Bord Gáis Energy Index

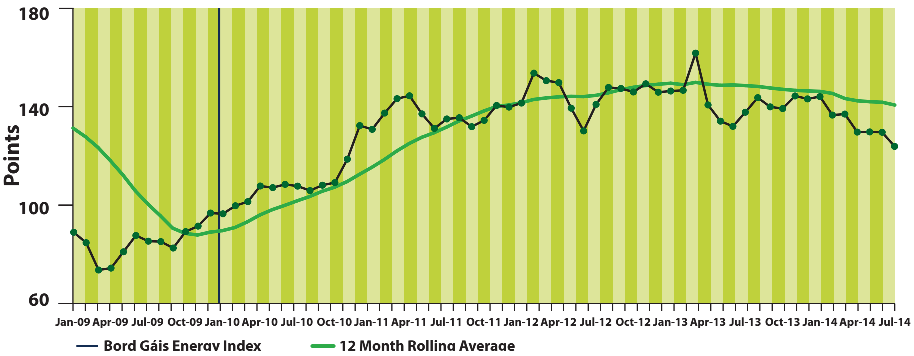
UNDERSTANDING ENERGY

July 2014

Bord Gáis Energy

International incidents, supply concerns, weakened demand and increased price volatility reflected in Bord Gáis Energy Index

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



1 Mth	-4%	3 Mth	-4%	12 Mth	-10%

Summary

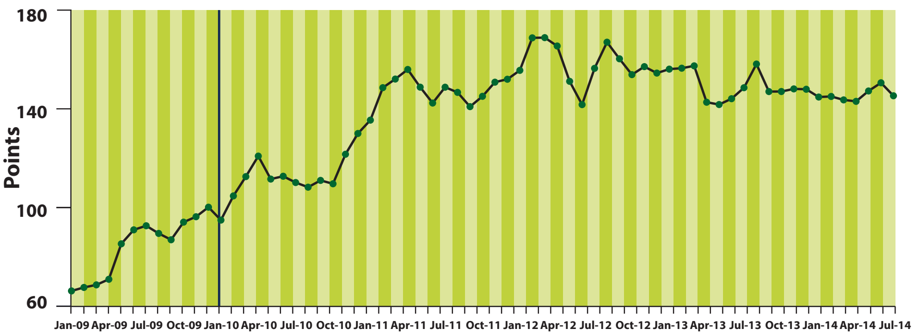
The Bord Gáis Energy Index fell 4% month-on-month in July with Brent crude oil, gas and wholesale electricity prices all weakening.

Despite the tragic downing of flight MH17 in eastern Ukraine and the announcement of the toughest sanctions against Russia since the end of the cold war, wholesale gas prices continued to weaken. Global oil supplies were strong in July, despite numerous geopolitical risks, and this weighed on Brent crude prices.

This month witnessed some interesting moves in the foreign exchange markets as the euro weakened against the Dollar and Pound. A low interest rate outlook for the euro zone contrasts with growing anticipation of rate hikes in the US and UK following positive economic numbers. Because of the euro's weakness over the month, falling wholesale prices were not fully captured in euro terms.

In July 2014 the Index stood at 127. Amid on-going military and political tension due to the crisis in Ukraine, the current "Gas War" between Ukraine and Russia rumbled on in July. On 16 June Russia suspended gas deliveries to Ukraine. Since then Russian gas flows into Ukraine have been destined for customers in Europe only. Invoking a clause in the existing 2009 gas purchase contract between both countries, Russia is insisting on a payment of close to US$2 billion before it resumes deliveries to Ukraine. Gazprom has officially filed a brief for arbitration in Stockholm against Naftogaz (the national oil and gas company of Ukraine). Naftogaz in turn filed a counter-claim seeking to have the 2009 contract annulled and to secure a "fair market price" for gas deliveries by Gazprom. Because the agreement links the price of gas to a basket of reference fuels (fuel oil and gasoil) and contains no reference to market traded gas prices, Naftogaz is of the opinion that the agreement allows for a re-examination as the contract price no longer reflects prices in the market. Since the contract was signed, major changes have taken place in the European gas market with the adoption of hub-based market pricing. By eroding the dominance of oil-based contracts, buyers of Russian gas under long-term contracts (particularly those in Northwest Europe) are achieving lower prices by blending hub-based pricing into the traditional oil-based contract to create more favourable hybrid contracts. Gazprom are seeking to maintain the current contract and originally insisted on a unit price of US$485 based on the price of oil. However, Gazprom have since offered a discount of US$100. Naftogaz are insisting on what it sees as a fair market price that reflects in some way spot-market prices and it is agreeable to a price of US$268.50 per unit. It has been reported that US$286.50 is lower than any price currently prevailing in the European market. Both sides have shown no sign of closing the gap but as winter approaches pressure will mount on both parties to find a way out.

