Click here for Full Issue of EIR Volume 28, Number 5, February 2, 2001

California Crisis Could Trigger A Global Financial Crash

by Marsha Freeman

The policy of electricity deregulation which has driven California's two largest utilities to near-bankruptcy, is now threatening to spread the crisis throughout the financial sector, in the United States and internationally.

Almost every day of the week, one or another bank or financial institution issues a press release claiming that the California defaults will not affect its financial health or creditworthiness. This whistling past the graveyard is a sure sign that many see a financial crisis looming, and that few really think that it can be avoided.

The utilities in California are immediately faced with more than $6 billion in short-term debt contracted for power purchased at outrageously high prices. Were they to declare bankruptcy, an additional $20 billion in cross-default debt of just those two companies would immediately be affected. Smaller utilities that are not being paid by the California utilities, are threatened with bankruptcy. And in the electric industry as a whole, $400 billion is at stake in outstanding debt, against about $500 billion in physical assets.

For the past eight months, thanks to deregulation, Pacific Gas & Electric (PG&E) and Southern California Edison have been buying electricity on the state-mandated spot market, where the price zoomed from $30-40 per megawatt-hour in 1999 to peaks of more than $2,500 last Summer. At the current time, the gap between what the utilities had to pay, and what they could recoup from their customers, has grown to more than $11 billion.

On Dec. 13, Edison International Chairman John Bryson warned that Edison has had to borrow "huge sums of money in the commercial markets" to fund the $3.5 billion deficit it had incurred, and to purchase additional electricity. "This situation is not sustainable," he said. On Dec. 20, PG&E reported that it was borrowing an average of *$1 million per hour* to pay for the price gouging by wholesale suppliers, and that it had "exhausted its financial resources."

One week later, while Wall Street was promoting the fairytale that the financial community was not concerned with the imminent utility bankruptcies, Federal Reserve Chairman Alan Greenspan and U.S. Treasury Secretary Lawrence Summers were meeting with California Governor Gray Davis in Washington. After the meeting, it was reported that the two Federal officials had restated their belief in "free markets," and would do nothing to forestall the utilities' bankruptcies. But when Greenspan lowered interest rates on Jan. 3, there was widespread speculation that the California crisis had prompted the rate reduction.

On Jan. 16, Southern California Edison, in a filing with the Securities and Exchange Commission (SEC), stated that it was "temporarily suspending" payments on nearly $600 million of bills and debt repayment due, all contracted because of deregulation. Two days later, PG&E notifed the SEC that it was defaulting on $33 million in commercial paper, and its parent company, on $43 million in payments.

Immediately, both utilities saw their credit ratings on Wall Street downgraded to "junk," ensuring that they could no longer borrow to keep their operations running.

But the few billions of dollars these two utilities owe for the recent shortfall in income, pale by comparison to the $20 billion that could be affected by a bankruptcy through cross-defaults on longer-term debt, which becomes immediately due in full in the event of defaults and downgrades by debt-rating agencies.

In July 1998, the Federal Reserve Bank of New York brought together a group of lenders to bail out Long Term Capital Management, a failing hedge fund, to the tune of $3.5 billion. The LTCM debacle, it was noted, could paralyze world financial markets. Now, the situation involves *tens of billions of dollars* in utility defaults.

Who Is Exposed?

Following the defaults, most banks and financial institutions were closed-mouthed about the extent of their exposure. But, it was made public that Bank of America, the nation's third-largest bank, led a group of financial institutions that extended an $850 million credit line to PG&E last year, while J.P. Morgan Chase, the nation's number-two bank, was the leader on a $1 billion credit to Edison. Each institution is estimated to have a $500 million direct credit exposure.

While both banks declined to comment to the press on their loans to the California utilities, Bank of America's chief financial officer told analysts that the bank projects that it will write off $3 billion in delinquent credits this year, which

© 2001 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

should cover utility defaults. The bank issued a statement denying market rumors that utility-sector problems would force it to absorb losses in its derivatives trading division, after its shares were dragged down amid rumors of massive debt and derivatives losses on Jan. 5. There, could start the fall of the whole house of cards.

The rumor was taken seriously enough that there was a suspension of trading of the bank's shares in London, and companies that sell credit protection for the bank (five-year default swaps), faced a substantial rise in costs, because of higher risk.

