12 July 2018

WHOLESALE ENERGY PRICES: MAY – JUNE 2018

In this article, Dominic Whittome covers recent changes to wholesale energy prices.

Oil

Despite reports of US influence, and of OPEC agreeing a relaxation in quota to offset supply problems from Venezuela and sanctions on Iran, crude prices extended their gains to end the period 11% higher.

This output increase is essentially a token gesture anyway, given that most OPEC and non-OPEC countries are already producing at or close to capacity whilst the global supply cushion stands below 4%, the lowest it's been for 30 years. Consequently, Vienna's meeting of minsters has done little to reverse the price trend. However, the recent levels also raise questions about the authenticity of the 'shale oil' argument.

It was barely two years ago when investment banks were issuing research papers declaring '$30 - $40 /bbl - the new norm' amid expectations of fracked oil and gas keeping the world over supplied. As things turned out, oil prices doubled and many forecasts were promptly re-written. Perhaps a reasonable question to ask is that if there is (or ever was) close to this amount of surplus shale, then why are prices this high now, despite the actions or inactions of OPEC producers?

Prices might soften over the coming months but they are very unlikely indeed to return to anywhere close to the levels discussed in the market barely two years ago. Meanwhile, rising world inflation, which will add to transport, production costs and enhanced recovery budgets, could also drive oil prices higher, whilst the talk of US fiscal tightening and the strong petro-dollar have taken some of the sting out of oil price rises in nominal/dollar terms. Any relapse though, or renewed money printing that sees the dollar fall, could repeat the surge in oil prices last seen in the aftermath of the First Financial Crisis, which witnessed a flight into safe assets, hard commodities, including oil, that then dragged the market above $80/bl when demand was actually weaker than now. The forward outlook therefore appears stable and the current 'high prices' environment may be with us for a while.

Gas

Forward gas prices climbed a further 15% amid an unreasonably strong prompt market, with even spot prices trading over 50 p /th and sharply rising petroleum product prices. Oil prices themselves last fell below $40/bbl in April 2016, although their main assent (from $ 45 to $ 75) took place within the past 15 months. This timing may be significant and it may partly explain why wholesale gas prices are rising as fast as they are now. The 'low' gas prices in 2016/17 are due to fall completely out of most long-term contract price escalation formulae soon, if not already. There will therefore be a contractual readjustment for gas via key take-or-pay Russian, Norwegian and LNG gas contracts, most of which account for marginal supply and will dictate forward prices as we move into the next buying round or into the next Gas Year on 1st October.

The OTC market has also seen carbon prices soaring. Today the EUA is trading above € 15/ tonne CO2 versus € 5/tonne CO**2** exactly a year ago. While a sharply higher carbon price might be expected to depress gas demand, its overall (and certainly more immediate) effect will be to increase the principal feedstock price for gas generators. Events in the EU ETS will therefore be doing nothing to support any renaissance in new-build gas-fired generators, which may well be needed before long as the national generation margin shrinks further.

12 July 2018

Electricity

Forward power prices surged 13% over the period. However, with the medium-term outlook for gas and most other indigenous power generation looking fairly soft, the grid will be relying increasingly on new interconnector imports from the Continent, Norway and potentially Iceland further down the line.

As previous articles have commented, this energy strategy may be unsound, not so much for 'import/export' reasons per se but basic reliability. Leaving to one side the question of plant reliability and ability or willingness of European suppliers to offer peak power when needed, the reliability of sub-sea cables needs to be considered as such systems are themselves prone to outages, even the newest cables with the latest electrical technology.

However, with the Hinkley Point power station (which when ready will barely supply 5% of the market) unlikely to produce at capacity before 2025, and other nuclear plants also delayed and unlikely to come online until ca. 2030, the short-term and medium-term generation outlooks are tight. However, rather than higher wholesale prices, the impact will be expressed in sharp rises in premiums and the cost of shape in end-users' commodity prices, i.e. on top of capacity price increases and increasing eco levies and taxes (now seven in total).

The recent changes discussed above suggest that, if anything, the average businesses will now see power bills rising by 40 - 45% (the top end of the range estimate) within just three years. This prospect should spur end-users to look at energy reduction, demand-side management, on-site generation and profile-correcting batteries.

Prospect Law is a multi-disciplinary practice with specialist expertise in the energy and environmental sectors with particular experience in the low carbon energy sector. The firm is made up of lawyers, engineers, surveyors and finance experts.

Prices quoted are indicative and may be based on approximate or readjusted prices, indices or mean levels discussed in the market. No warranty is given to the accuracy of any view, statement or price information made here which readers must verify.

Dominic Whittome is an economist with 25 years of commercial experience in oil & gas exploration, power generation, business development and supply & trading. Dominic has served as an analyst, contract negotiator and Head of Trading with four energy majors (Statoil, Mobil, ENI and EDF). As a consultant, Dominic has also advised government clients (including the UK Treasury, Met Office and Consumer Focus) and private entities on a range of energy origination, strategy and trading issues.

For more information or assistance with a particular query, please in the first instance contact Adam Mikula on 020 7947 5354 or by email on adm@prospectlaw.co.uk.