Bord Gáis Energy Index
Understanding energy

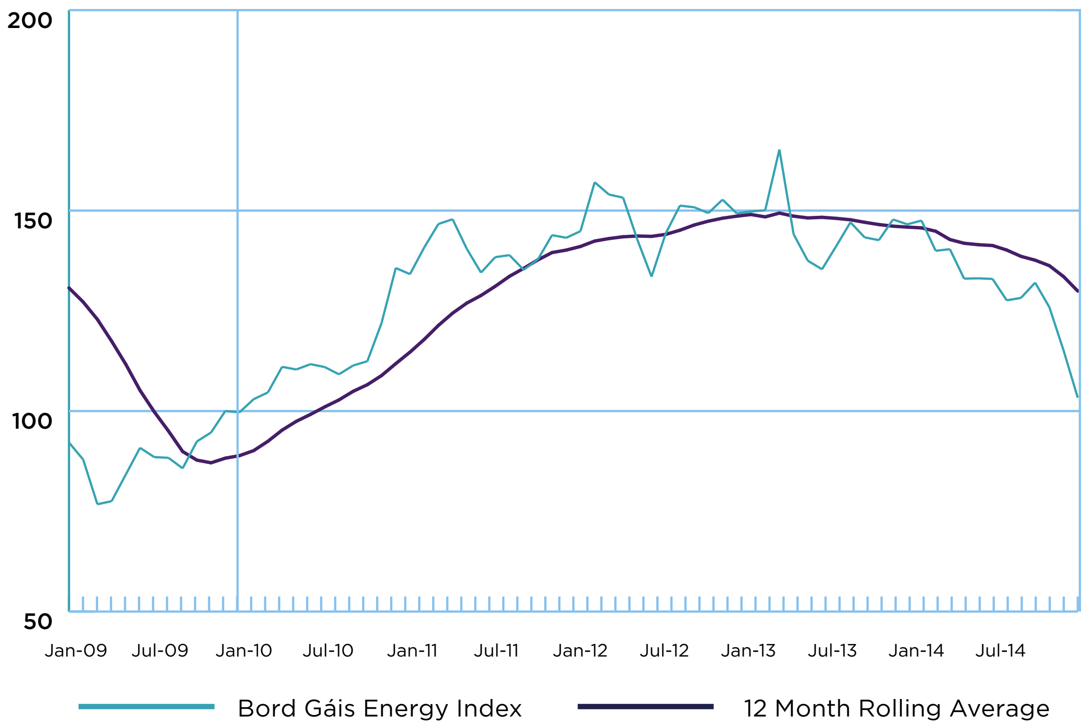
DECEMBER 2014

BGE/EI/UE/0115

Bord Gáis Energy Index

Commentary

Bord Gáis Energy Index (Dec 31st 2009 = 100)