Oil Index



*Index adjusted for currency movements.
Data Source: ICE

1 Mth	-4%	3 Mth	2%	12 Mth	-2%

Oil

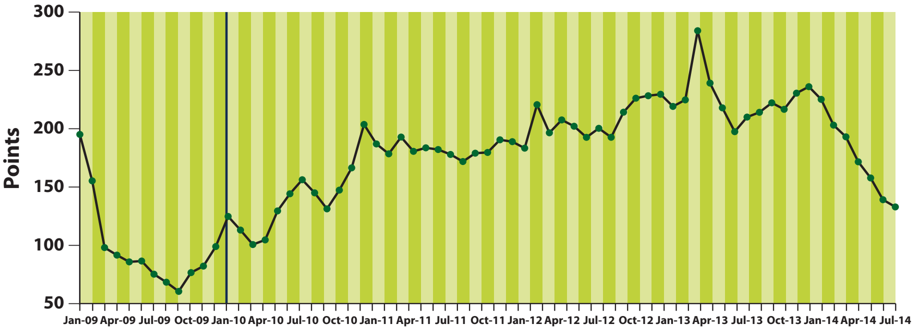
Month-on-month the front month Brent crude price fell 4% in euro terms as a lack of serious supply disruptions coupled with weak demand triggered a price fall.

In July there were tentative signs that Libya's oil production capabilities were improving and production reportedly hit 580,000 b/d having been reduced to an estimated 150,000 b/d following a wave of protests, strikes and blockades. Libyan production had been at 1.4million b/d and the potential of rising Libyan exports weighed on prices. This potential was positively reassessed following the reopening of the Es Sider and Ras Lanuf terminals which accounted for 500,000 b/d of oil exports prior to their closure. The positive momentum continued on news that the El Sharara oilfield had resumed operations after protesters ended a four month strike. Oil output recovered throughout the month despite further violence that shut down airports which effectively left Libya with no international flights. Toward the end of the month Tripoli and Benghazi were caught up in what was described as the fiercest fighting between rival armed groups since the fall of Gaddafi in 2011. Clearly Libya remains a fragile State and the recent oil production gains are vulnerable. In July Libya asked the UN Security Council for help protecting its oil installations, oil export ports and civil airports, warning that without more assistance Libya could become a failed State. Despite the State of the Islamic Caliphate (formerly ISIL) declaring a new Islamic State in the Iraqi lands it seized in June, Iraq's production and export numbers are expected to rise in July. Iraq's Oil Minister said exports this month will reach 2.6 million b/d with production running at 3.15million b/d. Despite on-going violence in various regions, including Ukraine, Iraq and Libya, oil production has yet to be disrupted and global supplies remain high. Due to this the market is currently positive on the overall global supply and demand balance.

The west and Iran agreed on 18 July to extend the deadline for a negotiated settlement of Tehran's disputed nuclear programme by four months to 24 November. Certain sanctions have been lifted but sanctions covering oil, banking and finance are to remain in place. In return for certain suspensions, Iran has agreed not to increase the number of centrifuges that enrich uranium. Iran has also agreed to convert more of its enriched uranium stockpiles at a faster rate into forms that make it more difficult to enrich uranium to levels needed for weapons. The extension confirms that the two sides do not want the talks to collapse but, after more than a decade of negotiations, a definitive and enduring resolution to the dispute remains elusive. The likely outcome of these negotiations will be a Western endorsement of an Iranian nuclear programme, coupled with inspections and the curbing of Iran's ability to develop nuclear weapons. Western sanctions are keeping about 1million b/d off the market. A collapse in the talks would have raised the risk of a military engagement with Iran at a time when there are on-going battles in Iraq, Gaza, Syria and Ukraine.

