Bord Gáis Energy Index

Understanding energy

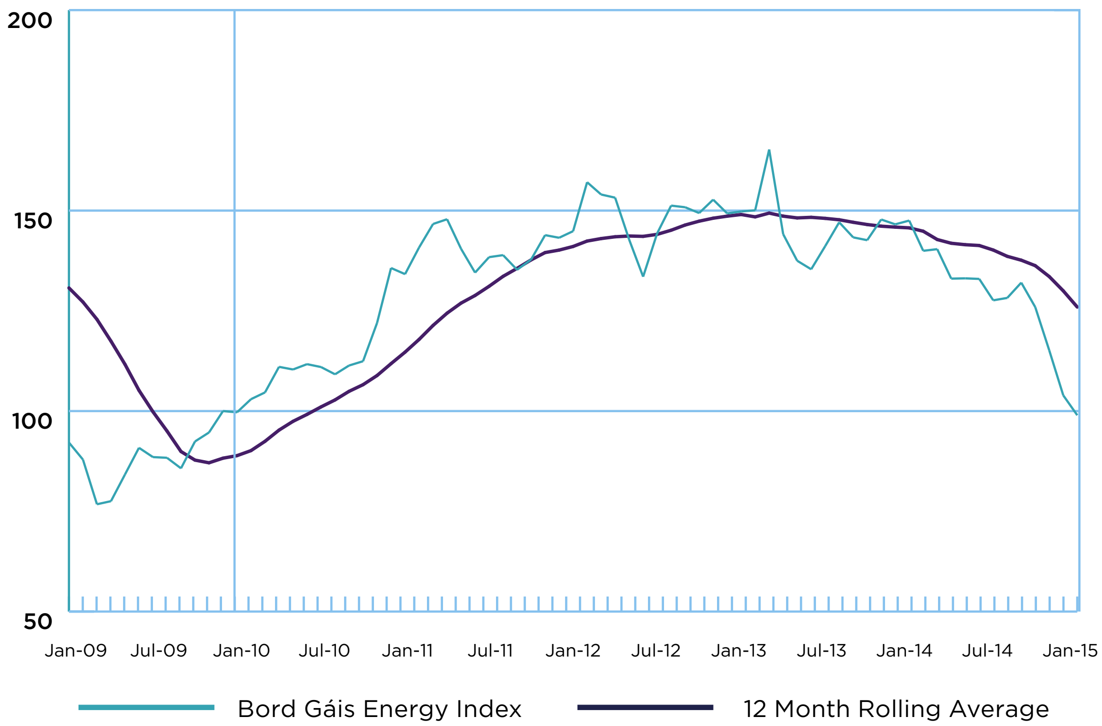
JANUARY 2015

BGE/EI/UE/0215

Bord Gáis Energy Index

Commentary

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



-5%	1 Mth
-21%	3 Mth
-33%	12 Mth

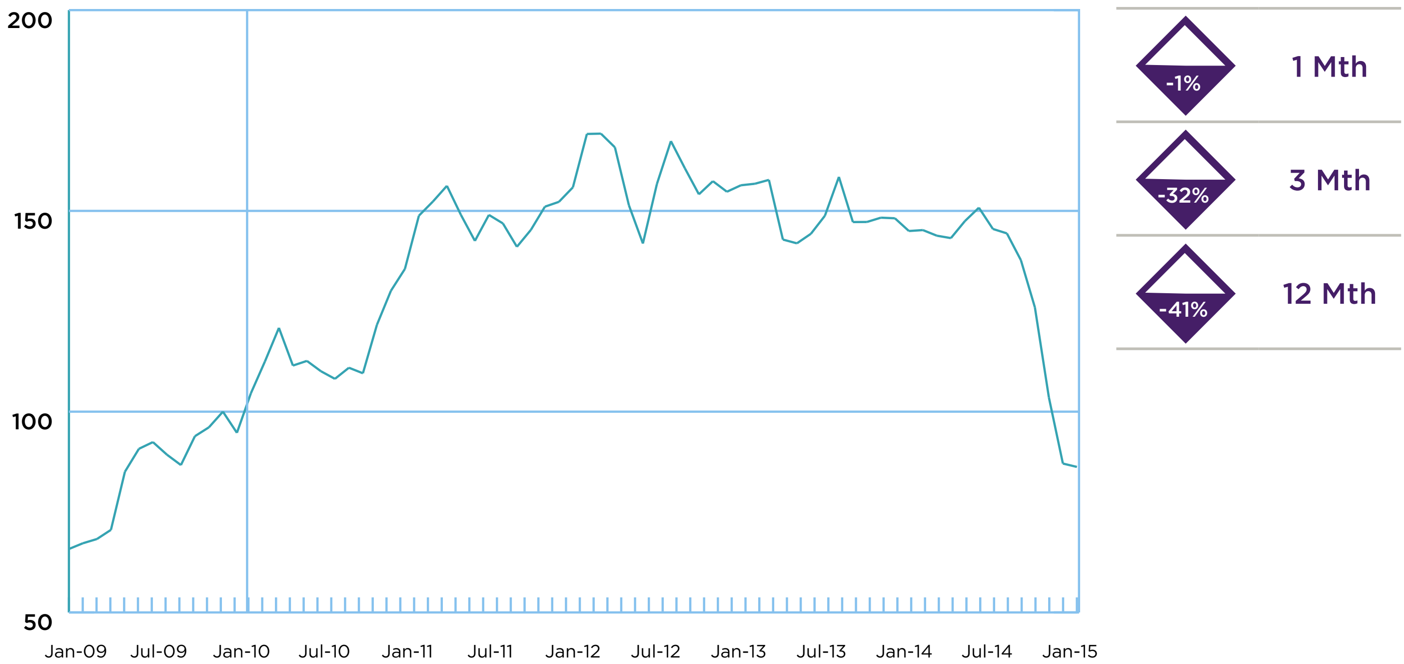
Summary

The January Bord Gáis Energy Index fell 5% due to lower wholesale oil, gas, coal and electricity prices. In January 2015 the Index stood at a record low of 99.

Brent crude oil prices continued to weaken in January but significantly the rapid price falls seen since June seem to have abated with the price appearing to stabilise around US$50 per barrel. Indeed, prices started to rise toward the end of the month on speculation that US production growth is about to be restricted because of the steep falls recorded. Furthermore, with growing geopolitical tension in the Middle East perhaps the current trend of consistently falling oil prices is broken? Despite stabilising oil prices, there are serious concerns about the state of the global economy as evidenced by 11 central banks taking the decision to cut rates in recent months and others, such as the US and the UK, appearing to put their rate hikes on hold. China's economic growth continues to disappoint and its debt continues to rise. Europe potentially faces years of stagnation and falling prices have been recorded for two months in a row. The region's economic performance has forced the ECB to take the plunge and announce a Quantitative Easing programme. The potential return of a European sovereign debt crisis will provide European policy makers with further headaches. If the world needed a barometer to assess the markets' view of the global economy it can look to the price of copper which hit a five year low during the month.

