewable portfolio standards.

Another example of a positive view is Blackstone Group's acquisition of Dynegy—in many ways a bet on higher power/energy prices in the longer term.

This wide variance of opinion and action account for the "split personality" of the US jobs market. There are jobs, but not many jobs in a particular category. Candidates have to dig very deep or be very patient to find a new position that takes them to a higher level. Also cost cutting will go on for the next year, so firms will continue to pressure middle managers to find functions to eliminate or outsource. The most vulnerable are staff positions not directly connected to short-term revenue, e.g. accounting and finance.

Other Signs of Optimism

Parts of Wall Street are on the march again. Commercial loan trading is coming back. Energy bankers are being hired. The most recent high profile example of this being Citigroup's hiring of Steve Trauber and others from UBS. His team is expected to boost Citi's investment banking activities in upstream deals. Private equity shops are on the prowl again for deals. One or two new tax equity players are emerging.

While there are many issues affecting the largest banks who operate globally, bank earnings have rebounded, so that banks have the opportunity to hire staff for important initiatives. A July 2010 Financial Times article indicates that UK banks are even hiring new graduates. To us, this is a sign of confidence in the future.

This Survey Covers Four Markets

Our firm deals with four sectors: Wholesale Energy Sales and Trading , Retail Energy, Renewables, and Consulting.

Each is in a different state of ferment and going through its own mini business cycle. All are affected by low natural gas prices and how it ripples through their business.

Each is linked to one or more political/regulatory issues decided in the next two years.

Key Non-Economic Issues That Affect All Markets

Here's the list, without conclusions.

- US November 2010 elections---??
- US carbon legislation---possible in some limited form?
- EPA regulation of emissions---??
- Rule making by the CFTC—clarity in later 2011
- Federal tax breaks and tax deductions for renewable energy projects
- State level renewable portfolio standards—likely to be increasingly rigorous

The first, the political climate, is key. The balance between the parties will be known in November. In January, when Congress re-convenes, we'll have a sense of the impact on energy-related regulation. However, since the ensuing battles over policy will be hard-fought, we believe that it will take until late 2011 for much resolution.

Wholesale Energy Sales and Trading

The Banks

Regulatory uncertainty is key for the banks that have energy trading groups, so we gather that it will be largely status quo in 2011---not much expansion, hold on to key staff members, expand only when a clear advantage is seen, and then only with modest commitments.

The Commodity Futures Trading Commission(CFTC) is targeting July 2011 for final adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act rules for commodity swaps. It is hoped that the rules for major swap participants and endusers will be settled by then. It may be that large corporations and funds that maintain very large positions in a certain product or index would be considered a “major swap participant” and have to conform to rules regarding credit/capital requirements.

This will have an effect on both endusers and the banks they deal with. So, even though the banks may have 2 or more years to conform to the new regulations, they need to know how their clients will be affected before they can plan their business.

So, it’s not just about proprietary trading, it’s the whole process of doing business in energy derivatives.

A consulting friend tells us that the reporting requirements for derivatives will become far more rigorous, so even after the rules are well-understood, getting into compliance will take time.

Non-bank Energy Trading Entities

Cost pressures will continue as margins remain tight until natural gas/power spreads widen.

It is felt that only the very largest will be able to sustain the full-service trading desk model of the past. The smaller firms may change to a “trading light” format, with fewer traders, smaller mid/back offices and less quantitative support. In addition, a number of data/analytical functions will be outsourced. This includes a) some portion of the energy risk and trading system development and maintenance, and b) modeling such as gas storage models, and power fundamental forecasting models.

The growth part of the business is to be found in the international trading companies. Unfettered by financial regulation, firms such as EDF, Noble, Mercuria, Vitol and others are expanding in the US as well as in their traditional overseas markets. In addition, their international portfolios allow them to not depend upon any single product or region, so they can manage their risks by diversification.

Another growth element is the diversifying by a number of trading firms into agricultural products and metals. In those sectors, one sees the kind of volatility that is needed to give traders a chance to profit.

While our sample of opinions from hedgefunds is small, we understand that the sector is in the same type of holding pattern as the banks, hamstrung more by the lack of volatility in energy prices than the regulatory issues.

The Utilities and Merchant Energy Firms

Consolidation continues. Conectiv's sale of its generation fleet to Calpine, the shrinkage at Mirant, the purchase of Dynegy—all reflect the pressures of generation economics, particularly coal-fired plants.

The old days of wide-spread construction of merchant plants whose output could be sold in the merchant energy market are gone. There are development programs going on, but the developers are cautious about getting power purchase agreements, financing and turbine costs in place before proceeding.

Conversions from coal to natural gas are significant. Progress Energy is abandoning coal, and Xcel(Public Service of Colorado) has announced plans to convert selected local plants to natural gas over the next five years.

Does this presage a power shortage and price spikes three years from now? While many people are forecasting low power prices, we might point out that an experienced commodity trader would say that when everybody takes one side of a market, then it's ripe for picking.

