Energy Outlook

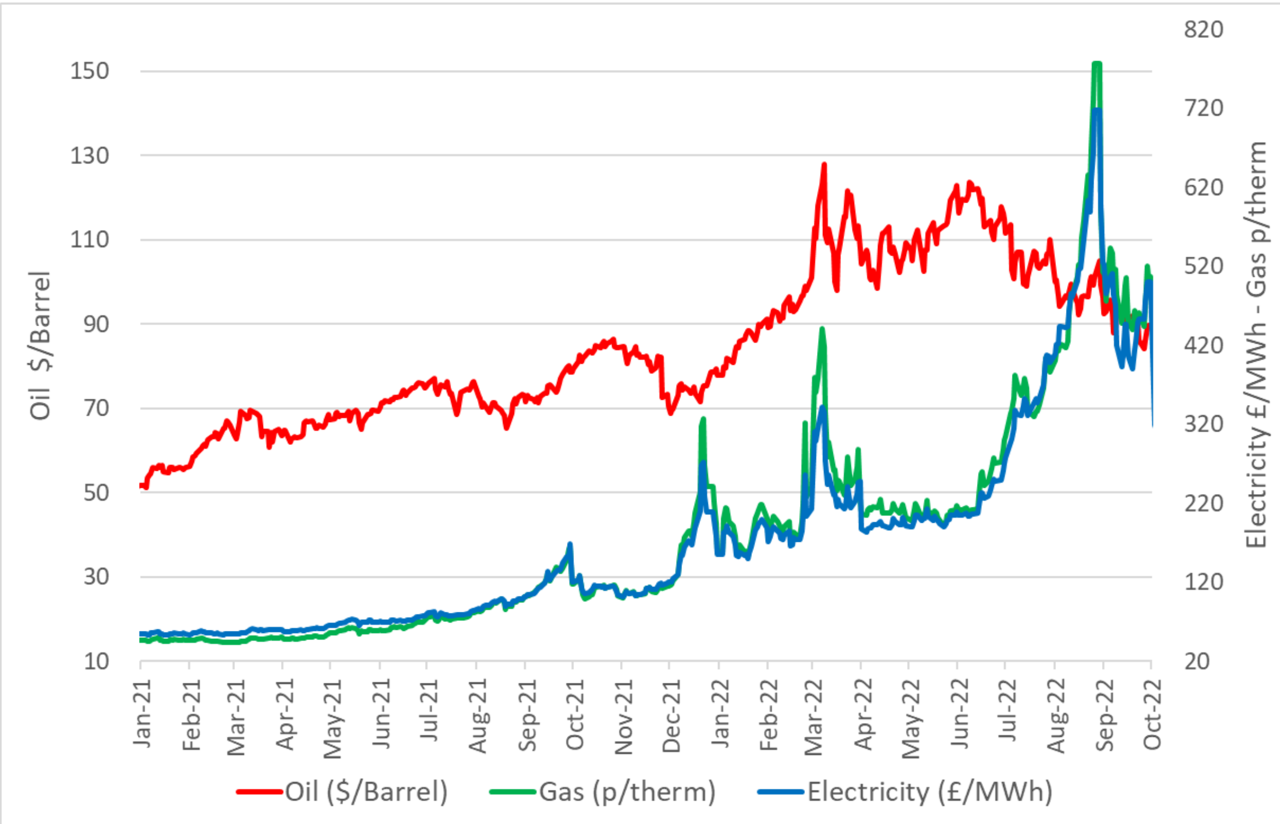
January 2023

What a year 2022 was! Prices were already riding high at the beginning of the year, then went stratospheric during the summer as market nervousness about the potential for gas shortages over the winter went into overdrive. It is well known that the root cause of the excessive prices has been Russia's war on Ukraine and the subsequent impact on gas supplies into Europe; however, a sole focus on this would be to miss a crucial underlying trend which started a long time before the aggression escalated in Eastern Europe.