In a month when the ECB announced a historic Quantitative Easing (QE) programme, when deflation finally broke through the ECB's defences and economic growth in the euro zone slipped to its slowest pace in 18 months, fears that the region's economy is facing a permanent condition of slow growth increased. "Secular stagnation" is a concept invoked by the economists Larry Summers which describes the situation faced by the region. Without maintaining sufficient demand in the region, how can normal levels of output be achieved? With a high propensity to save and a low propensity to invest, where is demand going to come from? To address the regions under performance, the QE programme announced by the ECB in January aims to reduce interest rates and theoretically will make investments attractive in sufficient quantities to get the economy humming and in turn stimulate demand. This appears to be an appropriate response by the ECB but Summers would question whether this response is sufficient on its own? Furthermore, with real interest rates already at record low levels, can lower rates encourage sufficient quantities of additional savings and investments to achieve the region's full growth potential and will low rates ultimately a threat to the region's financial stability? Summers suggests that important policy imperatives need to be addressed by governments such as deep structural reforms, spending on infrastructure and education, addressing politically challenging issues such as immigration reform, policies to promote family-friendly work, support the exploitation of energy resources and a review of corporation tax. According to Summers, a failure to achieve meaningful change in these areas could ensure that the damage from the recession leaves a permanent scar. Structural reform in southern Europe in particular has been both encouraged and demanded over the last number of years but it has proven to be unpopular and painful. After the recent Greek election results, speedy reform within the region is now questionable.

Oil Index



*Index adjusted for currency movements.