-10%	1 Mth
-22%	3 Mth
-30%	12 Mth

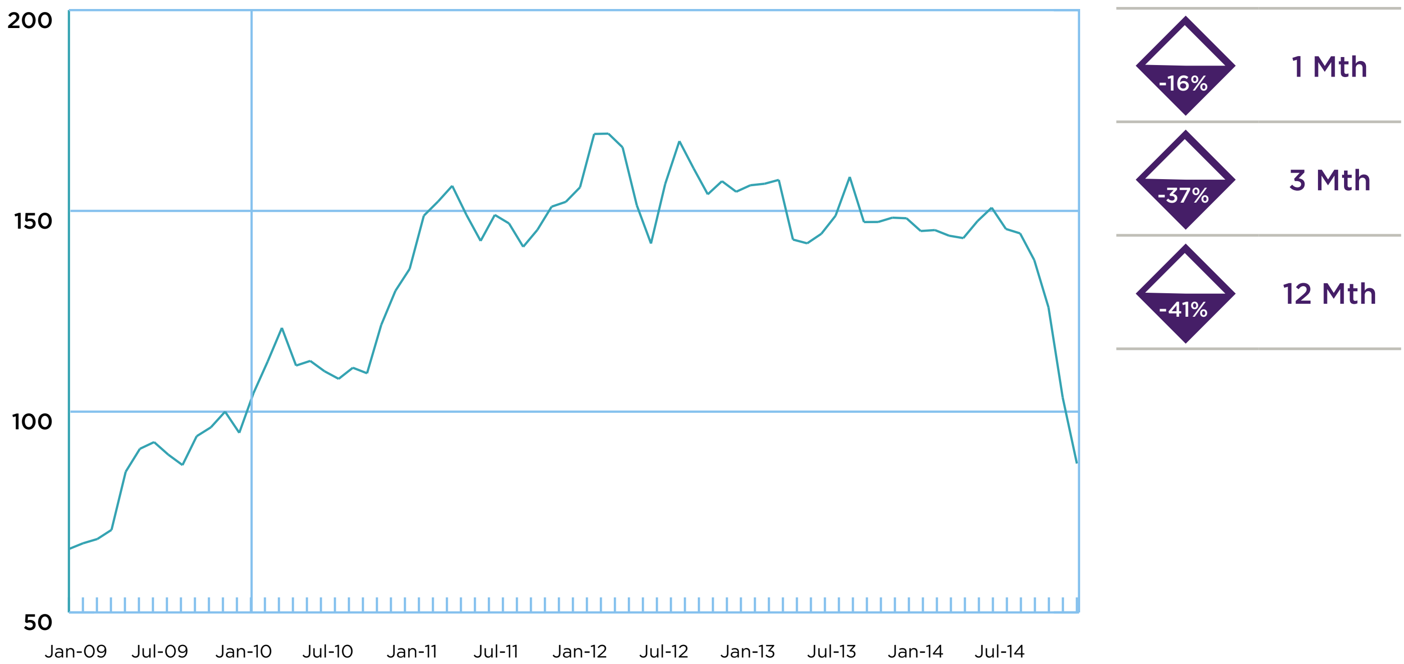
Summary

The December Bord Gáis Energy Index fell again this month due to the ongoing softening in global oil prices and in December 2014 the Index stood at 103.

As reported previously, over the last four years global oil prices have been propped up by the Arab Spring, tensions with Iran over its disputed nuclear programme, war in Syria, and the possibility of the Middle East being torn apart by ethnic differences and the threatening rise of Islamic State. North American oil has now trumped these concerns and the reality that the world is awash with oil and has insufficient demand to consume it has caused prices to fall. On 27 November OPEC had the opportunity to support prices. They chose not to act. This marks a significant shift in the world oil market. Despite some market sentiment that US production now has to slow, this is not expected until the middle of 2015 at the earliest. However, as consumers start to benefit, governments will be concerned by the possible reaction and consequences for those countries and economies dependant on oil revenues to meet budgetary requirements.

A shock to the global economy has been the fall in the price of Brent crude oil from US$115 in June to US$51 at the start of 2015. According to Christine Lagarde, "it is good news for the global economy" as consumers benefit from cheaper transportation and energy. This in turn will enable consumers to spend more money on other goods and services. It is estimated by Oxford Economies that every US$20 fall in the oil price increases global growth by 0.4% within 2 – 3 years. History also proves that lower oil prices, in both good and bad times, is good for global growth. In 1986 the oil price more than halved and global growth "surged" to 4.6% in 1988. Similarly, in 2008 prices fell from US$133 to US$40 and global growth "rebounded" in 2010. However, there are concerns that the reducing price means that Russia is starting 2015 in a difficult position. Funds to finance the battle against IS face greater pressure and the US is less likely to play global policeman now that it can satisfy almost 90% of its energy needs from domestic sources. In addition, with the fall in oil being associated with reduced demand in China, Japan and Europe, weaker prices are symptomatic of a wider economic shift. Oxford Economies estimate that with an oil price at US$60, 13 European countries will see their inflation rates fall below zero in 2015.

Oil Index



*Index adjusted for currency movements.