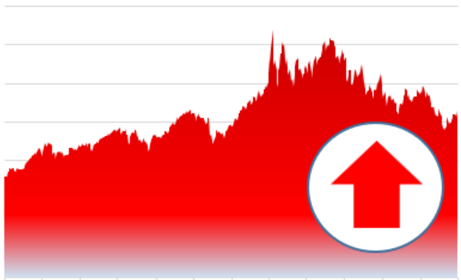
What should we expect for 2023? In this update we look at the major risks and potential opportunities which will drive prices up or down over the next year. It seems unlikely that the conflict will be resolved any time soon – and equally uncertain whether gas would start flowing again even if it did. Elsewhere, economic growth can be expected from China as it relaxes its extreme COVID restrictions, which may lead to an increase in the price of oil and other general commodities. That said, as we head into the second half of the winter season, there is some cheer to be had from the performance of the gas and power systems in the past few months with no blackouts in spite of a period of extremely cold weather at the beginning of December.

Energy Price History

The chart below shows the price history for the major energy commodities since the beginning of 2021, showing the dramatic volatility and ever-increasing prices over the last year, peaking in August.

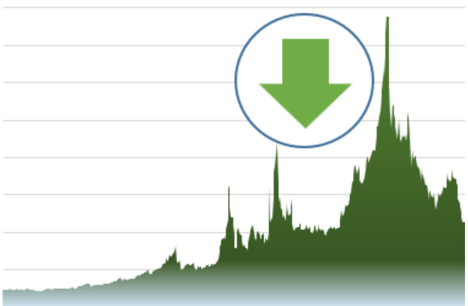


OIL



Oil has taken something of a back seat recently as its influence on gas prices has been heavily outweighed by the Ukraine situation. It would be foolish to ignore it, though, since it will continue to be the long term fundamental driver of energy prices. There are two key things to look out for in the short term: the first being the new G7 prices cap and refined product embargo on Russia. Analysts expect this to cause a reduction in the global supply of oil as Russia runs out of capacity to divert supplies to Asia. At the same time, a reviving Chinese economy is expected to drive prices up further. With OPEC already under-producing versus its quotas and a slow down in growth of US shale oil, the outlook for the crude price is distinctly bullish.

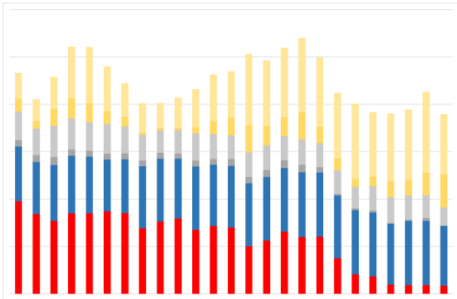
GAS



Europe had allowed itself to become dependent on Russian gas. The question that has brewed since before the war is: To what extent are we critically dependent upon it? The huge price spikes in August were a reflection of the real uncertainty about this – the key question is to what degree that uncertainty has gone away.

The chart (below, right) shows where imports of gas have come from every month since the beginning of 2021. The red bars are imports from Russia – now dwindled to almost nothing. The blue bars are imports from Norway, which have remained fairly constant. There are two things that have made up the difference: (i) reduced overall demand in response to mandatory and voluntary measures by industry, and (ii) a significant increase in Liquified Natural Gas (LNG) shipments.

Whilst this is encouraging, and proves that we can survive entirely without Russian imports, it is important to note that LNG flows to the highest bidder. Whilst we can be comfortable that physical security of supply will be met, it comes at a price. Storage capacity is also increasing – Centrica has recommissioned the North Sea Rough storage facility in double-quick time. This is great news for day-to-day physical security, but also means higher demand for gas over the summer (to fill it up). This combination suggests that overall prices are likely to be more stable, but will remain relatively high.