Data Source: ICE

Oil

Brent crude prices closed the month at US$52.99 per barrel. Despite this fall in the price of Brent crude price, prices appear to stabilise around US$50 per barrel during the month. It was observed that the price started to rise at the end of the month and this continued in early February. It is now being reported that investors are speculating that the current period of falling Brent prices may have ended. This speculation arose on the news that US demand for leasing oil rigs was slowing, suggesting that producers might be preparing to cut production. Today American production is almost where it was in 1970 when it reached its high point of 9.6 million barrels per day. By the end of 2014 oil production in the US was 80% higher than it had been in 2008 due to hydraulic fracturing and horizontal drilling.

Despite the modest month end rally, the now well reported narrative of production growth and lacklustre demand continued to weigh on prices in January. Growing concern about China's slowing economic performance is raising question marks about global oil demand growth as Asia has become the primary source of this growth. Slightly slower economic growth in China is part of the government's plan for steering the economy onto a more sustainable path as it concentrates on structural reforms such as creating a social safety net. Concerns about the euro zone economy will also be a factor weighing on demand growth expectations. On the supply side it is expected that the world will produce an extra 2 million barrels per day in 2015 with demand only increasing by 1.25 million barrels per day leading to an increase in surplus oil globally. News that Iraq exported 2.94 million barrels of crude per day in December and that it had recorded its highest production since 1979 at about 3.4 to 3.5 million barrels per day added to the overall view that the world is awash with oil. News that Libya's production was down to 200,000 barrels per day had little impact on the market. Things are deteriorating in Libya, the scene of a forgotten conflict. The struggle between the country's two governments, one in the west, the other 500 miles to the east, is descending into civil war and the conflict has once again restricted the country's production capabilities which had reached closed to 1 million barrels per day in 2014.

While the world welcomes the fall in oil prices, falls in the price of copper are more ominous. The red metal is known as Dr Copper for its supposed ability to predict where the world economy is going. Copper crops up in everything from cars to phones to computer chips. A fall in its price, the theory goes, suggests global demand is slowing. In fact, copper's fortunes are more closely tied to China than anywhere else. Its downward trajectory feeds broader fears. In January the World Bank cut its forecast for global GDP growth in 2015 to 3%, from 3.4% in June.

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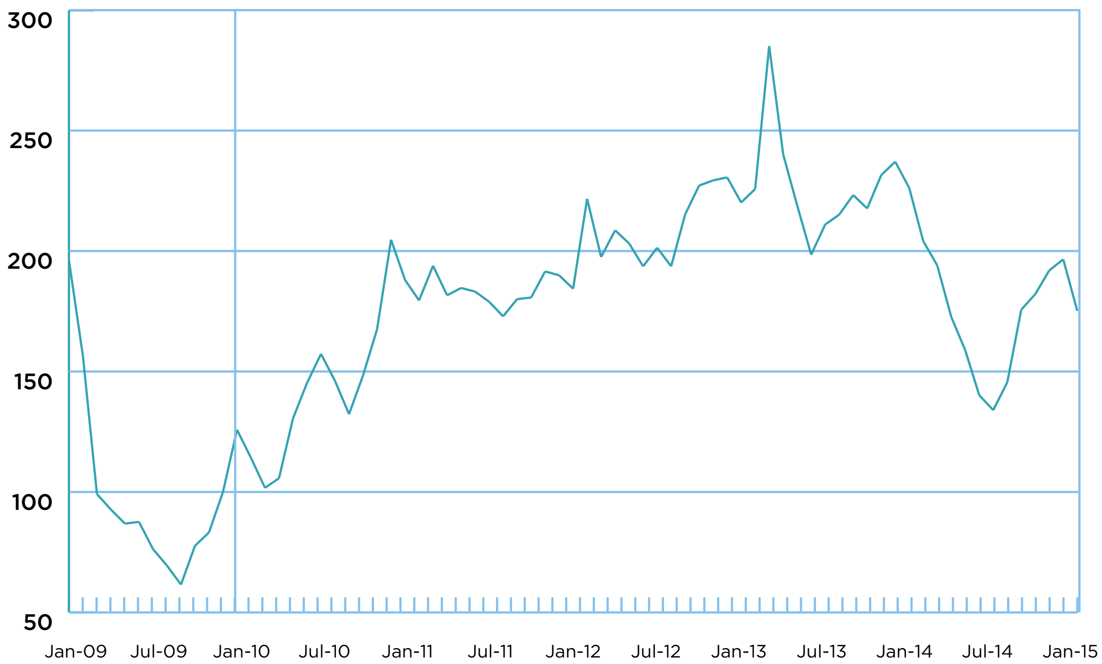
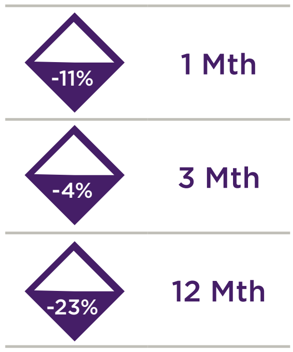
Natural Gas Index





