Energy Outlook

July 2022

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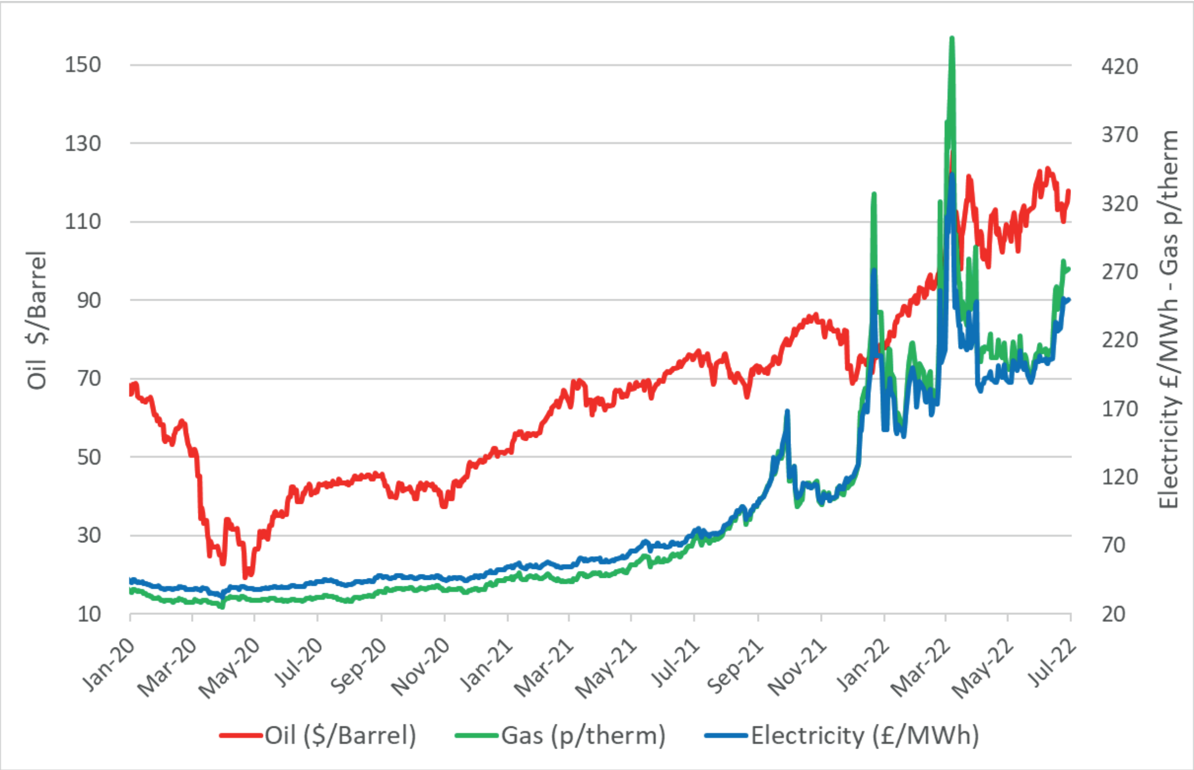
As we pass through the height of summer, there is very little cheer in the energy market for buyers as the war in Ukraine continues and Russia steps up its rhetoric regarding threats to European gas supplies in the coming winter. The massive hike in prices has now filtered through to the majority of both commercial and household users now which means we can expect significant voluntary turn-down in demand, which could accelerate as global economic recession looms.

The question is: Will this be enough to keep prices under control or will a complete shutdown of Russian supplies cause a renewed crisis and even higher prices than we saw last winter? Either way, significant day to day volatility in futures prices should be expected in the coming quarter.

Energy Price History

The chart below shows the price history for the major energy commodities since the beginning of 2020, showing the dramatic change from the lows at the beginning of the coronavirus pandemic to the unprecedented highs towards the end of last year:



Timing for making buying decisions for energy has always been important – this has never been truer than in the current market as we face both a severe underlying trend of price increases and patches of extreme volatility. Although no one has much of an appetite to lock into these high prices for this year and next, it is important to understand that we're still in the midst of an energy crisis and this winter has the potential to be the biggest test we have ever faced.