According to research by Loan Pricing Corp./Gold Sheets, banks from all over the globe are exposed in the California crisis. These include Britain-based Barclays Bank PLC, France's Crédit Agricole, and Credit Suisse First Boston.

On Jan. 8, Barclays Bank issued a statement that it need not make provision against its exposure to a default by PG&E, but refused to reveal what its total exposure is. On Jan. 17, ABN Amro Bank NV in Amsterdam issued a statement that the Netherlands Bank is not at risk from the California crisis. ABN Amro was part of a syndicate that has a $4.2 billion agreement with PG&E. It was reported that ING Group NV in The Netherlands could face a loss of more than $80 million from a loan to a unit of Edison International in the United Kingdom.

While details have been slow to emerge, it is reported that Japanese, German, and South Korean banks also have substantial exposure in the U.S. utility sector. Thanks to "globalization," the financial problems of two companies in California can spiral into a worldwide financial blow-out.

Banks that lent to the near-bankrupt utilities are not the only part of the financial sector that will be socked with losses. The financial guarantee industry, or bond insurers, are already paying out claims on defaulted California utility debt. Ambac Financial Group, Inc. reported on Jan. 18 that its municipal bond division made a $36,000 interest payment on a bond for a California utility that is on the brink of bankruptcy, when it defaulted on payment. In total, Ambac has $75 million in exposure to Edison, and $73 million to PG&E.

Also, MBIA, Inc. reported that it expects claims of about $660,000 because of missed interest payments by Edison. Moody's reported that MBIA has a total of $445 million of exposure to Edison debt, and $590 million to PG&E debt. Financial Security Assurance, part of the Belgian-French bank group Dexia, has $6 million of exposure to Edison and $13 million to PG&E, and Bermuda-based ACE Ltd. has about $138 million in aggregate exposure to both utilities, representing 15% of its capital base.

Then there are the investment funds that hold stocks and bonds issued by the utilities, paper on which the utilities are not paying interest. John Kohli, manager of the $1.6 billion Franklin Utilities fund, has noted that "the reverberations would be widespread, in the near term." There are about 40 mutual funds that specialize in utility stocks (for decades considered to be the safest possible investment), with a total of $30 billion in assets, which are at risk in the case of defaults.

TIAA-CRFF, a financial services company that manages many pension funds for teachers and educators, has $335.8 million worth of bonds issued by the two California utilities. The Prudential Utility fund, the nation's largest utility-sector fund, manages $4.5 billion in utility stocks, which is at risk in a cascade of defaults.

In addition, municipal districts, such as Orange and Riverside Counties in California, each hold $40 million in utility notes and commercial paper. The income from those investments finances public schools, public transportation, and other essential economic infrastructure.

Small energy suppliers, which sell electricity to the California utilities, and which have not been paid in three months, are starting to fold up shop. In the industry itself, layoffs and capital expenditure cut-backs have not only eliminated nearly 1,000 jobs, but they have also put the reliability of the entire electric grid at risk, by cutting back on maintenance.

In mid-January, northern California suffered two consecutive days of rolling blackouts, and many other days on which industrial customers had their power shut off, to prevent blackouts from becoming necessary. It was estimated by the Los Angeles County Economic Development Corp. that these disruptions in power supply cost the economy of California $1.7 billion in lost wages, sales, and productivity, in *one week*. Just as utility defaults will cascade through the financial sector, and other utilities, severe economic declines in California will quickly ripple through many other parts of the country.

Many of the so-called (and actual) high-technology companies with substantial facilities in California do business nationwide, and internationally, in parts supply and product sales. "Interrupting power to them could conceivably filter through the entire economy," University of California at Los Angeles economist Bradford Cornell told *Newsweek*. And, the speculative prices citizens are already paying for gasoline, heating oil, and natural gas, are now being rivalled by double-digit increases in electricity rates.

On Jan. 23, *USA Today* summarized the risk faced by the nation if the Bush Administration does not take the appropriate steps to re-regulate. There would be a "worsened economic slump," indicated by the recent closure of the largest steel plant on the West Coast. Second, there could be a "credit crunch," as the cost and terms of borrowing nationwide are tightened by creditors afraid that they will not be repaid. And, third, there could be a "banking crisis if the utilities are unable to pay back their loans."

The global financial crash that could be triggered by the same economic axioms that have left in ruins the state with the largest economy in the United States, should bury those axioms forever.