Positive news on Libya, high prices following the insurgency in Iraq in June, on-going negotiations with Iran and weak demand encouraged financial speculators to close nearly US$6 billion worth of bullish bets on US crude oil in July. The forecasted end of the Fed's asset purchasing programme this October may have also weighed on prices. A sign that the pattern of global oil supplies may be in the early stages of change came as the first light crude/minimally-processed cargo in a generation was exported from the US in July.

Natural Gas Index



*Index adjusted for currency movements.
Data Source: Spectron Group

1 Mth	-4%	3 Mth	-22%	12 Mth	-37%

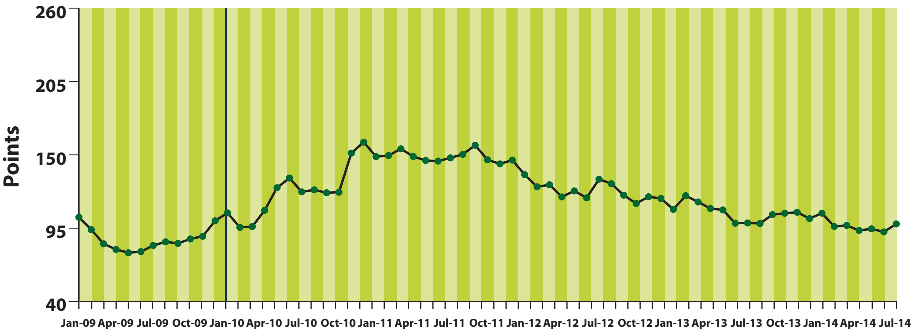
Natural Gas

In euro terms the average Day-ahead gas price for July was 4% lower month-on-month. At an out turned monthly average price of 37.48p a therm, the July price was the lowest monthly price in over four years. At one point the Day-ahead gas price hit 34.50p a therm which itself was the lowest closing Day-ahead gas price since 21 September 2010. On that day the price was 33.19p a therm.

In the first half of July the Day-ahead gas price continued its path lower and this has been a strong trend in 2014. Typically, bouts of cold weather in the first quarter lead to price events. However this winter was unseasonably mild and prices softened amid ample stocks and sufficient gas supplies to leave the market comfortably balanced. Actual gas demand this winter surprised the market which had geared itself up for a repeat of the events in the previous winter when there was an extended cold spell that completely eroded stocks and left the market struggling to meet demand. Since the start of 2014 these fears have been largely eroded and prices eased with every passing mild month. The crisis in Ukraine began to be reflected in prices in March following the annexation of the Crimea peninsula by Russia and, for short periods since then, prices have been nudged higher. The UK gas market always has the capacity to surprise given its reliance on imported gas and vulnerability to global events. With the downing of flight MH17 in Eastern Ukraine, the downward price trend was suddenly and dramatically reversed as the market feared that European gas supplies could be at risk if the EU responded aggressively to the attack. This uncertainty pushed prices up from the intra-month low of 34.50p a therm to 41.43p a therm. At the end of July the EU agreed to its toughest sanctions against Russia since the end of the cold war and these are intended to cripple the Russian economy and convince the Kremlin to abandon its support for separatists in Ukraine. However, the gas market's fears were abated and wholesale gas prices softened once again as the sanctions announced avoided measures that would weaken Russia's gas industry for fear of retaliation. Unfolding and surprising events in the Ukraine have greatly increased price volatility this summer. The market is likely to remain volatile in the short-term fearing that Russia may retaliate. These anxieties will be amplified given that the third Gas War is simmering unresolved in the background.

Bumper supplies this month helped to weigh on prices in periods when geopolitical issues were not making the headlines. The UK is currently experiencing brisk LNG imports due to high inventories of gas in Asia and low prices.