Data Source: ICE

Oil

Brent crude prices closed the month at US$57.13 per barrel. The decision by members of OPEC on 27 November not to cut production reflects a shift in the world oil market. In the first half of 2014, price movements were influenced on one hand by concerns over global economic growth (with a particular significance being placed on China's slowing growth levels and that of other emerging economies) and on the other by supply concerns due to the geopolitical issues that threatened to engulf the Middle East. With Saudi Arabia relinquishing its role as the swing producer on 27 November 2014, the surge in US oil production since 2008 has now come to dominate price behaviour. At the same time as US oil production reached over 9 million barrels per day (US production has risen by 80% since 2008), Libyan production had quadrupled to almost 1 million barrels per day (Libyan production was reduced to 500,000 barrels per day by mid-December as the struggle between the country's two governments is appearing to descend into a civil war which shut down the country's two largest ports, Es Sider and Ras Lanuf). The question that will be answered in 2015 is whether US production can continue to grow with the US benchmark crude price trading at US$53.27 on 31 December. According to the IEA, the impact of lower prices will start to emerge by the second half of 2015. Despite lower prices, the IEA is forecasting 2015 non-OPEC liquids growth of 1.3 million barrels per day and for demand to rise by just 904,000 barrels per day. As a result, the 2015 call on OPEC has been reduced by 338,000 and is now forecast to be 28.9 million barrels per day. The equivalent figure for 2014 was 29.5 million barrels per day.

Another question that may be answered in 2015 is what the consequences of lower oil prices will be on oil producers that are vulnerable to lower prices. In Venezuela, 65% of government spending comes from oil revenue. In Iran the number is 50% and 40% in Russia. The economic impact of lower prices is somewhat clear but the political and social fall-out could prove more uncertain. The fall in the value of rouble has been associated with the falling oil price but also with declining confidence in the Russian Central Bank and western sanctions against Russia. This could present a problem for the country and its leaders who have reportedly failed to make clear how they plan to manage the US$600 billion foreign debt of the country's banks and businesses.

One thing that is clear is that the drama is far from over. If prices continue to weaken, and they have done so since the start of 2015, OPEC members may come together again to reassess the market. However, in late December, Saudi Arabia's oil minister said that OPEC will not cut production even if the price falls to US$20 per barrel.

(Continued overleaf)

Oil Index (continued)

During December oil supply looked set to continue apace both in the US and internationally and this applied further pressure on global oil prices. The recent Iraq/Kurdistan Regional Government export deal was expected to increase global supply by 150,000 barrels. Additionally, exports from Nigeria and Angola were likely to increase 300,000 barrels per day to 400,000 barrels per day as operations reportedly proceeded smoothly in Nigeria and maintenance ended at the Plutonio deepwater field in Angola. Russian exports this month are expected to increase due to reduced export taxes effective from 1 January and new pipeline links in the US will put more oil into the Gulf of Mexico refining complex in January.