*Index adjusted for currency movements.

Data Source: Spectron Group

Natural Gas

The average Day-ahead gas price outturn for January was 46.20p per therm (p/th).

Despite an increase in demand of 7% month-on-month and demand hitting highs not seen since March 2013 on a number of occasions during the month, ample supplies meant that prompt prices remained stable. The highest closing price being recorded in January was 49.27p/th despite some cold weather spells.

UK storage levels were well stocked at 2.77bcm at the end of January according to Gas Infrastructure Europe. 2.77bcm represents about 60% of UK storage and while this is less than this time last year when stocks were over 75% full, it still leaves plenty of gas available for the remainder of the winter period which finishes at the end of March.

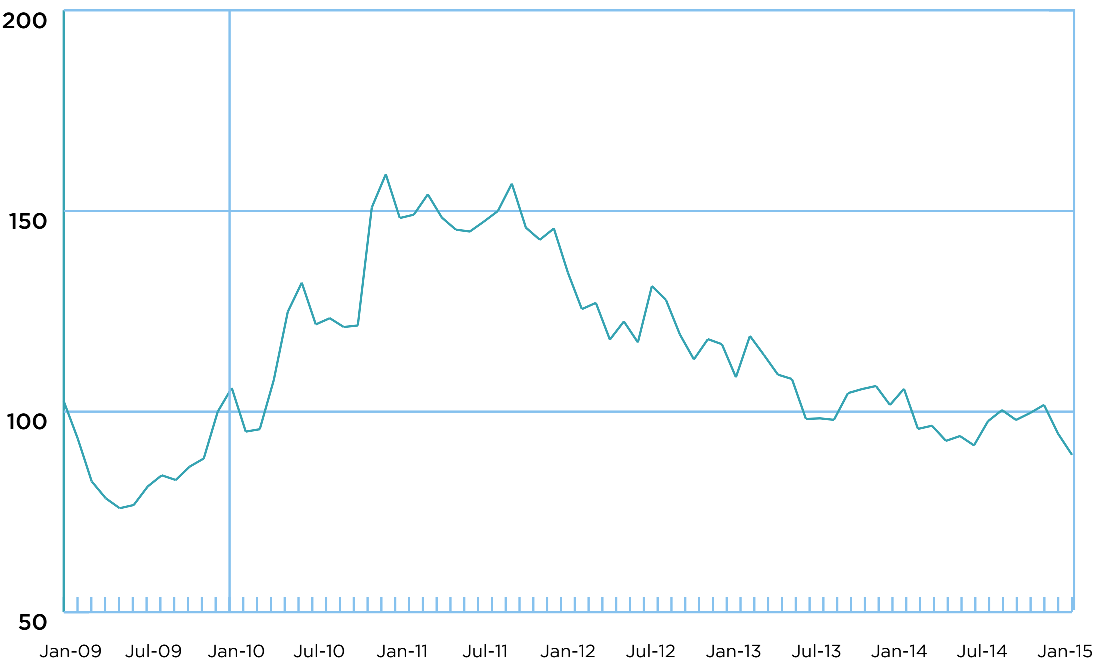
The continued weakness in Asian LNG prices resulted in relatively high LNG cargo arrivals to Britain. LNG flows in January averaged in excess of 30mcm, a significant increase on an average flow of 11mcm recorded in January 2014.