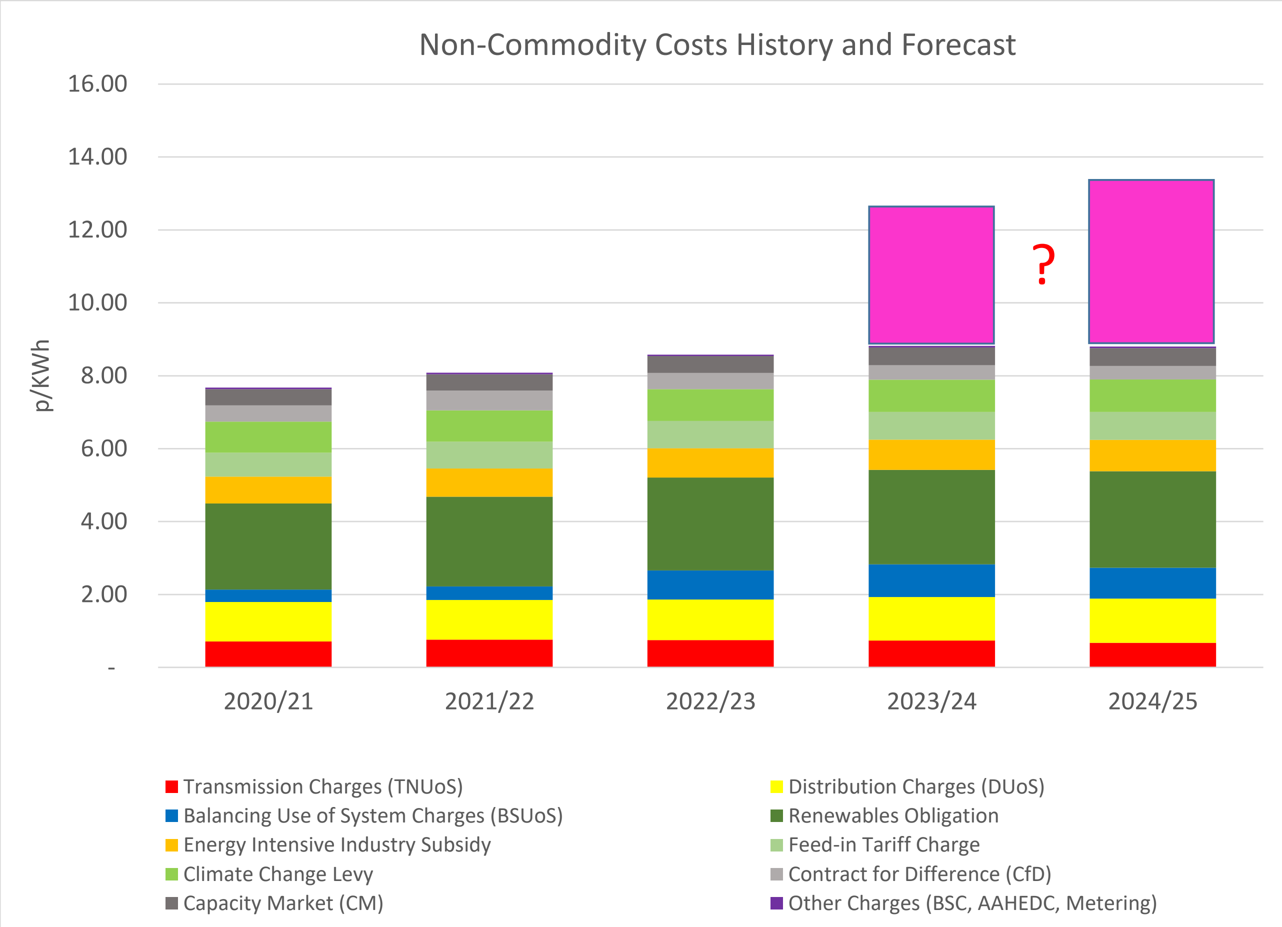


ELECTRICITY

Gas-fired electricity generation still makes up some 40% of the UK's electricity production and continues to be the 'marginal' form of baseload generation, which means it sets the price for the market. As such, all the trauma of the gas market feeds directly into power prices, so they remain stubbornly linked. The industry has had its additional pressures, with the majority of the French nuclear fleet out of action until recently and carbon prices becoming almost as volatile as energy in recent times. On the positive side, the proportion of renewable generation continues to increase – and when the wind really picks up it becomes the highest single contributor!

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

The outlook for non-commodity costs is mixed. Although they don't change with the same frequency as wholesale gas and power prices, they are not immune to market forces. On the positive side, the exceptionally high power prices we have seen means that generators supported by the 'Contracts for Differences' (CfD) scheme will be paying back into the scheme instead of taking from it – filtering into bills from next April.

Conversely, the high prices and volatility on wholesale markets mean that National Grid's costs to balance the electricity system have grown significantly. This means that BSUoS charges will continue to increase for at least the next two years.

Of more potential concern is the possibility that the government will seek to recoup the costs of its energy price guarantee mechanisms this winter. The pink bands above give a conservative estimate of what impact this might have – potentially adding 4p/kWh or more to everyone's bills from 2023 or 2024.

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