Energy Outlook

April 2022

Let's do more good together

utility aid

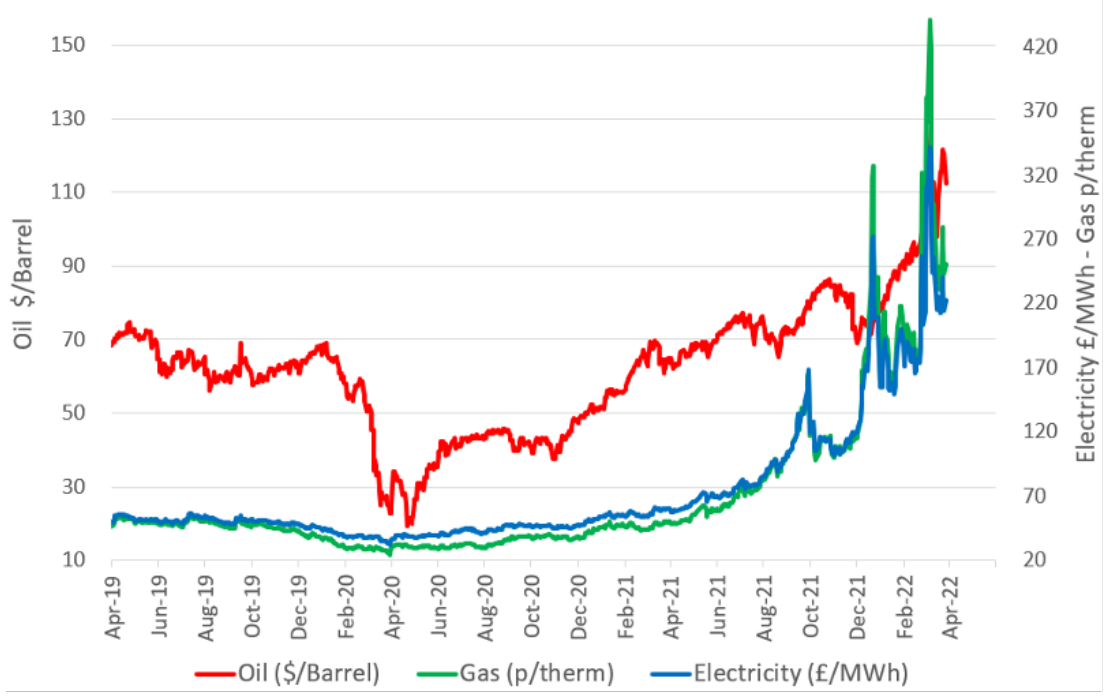
April 2022

The first quarter of the year is now behind us and tragically, the worst fears of market watchers have come true, with Russia launching a catastrophic invasion of Ukraine. Russia's actions have consequences that go far beyond the tragic loss of human life and devastation caused to the millions who are being displaced. Their actions have consequences that will negatively impact the lives of almost every person in the World and one of those consequences is the shock to the energy markets.

Gas and electricity prices have been out of control since the middle of last year and now oil has joined the party, threatening to rise to historical highs. As we write, negotiators from both sides of the conflict are behind locked doors attempting to negotiate an end to the conflict. It's too early to call this a turning point, but it's the most positive move we've seen in the last month. Will this hasten a downward trend in prices or is there more extreme volatility to come? The answer is we just don't know, no one does. And, whilst all this is going on, what is happening with non-energy costs, otherwise known as non-commodity costs? Are they affected or not?

Energy Price History

The chart below shows the extraordinary progress of energy prices in recent times, with year ahead gas prices in March topping 400p per Therm, some 10 times higher than they were trading just over a year ago! World markets across the board have been impacted by the situation in Ukraine; read on as we explore the impact for each of the main energy commodities.



Energy Outlook

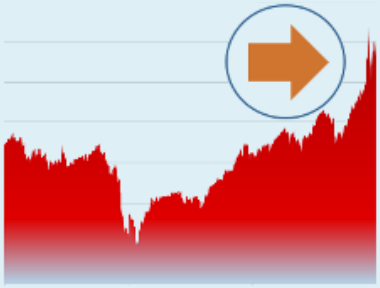
April 2022

Let's do more good together

utility aid

OIL

As you might expect, the Ukraine situation has been the biggest influence on oil prices in the first quarter, with market nerves driving the price up even before the full conflict broke out. Russia supplies 10% of the world's oil and around 30% of European demand. Although oil (as well as gas) is actually excluded from the sanctions imposed by the West, the US and the UK have unilaterally banned Russian imports and many businesses are shunning Russian crude in spite of not being forced to do so.