Coal Index



*Index adjusted for currency movements.
Data Source: ICE

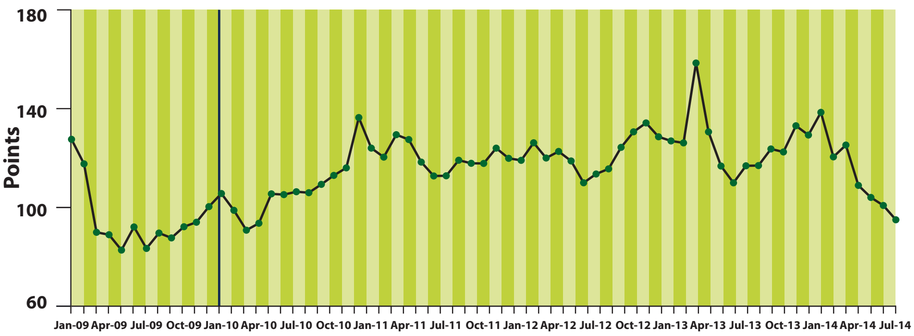
1 Mth	7%	3 Mth	5%	12 Mth	-1%

Coal

Unlike wholesale gas, oil and electricity, the European wholesale coal futures contract rose 7% month-on-month to close at US$76.30.

It has been reported that the European physical markets have been locked in a battle between a single buyer and single seller for months now. Up until the last week of July it was the seller who seemed to have the upper hand. This seller has successfully pushed the ICE Rotterdam Monthly Coal Futures physical price down to a close of US$72.25/mt on 24 June, which was a level not seen since March 2010. This month however the selling interest has waned somewhat and as a result the physical market started to rise. Following the downing of flight MH17 in Eastern Ukraine and the threat of fresh US and EU sanctions, the European coal market appears to have gotten nervous and uncomfortable at very low coal prices. This nervousness was also reflected in wholesale European gas market prices which also rallied at the time and seem to have awoken European fuel commodity markets from their collective summer slumber. However, unlike gas, coal prices did not give up as much of the price gains toward the end of the month.

Electricity Index



Data Source: SEMO

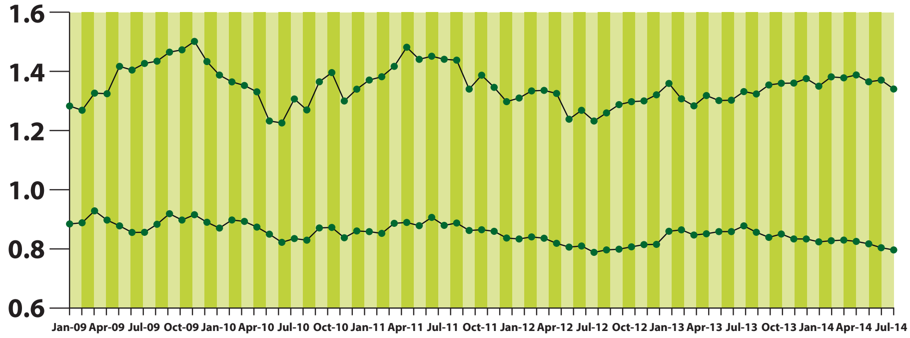
1 Mth	-6%	3 Mth	-13%	12 Mth	-19%

Electricity

In July the monthly average Irish wholesale electricity price fell a further 6% month-on-month. This has been the fourth month in a row where the average monthly electricity price has fallen and the weakness is associated with softer wholesale gas prices in the UK (as gas powered generation dominates the generation mix on the island of Ireland, the price of imported gas from the UK has a significant influence on Irish wholesale electricity prices). In July gas plants set the wholesale electricity price 63% of the time. Similar to the price pattern seen in gas, at close to a monthly average of €48/MWh, the average monthly electricity price hit a level not seen in over four years.

The average 'clean spark' in Ireland fell month-on-month by approximately €3/MWh to a monthly average of over €12.40/MWh (the 'clean spark' is the theoretical gross margin of a gas-fired power plant from selling a unit of electricity, having bought the fuel required to produce this unit of electricity and the cost of abating the carbon emitted). However, the average spark in June was relatively high as the system called on a plant to start for a short period of time and the associated start costs pushed the average spark for June upward.