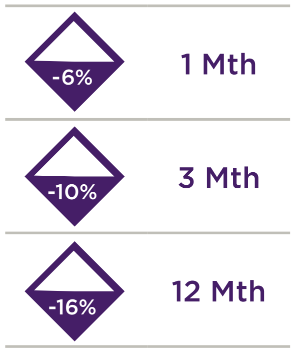
With prompt prices falling, forward gas prices continued to weaken in January. Over the month, summer 15 contract fell by 3.59p/th while winter 15/16 weakened by over 4p/th. Along with softer prompt prices, weak Brent crude prices and a possible reduction in the need to replenish winter stocks over the summer month weighed on forward contract prices.

However, despite the softening in prices, the market was concerned during the month about developments in Ukraine where fighting in Ukraine's breakaway east escalating and Russian involvement is reportedly increasing. The possibility of indirect western military involvement has the potential to change the dynamics of the conflict and falling oil prices may influence Russia's decisions.

Commentary

Coal Index





*Index adjusted for currency movements.

Data Source: ICE

Coal

The ICE Rotterdam Monthly Coal Futures contract closed the month at US$58.80mt.

With European coal prices at record lows the market appears to be trying to find direction amid several issues that could potentially hinder supply in the Atlantic. Earlier in the month, a Colombian court issued a ruling restricting night-time railings on the Fenoco line, which transports coal from Glencore's Prodeco, US-based miner Drummond and Goldman Sachs unit Colombian Natural Resources to export terminals on the Caribbean coast in order to reduce noise pollution. Market participants have pointed to uncertainty over the effects of a Colombian court's ban on night-time coal transport and its potential impact on Colombian exports in 2015. In addition, South African physical thermal coal prices rose toward the end of the month to over three-week highs on the news that Glencore may idle its South African Optimum mine, potentially taking out about 5 million mt/year from the market. Glencore said in a statement that the continued deterioration in the export coal price had resulted in ongoing financial hardship at Optimum, which produces about 10 million mt/year of saleable coal, of which half is exported while the other half supplies South African power utility Eskom. There are no immediate concerns over Russian coal supplies being shipped to Europe. However, the market will be increasingly aware that the recent escalation in the military conflict in Ukraine might cause some renewed sanctions imposed on Russia and this could reduce future supplies.

Despite these potential supply threats, European coal prices over the month weakened along with oil prices. The market has been described as "very bearish and difficult" as summer draws closer, with most utilities fully stocked and the ongoing Atlantic supply glut is expected to continue through the year. The extent of European coal stocks were revealed toward the end of January when it was reported that combined coal stocks at three delivery terminals in western Europe's Amsterdam-Rotterdam-Antwerp trading hub were around 5.722 million mt, 15.6% higher than the same week last year and the highest since late November. With weather forecasts having been revised for Europe indicating milder temperatures, the market is increasingly comfortable with current stock levels. These are unlikely to be eroded in the short-term and this is now especially true as winter draws to a close.

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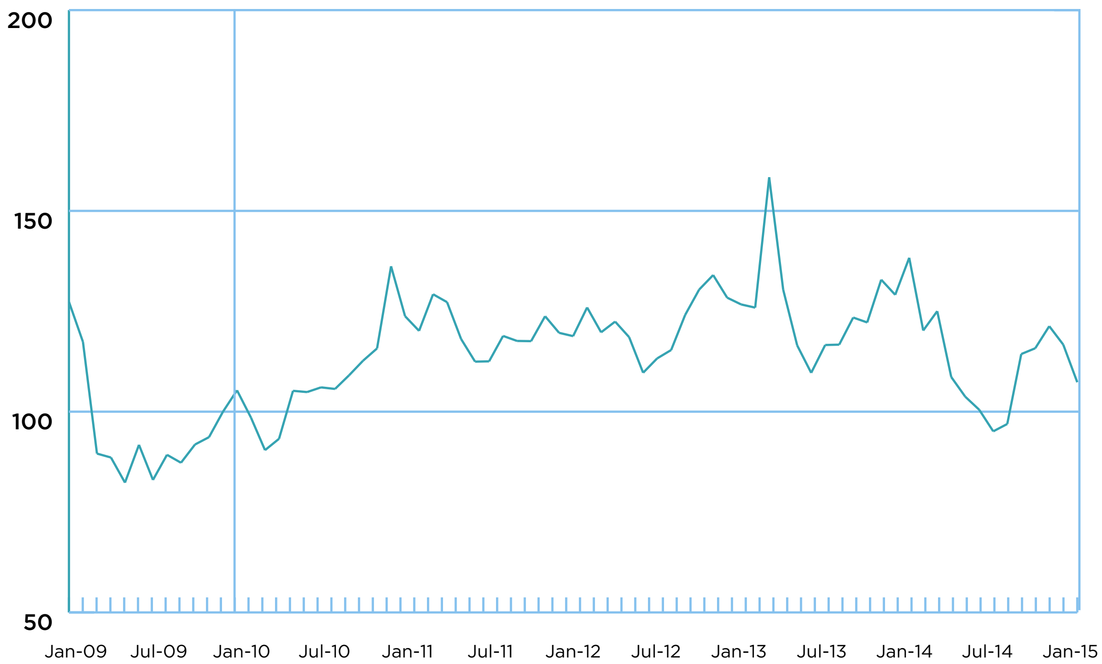
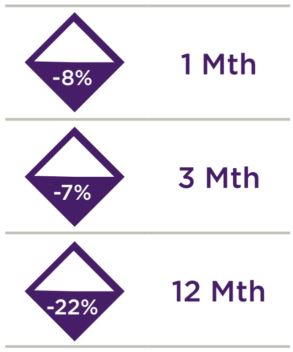
Electricity Index