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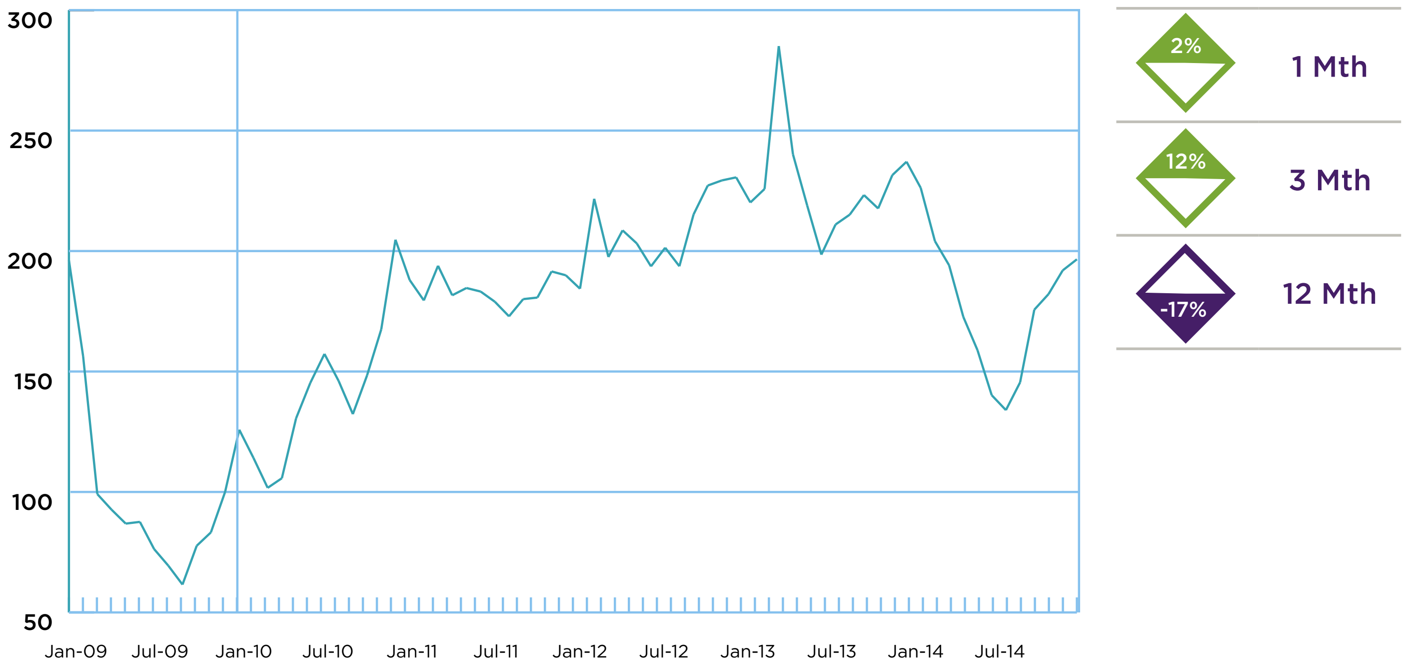
Natural Gas Index



*Index adjusted for currency movements.

Data Source: Spectron Group

Natural Gas

The average Day-ahead gas price outturn for December was 53.71p per therm (p/th), in line with the average price for the previous month of 53.75p/th. A weakening euro helped nudge the cost of gas higher for euro zone buyers of gas sourced in Britain. Gas supplies were stable over the month and this stability was reflected in wholesale prices. Of particular note is the continued attraction of the UK market for spot LNG cargoes due to weak Asian LNG prices.

Looking back over the year, prompt wholesale UK gas prices have reduced lower throughout 2014 with temperatures among the warmest on record. The Day-ahead contract for 2014 averaged 49.91p/th, with UK demand averaging at 220mcm per day. The largest upside risk to gas prices throughout the year stemmed from the Russia-Ukraine crisis. Russia supplies about one third of all EU gas, much of it via pipelines that transit the Ukraine. However, news flow in this area has been particularly positive over recent weeks as gas flows from Russia to Ukraine have resumed following Ukraine's prepayment for December gas supplies. In addition, Ukraine transferred US$1.65 billion to Gazprom at the end of 2014 in line with the agreement reached. This was the second and final instalment to repay the agreed gas debt of over US$3 billion. This news has continued to reduce the risk premium in prices. Given oil indexation remains a feature of some European contracts, the falling oil price has effected the gas curve contracts throughout Europe. The summer 15 contract finished the year at 46.50p/th and winter 15/16 closed at 53.08p/th.

Month-on-month, this is a drop of 6.76p/th for the summer 15 contract and 7.08p/th for winter 15/16.