Read on for our analysis and outlook for each of the main commodities, with the risks to look out for in the coming quarter.

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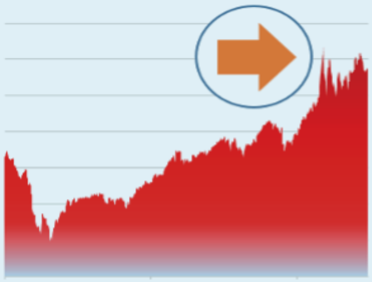
OIL

As anyone who has had to refuel a car in recent times knows, oil has continued its relentless rise, having increased month-on-month since the big dip back in March 2020. Fuel prices at the pump are now at record levels – levels which in the past have caused widespread protests and blockades.

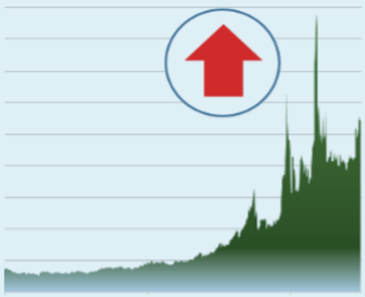


In spite of OPEC increasing its quotas and President Biden flying out to try to charm Saudi Arabia and the UAE into expanding output further, several members are already struggling to produce enough. Iran has declared it is ready to expand output, but at the same time has removed most of the nuclear monitoring equipment installed by the UN, meaning that western sanctions are unlikely to be lifted and Europe and the US will not benefit from any supply increase from this source.

The only 'bright spot' for buyers is a double-edged sword – the risk of global economic recession. We are already seeing this in several major economies and it could cause prices to flatten out in the coming quarter.

GAS

The European gas supply situation remains critical and is the single biggest threat to the economy across Europe (including the UK) this winter. Whatever happens, the high prices will result in reduced consumption, but this won't be enough to make up the difference if Russian gas supply is curtailed entirely. Russia is fully aware of this and has been stoking anxiety by messing about with flows through the Nordstream 1 pipeline, leading to accusations from Germany of 'weaponising' gas supply. Although Russia deny this is the case, it is clear that they don't have any other significant levers to counter against western sanctions, so more twists and turns should be expected here.



The major economies, including Germany, France and UK, have been drawing up contingency plans (which essentially means forced shut-downs and restricting pipeline flows), which is better than no plan, but would be economically disastrous if it has to be enacted for any significant period of time. In any case, it is this which is driving market jitters.

ELECTRICITY

As can be seen from the graphs, UK electricity prices continue to closely follow gas due to our reliance on gas-fired power stations. The extreme situation for the gas markets will dominate power prices, with very little relief to be had from increasing renewable generation. The high prices and threat of gas supply disruption means, regrettably, that we may see a resurgence in coal-fired generation in the UK and across Europe this winter, with carbon targets being temporarily sacrificed for short term energy security.

Whilst this will help to keep the lights on, it won't result in much relief in prices, since the increased emissions will push UK and EU ETS carbon prices up, adding more misery for end users.

