

# Oil Market Report – May 2012

12 months ago, Portland wrote in our May 2011 Oil Market Report that those wishing for lower fuel prices should be careful what they wished for. The article considered that the only likely way that prices would fall was the arrival of another financial crisis and associated recession. One month after that (June 2011), Portland also wrote that the EU's treatment of Greece was akin to pinning your elder brother to the floor against his will. You know that everything will go horribly wrong when you let your brother go, so you keep him pinned down to try and buy time, whilst the underlying situation steadily deteriorates.

Well prices throughout May truly plummeted and any optimists left out there who believe we are not facing a new and very serious economic crisis, no doubt still believe in Santa Claus. Furthermore, much of the current problem once again begins (and ends?) with Greece.

First let's look at what happened to fuel prices in May. Down, down, down! Down 0.78ppl on 2nd May, down 1.75ppl on 4th May, down 0.58ppl on 8th May, another big drop (0.57ppl) on 17th May and at the end of the month, a further drop of 1.08ppl. At the beginning of the month, Brent Crude sat at \$119 per barrel – it ended at less than \$103. When prices weren't falling heavily, they still fell – just not by such big amounts. In fact, out of the 21 working days in the month, prices dropped on 13 of those days, meaning that over 61% of the month experienced price falls. The last time that happened was in October 2008, when Lehman Brothers collapsed and the financial storm really hit home. The graph below shows the Rotterdam prices of the four main grades of fuel (Petrol, Diesel, Kerosene / Jet Fuel and Gasoil) in May. Whilst Petrol fell the least – slightly buoyed by the onset of the US “driving season” – the grades that most closely reflect economic performance and outlook, were in free-fall for most of the month.

The current bleak outlook is dominated by the ongoing problems facing Greece. In the same June report mentioned above, Portland wrote “that Greece WILL default on its debts” and sadly this remains as true today as it was last year, just that they now owe more money. Furthermore, the indecisive elections in Greece have shown that an ever-increasing number of voters are rejecting austerity and perhaps worse, the idea that Greece has to pay its debts at all. Non-payment of Greek debt (and subsequent exit from the Euro) could destroy several European banks (the lenders), notably in Spain, France and possibly even Germany. Further bank bail-outs would be required to prop things up and there is a point at which questions have to be asked as to whether such funds actually exist. But on the other hand, keeping Greece in the Euro, pumping bail-out after bail-out into a broken system, preventing them from ever growing out of the problem and offering them no means or hope of repayment, could bleed the EU dry anyway.

So whilst falling oil prices might be good news for the consumer and may even (paradoxically) take some heat off the politicians, the backdrop is a deeply worrying one. Lower fuel bills are meaningless if businesses can no longer make and transport their products. Families might have more money to spend if petrol prices drop, but driving might not be much of an option if 15% of Europe is unemployed. All of this sums up the problem of oil prices and the economy. We all want oil prices to fall, but we certainly do not wish for the economic stagnation that lies behind such falls. At the same time, we all desperately want economic growth, without fully grasping the implications that such growth will have on oil demand and price in an over-populated and under (oil)-supplied world.

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.

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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!