We don't know the answer, but for the next two years, however, the impact on sector jobs is negative.

Electric Utilities

Generally, we see utilities still in a cost-cutting mood, having been successful in reductions in force in 2009. These utilities are still shrinking their workforces and seeking to minimize risk in their trading activities. But the across-the-board reductions in force are over. Now, it's more about selling non-strategic assets or getting out of certain businesses

For those utilities with un-regulated generation, trading is still a vital part of their business, since they need sales and trading to optimize asset profitability, and generate maximum profit to supplement the earnings from ratepayer activities.

Behind-the-scenes re-regulation is going on, as utilities put transmission and renewable projects into the rate base to achieve good long-term returns.

Development activities or asset acquisitions are re-emerging, mainly in renewables.

California utilities are a special study, in that they are involved in major programs to meet state mandates in renewables.

Natural Gas Utilities

These utilities can pass through the cost of natural gas, and so are not so immediately dependent on the commodity price. However the Marcellus Shale gas development will have an enormous effect on the business.

Shale gas prices and drilling locations have the potential to dramatically change transportation patterns from the Gulf Coast to the Northeast. The implications in basis prices are enormous in the longer term.

Note, of course, the potential of ground-water pollution from this type of drilling, so even this is subject to the same political/regulatory forces as other markets.

The Retail Energy Business

The spreads between retail (commercial & industrial) energy prices and wholesale prices continue at the high level that began when wholesale prices tumbled several years ago. That said, the competition among retail energy vendors continues to escalate and entrants from major wholesale energy firms keep appearing as they seek ways to increase margins. One example is NRG's purchase of Reliant's retail group, others are Exelon's and PPL's efforts in retail marketing in Pennsylvania.

However, there is net growth in the business and the client base of commercial and industrial firms seem to be receptive to cost-saving ideas from the retail providers.

What seems to be different now compared to earlier years is that the retail energy providers are larger and better funded. There has been consolidation in the business as books and companies have been acquired. So, we expect the growth in the business to not generate as many new entrants as in the past.

Credit availability plays a big part in all of this, so those firms with established credit ratings will have a big advantage.

Our conclusion: the big will get bigger, and develop more robust supply and risk management groups to protect their margins.

Wind and Solar Development

Even with federal government subsidies and tax writeoffs, it continues to be difficult to develop profitable projects in wind and solar. The big problems, of course, are the low level of power prices and how renewable energy credits are valued in the forward markets. Also, bank financing has been hard to secure and the tax equity players have been largely absent from the scene since those were investment banks (including Lehman Brothers) which are now in a recovery phase.

Despite the problems, a select number of wind developers are plowing ahead, seeking to get more projects going to capture the currently available federal tax program benefits. There are a few outright business failures in wind, but it's more about projects are being sold by firms so as to minimize their financial exposures.

Some of these firms built a cash war chest before the meltdown and have a portfolio of cash-flow producing projects in place. Some examples of large wind developers moving ahead are LS Power, Invenergy and enXco.

It is the state regulatory policies that are driving solar and wind markets. So even if we do not get a carbon tax or a federal renewable portfolio standard, there will be support from the states---California being the best example.

Solar is getting a major boost from certain state programs, notably New Jersey and California, and development activity is increasing. Money from Japan, Europe and China continues to flow to the US as the international development firms seek some diversification from their local markets and offshore photovoltaic panel producers seek to market in the US.

On balance, there is significant growth, both in the US and Canada. However, the high percentage growth in solar comes from a very low starting point

The utility-scale solar market is in great turmoil as participants fight to get power purchase agreements (PPA's) in place with utilities. The utilities are seeing many solar developers come forward, some well-financed, some only ventures with little prospects of getting financing. How this will get "sorted out" remains to be seen. So, the growth statistics may be over valued in the short term.

The commercial & industrial solar market is in the same degree of ferment as real-estate management companies and industrials get bids from many developers. So far, the large investment banks haven't been supporting the financing of such projects, it's mainly the regional banks and other intermediaries.

Like any nascent market, it's tumultuous but growing.

Consulting/Data Services

Outsourcing trends continue as all types of energy firms seek to pare costs. This has been going on for some time and is expected to continue.

The data services business (some participants being Bloomberg, Reuters, Platts, Wood Mackenzie, Ventyx) is continuing to grow as clients seek information but decline to create their own staffs to do the analysis. But within the data services firms, there's fierce competition as vendors push new product development and harder edged marketing to a client base that has shrunk due to the recession.

IT/backoffice consulting in the energy business is not shrinking, and appears to be on the brink of renewed growth.

Traditional management consulting is growing as regulatory challenges and strategy issues force client firms to deal with compliance issues and financial regulatory changes that mandate changes in business models.

Job Survey Ahead

In a few weeks, we'll provide comments on the job market that reflect the extraordinary tumult in the energy business.

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