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WHY IS OIL PRICE RISING AND WHAT'S THE WAY FORWARD?

Relevant for: Indian Economy | Topic: Infrastructure: Energy incl. Renewable & Non-renewable

There is a hike in prices due to an increase in demand and supply shortages

Over the past month, natural gas and crude oil prices have shot through the roof, rallying about 14% each. In fact, since the beginning of the year, oil is up 63.5%, reaching a 7-year high on the back of buoyant demand and limited supply. Natural gas prices have risen even more strongly—more than tripled in Europe and almost tripled in the UK. This has widespread implications for global growth, inflation and the real economy.

We are clearly seeing an upswing in demand due to reopening of economies, i.e. more travel, manufacturing etc., as well as the release of pent-up demand from last year. More importantly, this is coinciding with supply side shortages.

Last year, when we had lockdowns, natural gas, coal and oil storages could not get replenished to the usual extent, due to movement restrictions. As such, during winter, storages were drawn down as these natural resources were used to heat homes. At the same time, while truck drivers were considered essential employees and allowed to work, the training schools for these truck drivers were shut down. As a result, today we have an acute shortage of trained truck drivers who can transport these natural resources in large container trucks, which in turn, is leading to storages not getting replenished as quickly this year too. Going into the 2021 winter season, storages across Europe, particularly the UK, and parts of Asia are running at below average levels.

At the same time, the drought in South America has led to greater demand for traditional resources like coal and gas to generate electricity, which means that South America, Europe and Asia are basically competing for the same LNG trucks that are already in short supply. As a result, we are seeing widespread supply chain linkages breaking down, in some instances, trucks waiting 24-48 hours just to get the coal or LNG shipment to carry it forward. Various countries in Asia, like China (largest exporter of coal) and India have warned of late about dwindling reserves. This supply-demand imbalance alongside increased demand expectation given the impending winter has led to a surge in prices.

We can distil down the future of oil and gas prices to essentially three factors: 1. Severity of the winter season—current storage levels and ~70-75% utilization ratios would likely be adequate for an average winter, but a hard European winter would keep prices elevated. 2. Fresh supply from Opec+ or the US—seems low probability right now given in its recent meeting, Opec+ only agreed to increase production moderately. Similarly, while the US has not increased production, it has been pressuring Opec+ to ramp up production to control rising oil prices. 3. Fresh supply from Russia—while Gazprom could supply to Europe that can provide relief, their Nord Stream 2 pipeline's approval has been pending for quite some time and Russia is trying to use this crisis to get that approval over the line.

The surge in oil and gas prices has both direct and indirect effects. Oil prices have a more direct impact on inflation, as they constitute 9.5% in the harmonized index of consumer prices (HICP), with petrol, diesel and heating oil making up 4.1% of the aggregate HICP; followed by electricity (2.9%) and natural gas (1.9%). Apart from that, as prices rise, it erodes purchasing power of people leading to consumers spending less on discretionary purchases. Similarly, it erodes margins of companies that are then not able to offer higher wages to workers, in turn reducing workers' purchasing power. As such, these changes are stagflationary on the margin, even though a less likely scenario in our opinion. This is certainly not a localized dynamic but global, and has widespread implications—so important to keep a watch!

India's economy is heavily dependent on oil and coal. The coal crisis seems to be under some control on account of regulation of coal supplies to non-power sectors and allowing the participation of captive miners by Coal India Ltd. Since India imports 85% of its fuel requirements, the implications on the economy can be significant. Diesel is touching 97 at fuel stations, the cost of which directly impact the cost of household items.

Given that we are entering the festive season, the high cost of daily consumption products can make people cut corners when shopping. This will likely impact consumer segment sales. Consumers might also be hit by high electricity bills, especially the ones living in apartments that have power backups running on diesel. It's not just the urban population, but high fuel prices will also increase the irrigation and transportation cost for farmers. Clearly, these developments are inflationary. While we don't expect them to stifle the recovery, it is important to watch if these end up being more sticky than transient in nature.

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