Data Source: SEMO

Electricity

Month-on-month the Irish wholesale electricity price fell from an average of €56.23/MWh in December to €51.91/MWh in January. Weaker UK prompt gas prices in January compared to December were the main reason for softer wholesale Irish electricity prices. In general, the wholesale price of electricity is determined by the cost of producing a unit of electricity by the island's fleet of gas powered plants which in the main import their gas requirements from the UK.

A common feature of the island's electricity system is the volume of electricity produced by numerous wind turbines which has a significant influence on wholesale prices. During the month of January wind turbines collectively met a sizeable 22% of demand. 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. In January there were 6 days when the average clean spark for the day was negative and strong wind output had an influence on this.

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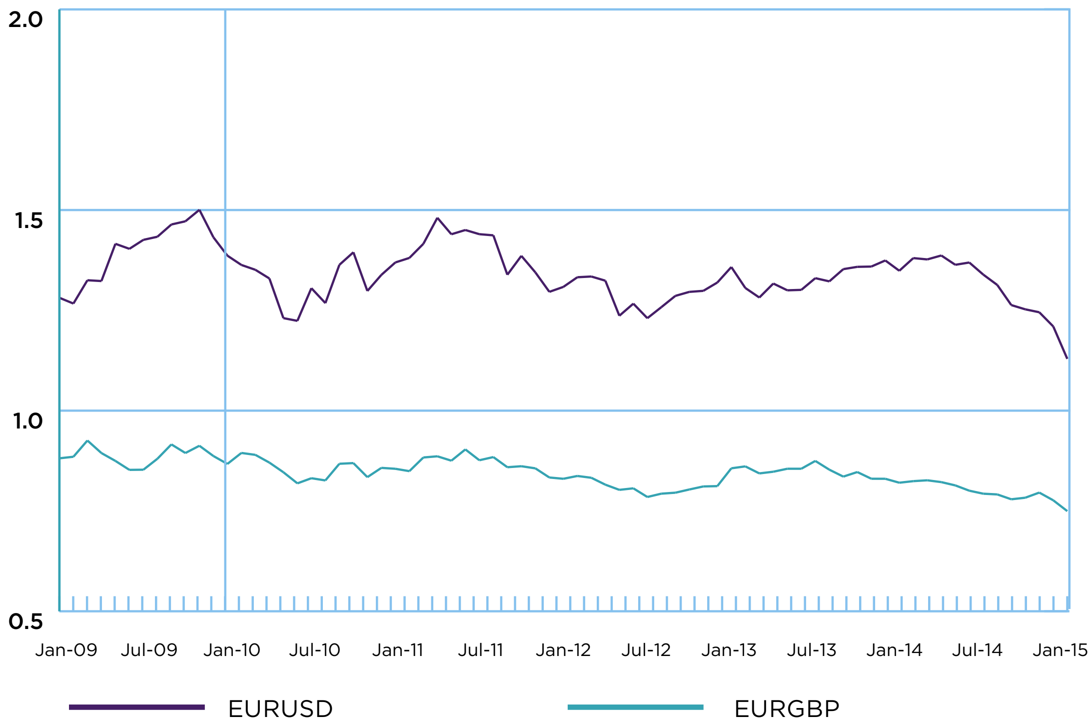
FX Rates