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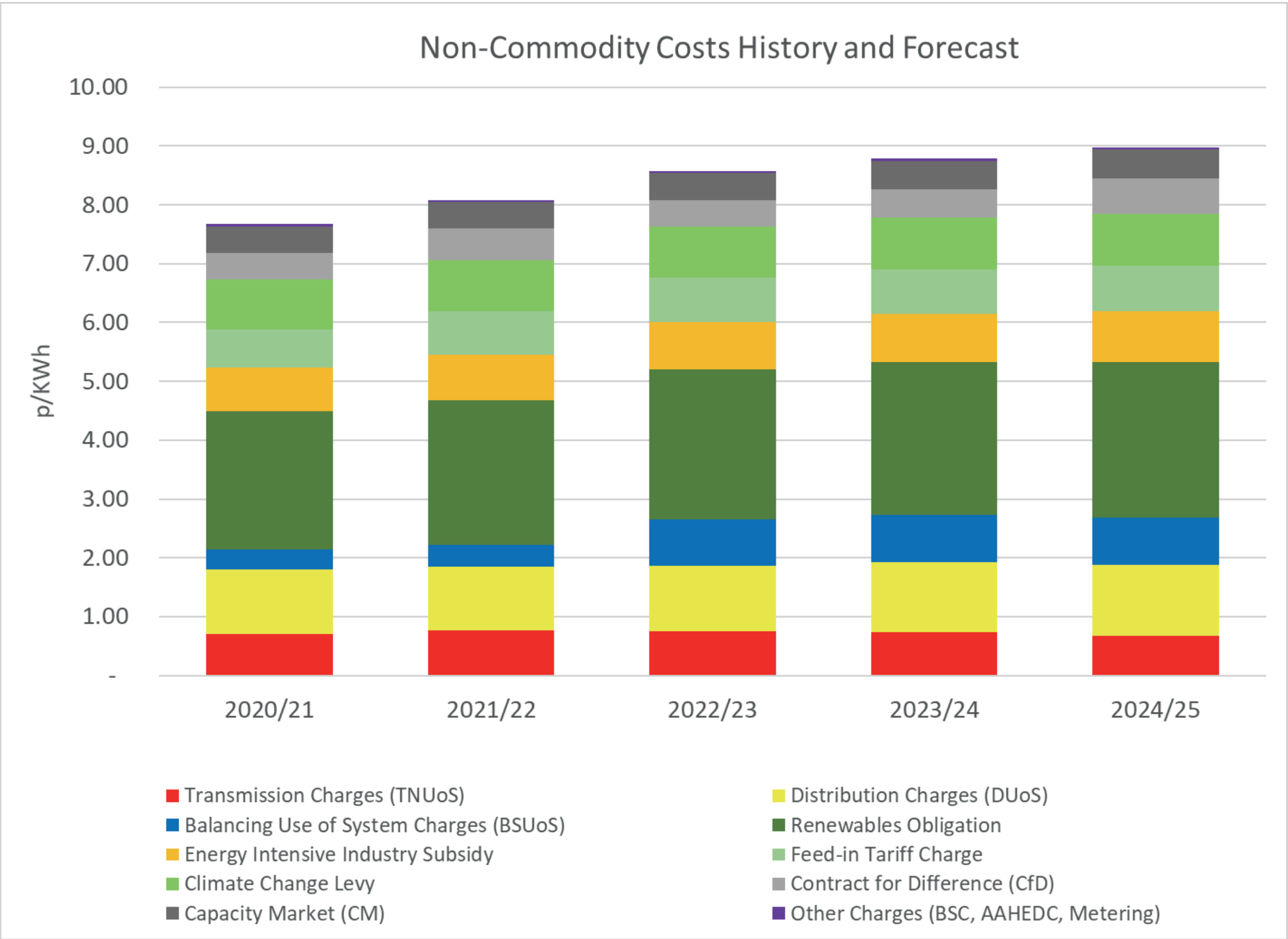
Non-Commodity Costs

Non-commodity costs (sometimes called 'Non-Energy Costs') are included in every bill and relate to things like the fixed costs of maintaining the physical electricity network (the National Grid Transmission System and local Distribution Network Operators) as well as the costs of Environmental Charges to fund renewable subsidies and taxes.



Figures based on an average UK Half-Hourly portfolio

NON-COMMODITY COSTS OUTLOOK

By their nature, non-commodity costs don't change as rapidly as wholesale energy prices; however, for several years up to 2020 they were the major cause of energy price inflation in the UK and still represent a significant part of the rate end users pay.

As described last time, the high wholesale cost is going to have a big impact on 'Contracts for Differences' (CfD) payments, although the way the mechanism works means that the benefit in bills will be delayed. Working against this is an increase in system balancing costs (BSUoS), which are very much driven by short term wholesale market volatility. The charges for this are set to double over the next few years as National Grid seeks to recover these costs.

Capacity Mechanism (CM) charges will also rise moderately after the decision to increase the volume to be auctioned earlier, creating a record cost increase to consumers of £375m for the year. This decision was driven by the security of supply concerns outlined above, and the main driver behind the increase in coal generation.

For more information, please get in touch with your Utility Aid Account Manager or call us on 0808 1788 170