FX Rates



1 Mth	-2%	3 Mth	-3%	12 Mth	1%	EURUSD
1 Mth	-1%	3 Mth	-4%	12 Mth	-9%	EURGBP

FX Rates

Month-on-month the euro dropped significantly against the US Dollar as signs of a strengthening US economy spurred traders to boost predictions for higher Federal Reserve interest rates. According to Bloomberg, at the end of July traders saw an 87% chance that the Federal Reserve would raise the target for its benchmark rate to at least 0.5% by September 2015. The figure was 78% at the start of the month. Rising inflation, which increased by 1.9% in Q2, has raised the odds of a rate hike in the US. In July it was reported that the US economy grew by 4% in Q2. Consumer spending, which makes up over two-thirds of US economic activity, also grew by a robust 2.5% in Q2. Despite strong growth in Q2 the recovery from the recession of 2008-09 has been the weakest of the post-war era and the economy's potential growth has fallen. The view is that the US' potential growth rate is being restricted by a labour force that has not grown and falling productivity despite the technological innovations that have been experienced over the last number of years. Higher productivity is the best justification for higher wages which fuels consumer spending and growth.

In contrast to what appears from the headlines as a positive economic story in the US, the euro zone is recording slowing inflation and is threatened by deflation. Maintaining low interest rates to support borrowing and spending is a key mechanism to tackle falling prices. In July the month-on-month inflation rate fell 0.1% to 0.4%, the lowest recording since 2009. The ECB considers an inflation rate of below 1% to be in a "danger zone" posing a threat of deflation. ECB efforts so far to tackle deflation have been limited to a cut in interest rates (including reducing the bank deposit rate to below zero) and making available cheap long term loans to banks.

Markets have also viewed positively the economic releases from the UK this month and the Pound strengthened against the euro to hit levels not seen for two years. Rising house prices, rising employment numbers (there are 929,000 more people at work than a year ago) and rising economic growth pointed to an economy that is leaving the recession behind. During that period UK GDP fell by more than 7% in just five quarters. Based on the latest growth figures, this decline has been recouped. Having fully recovered, the market will be monitoring every release and every line of the minutes from the Bank of England's Monetary Policy Committee to speculate on when the first rate hike will occur. However, the IMF did warn that the Pound could be overvalued and that it is preventing the rebalancing of the UK economy away from reliance on spending and imports.

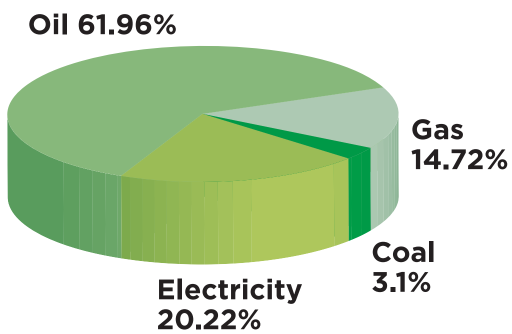
Market Outlook

The return of volatility to the wholesale gas market and the rise in prices from their yearly lows following the downing of Malaysian Airlines flight MH17 in mid-July may have signalled the end of a period of continuously falling prices. There are factors that suggest that prices will remain soft in the near term, such as healthy stocks, summer weather and gas supplies. However, the rapid escalation and decrease in wholesale prices seen this month suggests that the market felt a little exposed at the yearly lows recorded following 'the big fall' of 2014. As discussed, Ukraine and Russia appear to be locked in separate universes over their gas dispute which has not yet been reflected in prices. However, as we approach winter with the possibility of increased sanctions against Russia, anxieties may grow if the situation in Ukraine remains unresolved. Long range weather forecasts will also start to influence the market as it shifts out of summer mode and tries to gauge the correct price for future gas amid all the uncertainties. Europe is looking to untangle itself from Russian gas and Russian influence and in July the UK Government announced further steps to unlock a potential bonanza of shale gas sitting under the UK with a big expansion in fracking licences. However, there is no certainty that a significant UK fracking industry will emerge.

The last twelve months has seen a notable rise in tensions in many parts of the world. Thailand is back under military rule, China has become more aggressive with Japan and its other maritime neighbours, Russia invaded Ukraine and existing conflicts in Syria, Gaza and Iraq all intensified. Oil prices to date have not reacted as growing North American tight oil production and a steady flow of OPEC oil has sufficiently met global demand. Like supplies, oil prices have been extremely consistent and steady in 2014 despite significant tensions in the Middle East which have the potential to seriously disrupt supplies if left to fester.

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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