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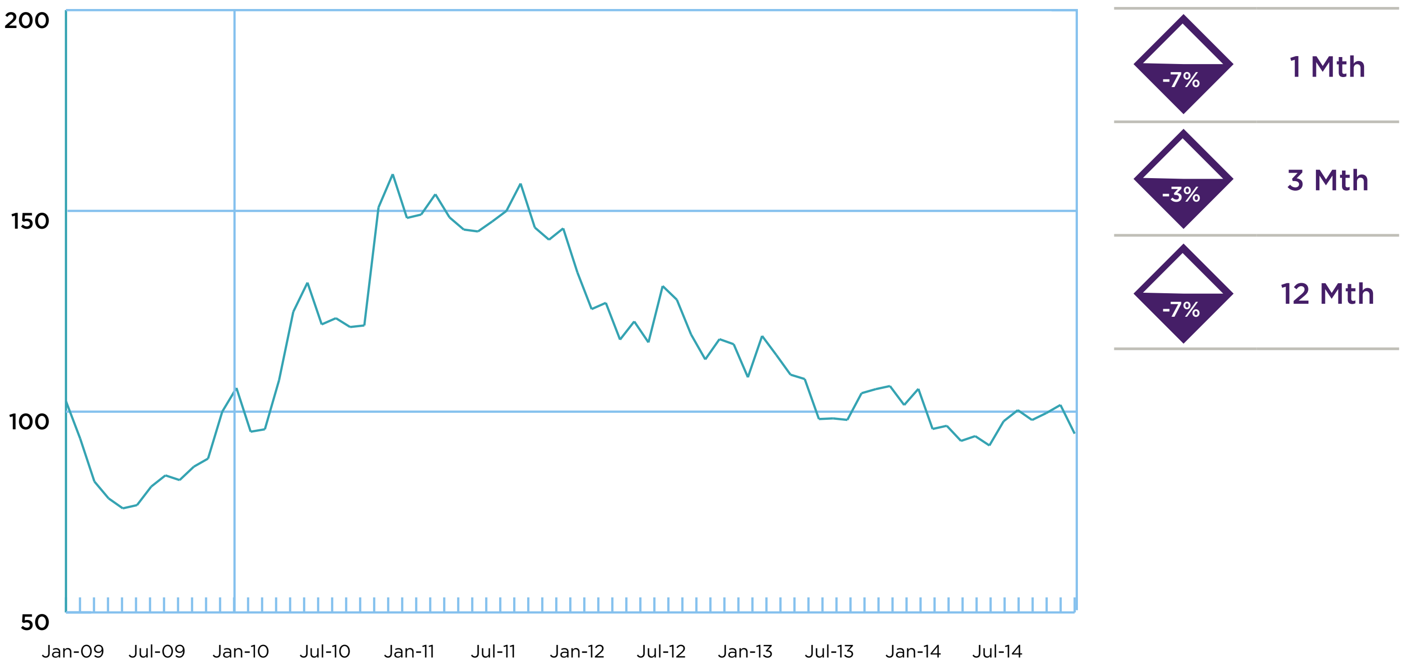
Coal Index



*Index adjusted for currency movements.