In spite of the high prices, the global market isn't under supplied – oil is still flowing at full pace into Asian markets, OPEC agreed at a meeting on 31st March to increase production by 430,000 barrels per day and President Biden has committed to increase this by 1m barrels by releasing reserves over the next six months. The Chinese lockdown of Shanghai to control the latest COVID outbreak has also switched sentiment and this coupled with inflationary pressures suggests a global economic recession might be looming at some point in the near future, which in turn could soften prices over time.

GAS

Gas has been the most directly – and dramatically – affected energy commodity. The markets are nervous because of the possibility that supply might be halted by either new sanctions, physical pipeline disruption or a decision by Russia to simply shut down the pipelines. As a whole, Europe is reliant on Russia for around 40% of its annual gas needs, so the impact of such a withdrawal would be significant.

In reality, gas flows from Russia have actually increased since the winter (and supplies were never halted during the entirety of the cold war) but worries remain because the behaviour of Russia has become so unpredictable. For example, from 1st April Putin has put in place a new presidential decree that all gas supplies must be paid for in roubles by 'unfriendly' countries. It's not clear how this will work in practice, although most analysts agree that this is political posturing, but not likely to actually halt supplies. Nevertheless, we should still consider any and all possible outcomes. Several European countries including Germany and Italy have now announced measures to ration gas and power at a national level ahead of next winter to reduce the exposure to these supply risks. Whilst it will take time for this to have a significant effect, it is a move in the right direction to reduce dependence.

The European Commission has also called upon EU countries to increase levels of storage to 80% by November 2022, and 90% by November 2023. This will place a huge demand in the short term on LNG availability as stock levels have been low, hovering around the 25% level. On this basis, it would not be unreasonable to see gas prices remain at today's levels for the foreseeable future, at least all the way through 2022 and into 2023. Forward prices we are seeing suggest this to be the case too.

ELECTRICITY

Although the UK only gets around 4% of physical gas supply from Russia, the market is linked with Europe, so supply shocks and high prices on the continent have the same effect on prices here. Gas-fired generation is the biggest source of electricity and therefore sets prices for the market as a whole. This is the reason that electricity prices have followed gas prices to record highs.

The surge in prices has now impacted almost every single business and household in the UK, fuelling a cost of living increase not seen for decades, and one which might inevitably lead to a downturn in demand as we progress through this year and next. We simply cannot forecast where electricity prices will be in 12 month's time, but as with gas if we look at today's forward curve prices for next year and the year after, they are still trading at three times last year's levels. We simply can't see where any respite might come from, in the short or near term but hope some does, eventually.

