

Oil Market Report – March 2012

When the inevitable “will fuel prices ever come down?” question is asked of Portland staff, the best thing we can do is talk about Natural Gas in America, as this offers a rare glimmer of hope for those waiting on a fall in fuel prices. In a climate where demand for gas has increased, American gas prices have actually fallen and the graph attached illustrates this. Against a back-drop of rising oil prices (the red line showing West Texas Intermediate prices), we can see Natural Gas prices actually dropping and the gap between the two products getting larger (the blue line shows Henry Hub prices – a pipeline facility in Louisiana and the Nymex pricing grade for gas).

How so? Well the reason behind this rather encouraging situation is the rapidly increasing production levels of gas in the USA, mostly as a result of shale exploration. In fact Shale Gas is fast becoming an energy phenomenon, not only generating 1,000's of jobs, but also improving US energy security and actually reversing US trade deficits, as gas looks likely to be exported from America in significant volume for the first time in decades. No wonder Barack Obama is smiling, and his Administration bull-dozing all environmental opposition to this mode of exploration. Whilst his Republican opponents knock lumps out of each other in the Primaries, here on a plate is a significant part of Obama's long-promised economic recovery*, that has little, if anything to do with Democrat policy.

So if prices can drop in the USA, can't the same happen elsewhere? Possibly... but probably not! The US example represents a simple case of supply increasing, meeting local demand, and thus suppressing prices. US gas also plays little part in the worldwide gas supply-chain, so whilst the situation may be bully for our American cousins, don't hold-out for anything similar in Europe. Our sphere of influence is more than ever being driven eastwards and here, it is difficult to see how any increases in gas supply can match the demand for gas. Recent International Energy Agency (IEA) calculations suggest that between 2012 and 2035, Chinese imports of gas will have to increase by 53% to meet their demand and that by that time, Chinese consumption will be equal to that of the EU in its entirety. With the appetite of India and other developing nations adding further pressure, the overall expectation for world gas demand is an increase of over 40% by 2035. So whilst large supply injections can have favourable short-term effects on price (as it has done in the USA), it is very difficult to see how overall worldwide supply of gas can adequately keep up with overall world demand in the long-run.

If there is to be one consequence though, of the divergence between gas and oil in the US, it is that the link between gas supply contracts and crude oil prices will almost certainly be broken. Looking at the graph, it seems remarkable that the majority of wholesale gas contracts are still priced off crude oil. This historical anomaly (a function of gas being a bi-product of crude oil exploration) is totally outdated and increasingly looks like a cynical attempt by gas suppliers to hold on to higher prices by selling gas based on a crude oil price, rather than gas benchmarks that more accurately reflect the market. Indeed, the core of the recent pricing disputes between Gazprom (Russia) and its national customers (Ukraine, Belarus, Poland) was this very subject and for all its power, Gazprom acquiesced in the end. This does not mean of course that gas prices will not eventually outstrip oil – only that gas is a big enough energy source to have all its prices based on gas sales rather than oil sales and the good news for the City, is that the dominant European Pricing Index is Britain's NBP (National Balancing Point).

Two other points of interest for March; the UK Chancellor confirmed that the scheduled 3 pence per litre fuel duty rise will go ahead in August and Francis “Jerry Can” Maude stoked consumer hysteria around a fuel strike that has neither been officially announced or has anything like the full support of the UK's tanker driver workforce.

* As purely anecdotal evidence of the likely economic benefit of Shale Gas, Portland has a US construction client that has recently been involved in the building of a 500 bedroom hotel in Eagle Ford, Texas (an area of large Shale Gas reserves). Despite the fact that the hotel is not yet even fully operating, all of its rooms are fully booked until the end of 2014!