Data Source: ICE

Coal

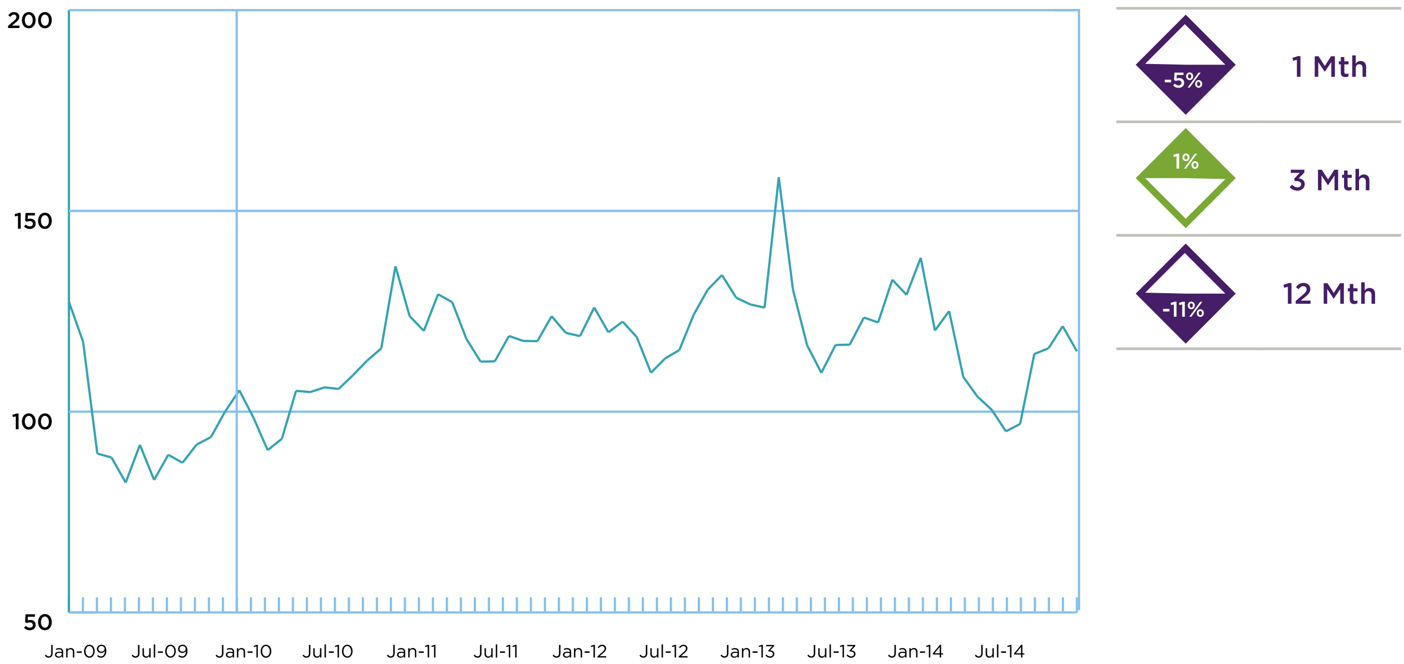
At US$66.75/mt, the ICE Rotterdam Monthly Coal Futures contract closed the month at its lowest point since July 2009.

The reduction in prices is associated with the milder weather conditions across Europe which has resulted in high coal stocks.

At US$66.75/mt analysts are questioning whether suppliers will be forced to cut production or idle mines. Traders are suggesting that there will be no factors to halt the current downtrend. However, it is being reported that the strong US dollar is helping to temper the impact of lower delivered prices, with weaker currencies in coal origin countries allowing producers to still make some profit.