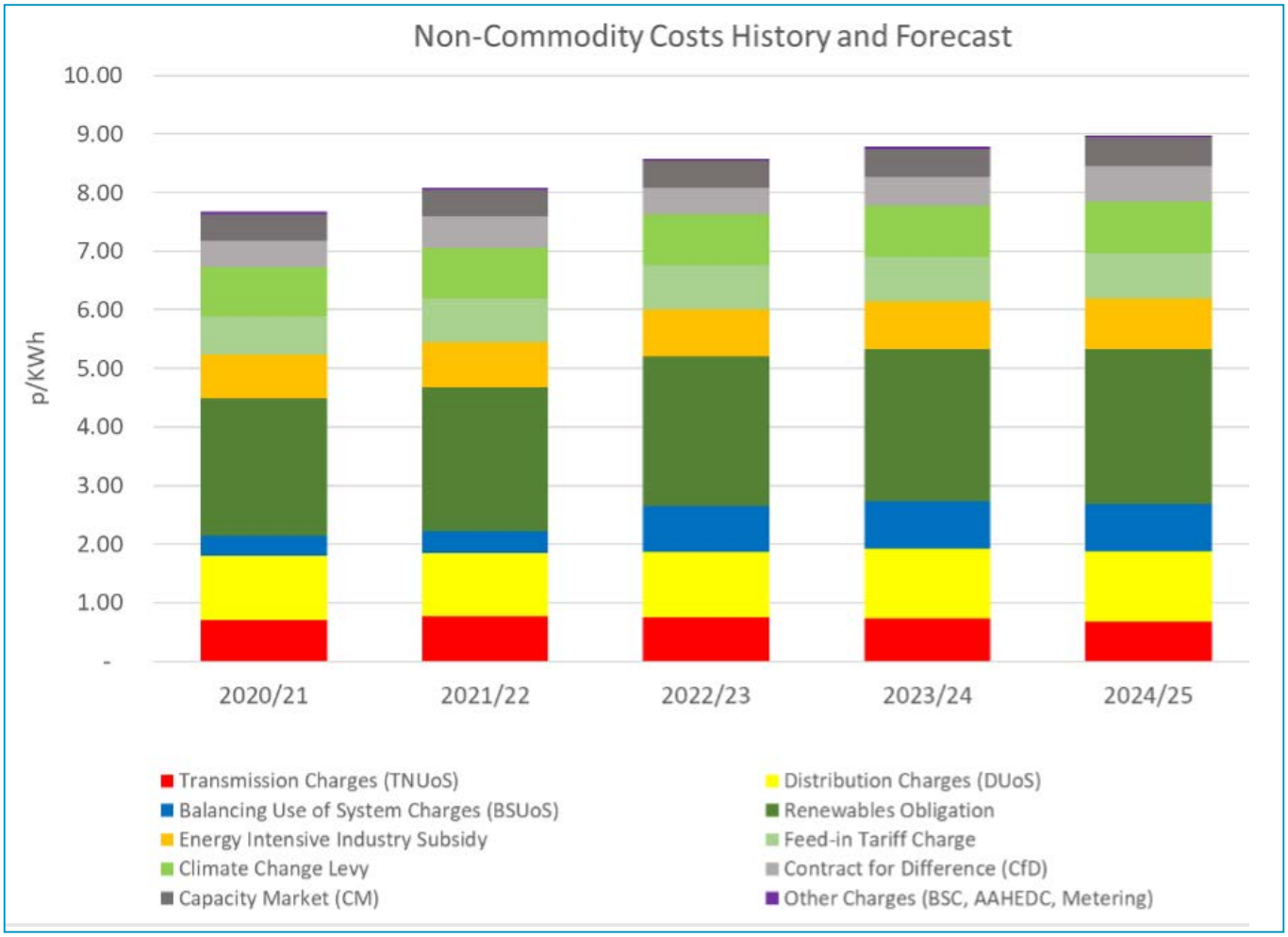
Let's do more good together

utility aid

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.

The chart below shows the recent history and our forecast of these charges over the next few years, based upon an average UK portfolio of sites. These costs now represent a large portion of everyone's electricity bill and are set to continue to rise:



Energy Outlook

April 2022

Let's do more good together

utility aid

THINGS TO THINK ABOUT

Many customers will have been sitting out of contract for some time. They will understandably have been holding off renewing a contract, hoping that prices will drop. To date, they haven't and now the incredibly high "Out of Contract" rates recently published by suppliers for April onwards will probably force them into having to make a decision as to how long a contract they should sign.

Our Opinion - From our standpoint today, one year contracts look very expensive. We are seeing some priced 50% higher than a two year one on a comparative monthly cost basis. Nevertheless, some customers still choose to enter such a duration in the belief prices will have dropped by next year. Market drivers suggest to us, that the drop in prices needed in next year's contract to compensate for entering this expensive short term one will not materialise. Of course, we don't know for sure as we haven't got a crystal ball, but the firming up of forward curves in recent weeks rather supports our supposition.

Many customers are choosing to "smear" some of this year's "pain" across a two or three year contract, with some even opting for longer durations. In doing this, customers protect their energy usage costs and therefore achieve more budget certainty and barring changes to government tariffs, have known energy usage costs for the duration. (non-energy costs are not fixed and therefore cannot be relied upon staying static throughout a contract)

Whatever contract duration you decide upon, as we always say, it should be based on your organisation's appetite for risk. If you have no appetite for risk, then you might want to consider longer durations. If on the contrary, your organisation has lots of appetite for risk, then shorter durations might be for you. Whatever duration you decide upon, please at least do something, and get into a contract. Out of contract rates are absolutely horrific.

Finally, we don't think there are going to be any winners in the next two or three years and we are not sure prices will ever return to levels seen early last year. All of us are going to have to accept the financial pain of energy costs for the foreseeable future, or at least until a recession hits us and we have a glut of supply. Neither option is necessarily better than the other.

MIXED NEWS FOR NON-COMMODITY COSTS

It would be easy to lose sight of what is happening with non-commodity costs whilst the crisis in the wholesale market continues unabated. In reality there is a lot going on which is worth taking note of.

The runaway commodity prices will have a positive impact on 'Contracts for Differences' (CfD) charges in bills. The CfD is a mechanism to support large scale renewable generation which normally tops up the wholesale price the generator makes up to an agreed fixed price. When market prices rise above this price, the subsidy reverses and the generators pay the difference back, reducing the charge for end customers.

The benefit of this will be offset to some extent by the increase in system balancing costs (BSUoS) which have been severely impacted by the volatile wholesale market. The charges for this are set to double over the next few years as National Grid seeks to recover these costs.

Finally, Capacity Mechanism (CM) charges will rise after a late decision to increase the volume to be auctioned in February from 4.7GW to 5.4GW, creating a record cost increase to consumers of £375m for the year.

If you are worried about your existing contract or position and want more information, please get in touch with your Utility Aid Account Manager or call us on 0808 1788 170