EURUSD

-7%	1 Mth
-10%	3 Mth
-16%	12 Mth

EURGBP

-3%	1 Mth
-4%	3 Mth
-9%	12 Mth

FX Rates

In the past three months no fewer than 11 central banks have cut interest rates, even the Fed and the Bank of England have contemplated raising them. It is this deviation that is causing currency volatility to be 50% higher this year than last according to Deutsche Bank. The strength of the US (nearly 3 million jobs were created in the US in 2014 and 252,000 were created in December) and UK economies has helped lift the dollar and sterling, most notably against the euro, in recent weeks. Currently there is no clear sign of a US rate hike as the Fed remains "patient" despite strong jobs growth. This patience will be supported by slowing core inflation (which is being supported by a strengthening dollar), the euro zone's weakness and a slowing Chinese economy (China's economy grew by 7.3% in Q4 2014. For the year as a whole the figure is 7.4%, the slowest since 1990. However, a 7% figure equates to US$700 billion and adds as much output as a turbo-charged 14% did in 2007). Similar to the US, the Bank of England does not appear to be in any rush to raise rates anytime soon. The January meeting of the Monetary Policy Committee (MPC) brought no change to interest rates. However, with plummeting oil price and reduced inflationary pressure, the entire MPC voted to keep rates at 0.5%. A unanimous vote pushed into the future the much anticipated move toward higher and more normal interest rates that had been gathering momentum in 2014. Expectations of low rates were supported by the news that UK economic output in Q4 came in slightly lower than what was expected by the Bank of England.

The weakness in the euro reflects numerous events in the month that point to the region's fragilities. Deflation across the 19 countries that use the euro gathered pace in January with prices down 0.6% on their levels one year ago. To tackle the dangers of falling prices, the ECB announced a historic programme of Quantitative Easing that will take its monthly expenditure on assets to over €60 billion. Latest euro zone growth figures provided further evidence of the economic malaise present in the region with France and Italy remaining stuck in recession and the region as a whole grew at its slowest pace in 18 months. Syriza's victory in Greece's election also reawakened the sovereign debt issues that had troubled the region in the recent past. Comments from Ewald Nowotny, an ECB governing council member, that the euro zone was experiencing a "massive weakening" reinforced the market's impression of the region and weakened the euro further.

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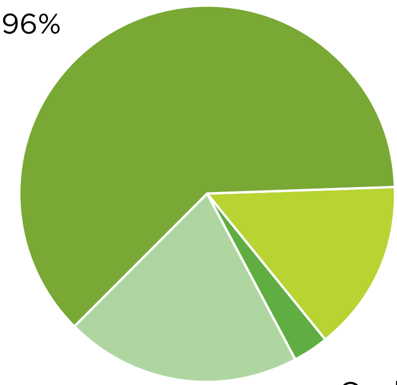
Market Outlook

US tight oil has proven to have had a dramatic impact on the world oil market that would have not been imagined even 12 months ago. The major question now is whether its impact will continue in a world of lower oil prices. At US$50 – US$55 per barrel it is believed that prices are too low for a good deal of any new shale developments to make economic sense. Despite this, commitments already made are expected to support US oil production growth in the first half of 2015. However, if prices remain at current levels, it is likely that production will decline in 2016. With the US Benchmark price of oil trading above US$50 per barrel at the start of February, the vast majority of current US tight oil production is secure. Strong US oil production is expected for now but the stellar growth experienced since 2008 is more uncertain. In January, the Brent crude price appears to have hit a floor of around US$50 per barrel and this price appeared to act as a key psychological support level during the month. With prices rebounding in early February on the news that 90 US oil rigs were idled, the largest number to be wound down in a single day since the mid-1980s, the market appears to be poised to rise on bullish news which suggests that the recent sell-off has found a bottom. Furthermore, with a number of oil majors having announced big cuts, perhaps the foundation for future price recovery have also been laid? A period of under investment today threatens the necessary development required to meet future demand. According to IHS, prices have to hit circa US$120 in the future to incentivise new development and replace conventional "cheap" production that the world is currently benefiting from.

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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