Commentary

Electricity Index



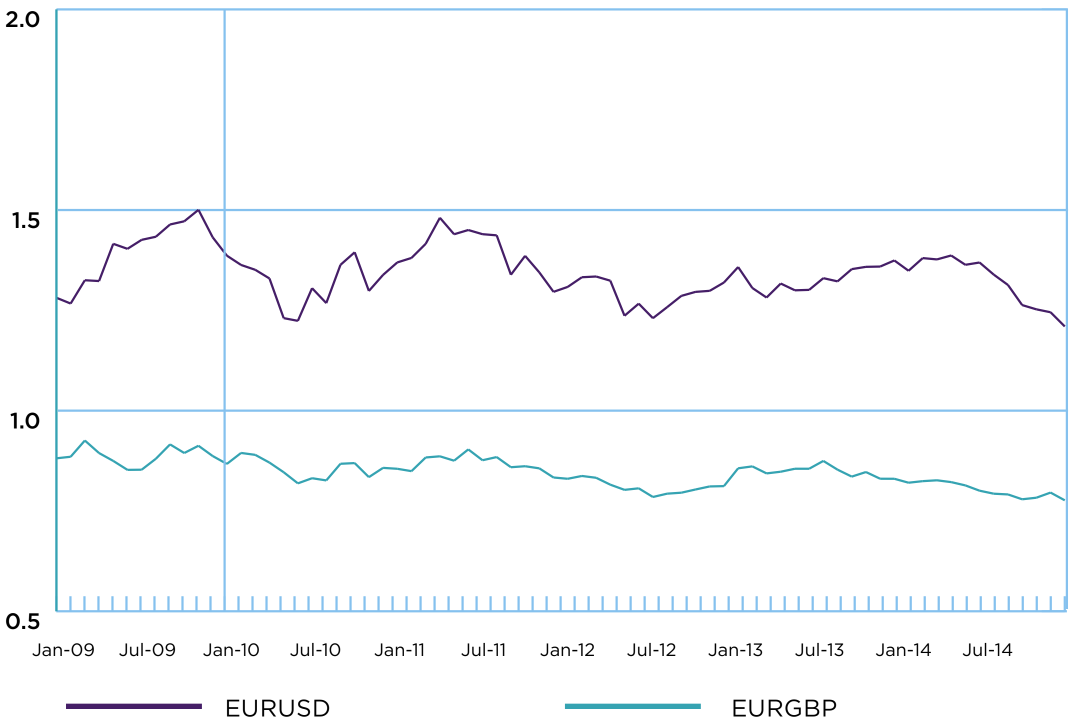
Data Source: SEMO

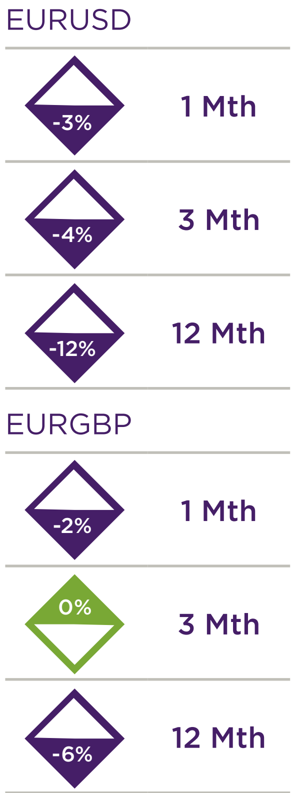
Electricity

Month-on-month the Irish wholesale electricity price fell from an average of €59.48/MWh to €56.23/MWh. The average clean spark in December was over €3/MWh lower month on month, further reducing the incomes of those utilities owning or relying on power generated from natural gas.

An influential feature of the Irish power market in December was the volume of electricity produced by the island's fleet of wind turbines. Although not reaching the record levels seen in December 2013, wind met a sizeable 21% of demand throughout the month. High wind volumes typically force more expensive thermal plant off the system and this reduces the revenues to traditional plant which now have to spread fixed costs over a far lower volumetric output, placing further question on their commercial viability in the current market structure. During the month, relatively cheap coal plants had a greater influence on the wholesale cost of power due to these high wind levels. As it is still cheaper to produce a unit of electricity by burning coal compared to gas, so the greater the influence of coal plants on setting the wholesale price of electricity. These factors coupled with strong interconnector flows, the testing of new gas powered plants and no significant outages throughout the month result in significant commercial pressures on any Generator or Supplier with reduced access to coal, peat or wind power sources.

FX Rates





FX Rates

The growing possibility that the ECB is about to start a policy of Quantitative Easing (QE) to try and stimulate the euro zone economies weighed on the euro in December. During the month, the official euro zone inflation rate fell to just 0.3%. At 0.3% there are fears that the region could be heading for a prolonged period of stagnation. Oxford Economies estimate that with an oil price of US$60 per barrel, 13 European countries will see their inflation rates fall below zero, at least temporarily, in 2015. The threat of deflation became a reality as it was revealed in early January that consumer prices in the euro area fell into negative territory by 0.2% in December. The last time the region's inflation was below zero, the economy was struggling to recover from the recession that followed the collapse of Lehman Brothers Holding Inc. QE (which will involve the buying of government bonds by the ECB) could stop this continued fall in general prices as it would inject cash into the banking system, stimulate the economy with fresh cash at low interest rates and ultimately push prices higher. Speaking in an interview with the German newspaper Handelsblatt, the ECB president said that "we are making technical preparations to alter the size, pace and composition of our measures in early 2015". QE would reduce the general level of interest rates in the euro zone banking system. It is this prospect which weakened the value of the euro on foreign exchange markets. The next ECB policy meeting will be on 22 January. However, there are no guarantees that QE will materialise. With the hard-left Syriza leading the polls in Greece before the upcoming election, it would be difficult for the ECB to consider buying Greek bonds. As the ECB considers deflation and lower interest rates, the US continues to ponder a rate rise with an expanding economy. Most Fed officials agreed their commitment to be "patient" on raising US interest rates at the last central bank meeting of 2014. It is now expected that there will be no increase in US rates before late April.

