13 March 2017

WHOLESALE ENERGY PRICES: JANUARY – FEBRUARY 2017: PART I: CRUDE OIL & NATURAL GAS

In this series of articles, Dominic Whittome covers recent changes to wholesale energy prices.

Crude Oil

Oil prices finished 2% down as the market remained pensive about the upcoming OPEC summit in April.

Although 'OPEC Alliance' countries (producers co-operating with latest output cuts) will not be attending the Vienna talks in a formal capacity, behind-the-scenes dialogue has been ongoing all the while.

With Iranian and Russian ministries having met up in January to discuss Russia extending its production cuts into next year and Saudi Arabia sending their foreign minister to Iraq (which was included in its latest production agreement) with a view to including Iraq in possible future production ceilings yet to be agreed.

Traders have been pointing out that there is no evidence to show that last November's accord between OPEC and OPEC Alliance countries made any impact. Although it is true enough that crude prices have flat-lined since November (having jumped in the weeks running up to the accord), conversely there is also no sign the accord has not worked. The agreed cuts were modest, the first in over nine years and also the first of their kind in that they included several non-OPEC producers.

OPEC ministers are possibly playing a long game, with modest but universally-orchestrated limits in output, to be increased methodically rather than in any way likely to destabilise the market, and we would need to wait and see if and what OPEC ministers decide on in April before one can second-guess the success or otherwise of last November's accord. The pace of oil price recovery has, however, been muted. This may or may not be connected to the delays to the public listing of Saudi Aramco, ostensibly due to 'complexities in the structure' of the company flotation plan.

The mooted delay (up to 18 months) may reinforce scepticism about the expected speed of any oil price recovery, if this reflects the kingdom's pessimism of the accord holding together. The value of the share offering is estimated at over £2 trillion and clearly very sensitive to prevailing oil prices. If market estimates are correct, the new company is valued at 20 times the capitalisation of the next largest oil major, ExxonMobil. It is conceivable that there have been worries that the oil market might not recover in time and these may have played a factor in the delay, although that itself is pure speculation. The Vienna meeting April could though be a turning point, in either direction.

With this week being CERA Week in Houston, perhaps we can expect the annual splash of shale stories over the next few days. While shale drilling should place a price ceiling on any sustained oil price recovery, as pointed out in past issues of Energy Highlights, shale plays are generally short-term and expensive. Oil prices could comfortably ratchet up to $75/bbl or beyond before shale and higher-cost conventional oil output starts to kicks-in. Either way, the oil market will never loose its capacity to take people by surprise.

Natural Gas

The forward-year gas contract finished the first two months of the year off 10%, closing below 45p per therm. This reflects the view held by most traders of a fundamentally well-supplied market with a spate of further LNG export projects set to come online this year and next, many landing at European terminals.

Notable supplies include projects in Australia and South East Asia, although shale gas from the Americas will have a role will to play too. The UK market recently saw shale gas imports from the Peruvian jungle due for landing at Milford Haven shortly before going to press, and this healthy looking forward supply-picture has been helped along by Japan.

The country has gradually been releasing more and more gas on to the world spot market: the LNG contracts it had bought up in the immediate aftermath of Fukushima. This may have contributed to (or certainly given the impression of) an 'LNG glut'.

The demand-side also paints a weak picture, with limited demand-call from generators and industry. However, there are some bullish signs on the horizon too. Geo-politics have recently turned adverse, with under-the-radar conflict areas in Russian-Ukraine and even the South China Sea among the potential supply-area worries.

However, any sustained uplift in gas prices is perhaps most likely to occur as a result of an indexation and long-term contracts issue. Indexation to crude prices still has the propensity to push prices up, with much of the piped and LNG sold across Europe still covered by these clauses. Within these contracts, even where oil and petroleum product indices may have seen their price-impact reduced or possibly removed altogether over the last 20 years, these price escalators indices have in most cases simply been substituted for producer price indices, which have recently been rising faster than oil prices themselves.

In fact, over the last five months alone, UK producer prices have been rising at annualised rates well over 10% according to estimates provided by industry trade associations. These will ultimately soon be reflected in official government statistics and will later directly influence gas contract prices, where the indexation effects can be lagged for six to nine months or, in unusual cases, even longer.

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