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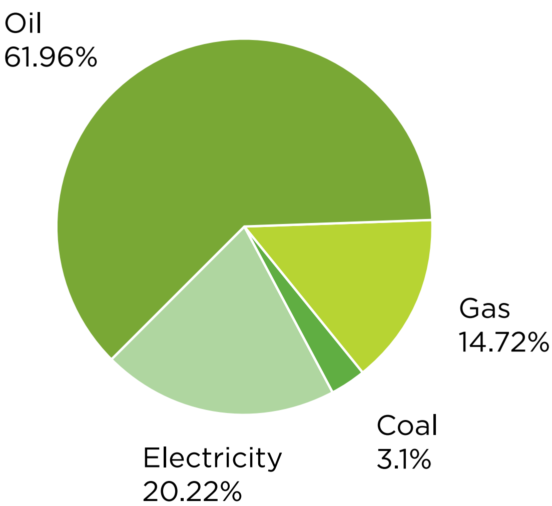
Market Outlook

The headline figure for total US crude oil production growth in 2015 is sensational - 1 million barrels per day, with most of this coming from tight oil wells. However, this is based on an assumed WTI price of between US$75 - US$80 per barrel in 2015. This increase is more than the entire annual production from Ecuador or Qatar, both of which are OPEC member. At the start of 2015, US production is around 9.2 million barrels per day and this is a year-on-year increase of 1.3 million barrels per day. However, with the recent drop in the benchmark price of oil, US production growth is expected to stop in the middle of 2015. If this materialises, it will impact the oil market and create a foundation for a potential oil price recovery. It is estimated that between 2009 and 2013, a quarter of a trillion dollars has been spent on US oil exploration and production. Of this quarter of a trillion dollars, around 40% was raised by taking on debt according to IHS Energy. Lower oil prices and stock valuations will mean that lenders will be averse to providing funding at anywhere near the levels that supported US production growth in recent years. With OPEC unwilling to act to support oil prices, confidence in future oil price levels has collapsed and this will make investors more unwilling to lend money to expand US oil production. According to IHS Energy, of the new wells that come on stream in 2014, 53% have a breakeven price (the price that covers capital and operational costs and generate a 10% return) higher than US$60. The US benchmark oil price closed 2014 at US$53.27. Looking ahead to 2016, if oil prices and margins for new drilling remain weak, US production could be flat or even decline. However, a potential recovery in oil prices, lower upstream costs, and improved well productivity could reinvigorate US growth in 2016.

Future economic growth in China will also have a bearing on oil prices. According to reports, Beijing says that additional growth driven by borrowing and investments has to stop. As a consequence, growth is expected to be slower in 2015 in order to be better, state-owned enterprises running on empty must be dismantled and private enterprise will have to provide jobs, especially in the service sector. Since 2008, China's money supply has expanded from US$7 trillion to US$20 trillion. If China continues to provide easy money, the risk will grow that popping asset bubbles will further slow the economy that has been the single largest contributor to global growth this decade.

Re-weighting of Bord Gáis Energy Index

Following the SEAI's 2011 review of energy consumption in Ireland, there was a 6.4% drop in overall energy consumption. Oil continues to be the dominant energy source with most of the oil used in transport and the remainder being used for thermal energy. For the purposes of the Bord Gáis Energy Index, the total final energy consumption in Ireland fell 1,089 ktoe (toe: a tonne of oil equivalent is a unit of energy, roughly equivalent to the energy content of one tonne of crude oil) between 2009 and 2011. This fall was made up of a 1,022 ktoe drop in oil consumption (down 13.5%), a 20 ktoe drop in natural gas (down 12.6%), a 7 ktoe drop in electricity (down 0.3%) and a 40 ktoe drop in coal (down 10.98%). The Bord Gáis Energy Index has been re-weighted in January 2013 to reflect the latest consumption data. The impact has been minimal and has resulted in slight reductions in the share of oil and gas and a slight increase in the weighting of electricity in the overall Index.



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