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GLOBAL ENERGY CRISIS ...HOW THIS IMPACTS SA

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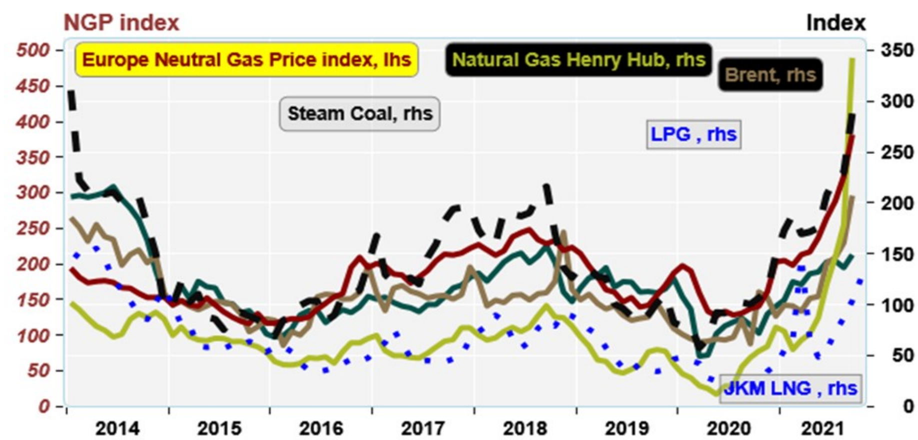
IN THIS ISSUE

All-time high international coal and gas prices have spilled over to the oil market as well (and its related refined products), rendering the current scenario a global energy crisis, impacting every economy in the globe. This article will focus on the reasons behind all-time high energy prices, how long it is expected to last and how this will impact the South African economy. The main reasons for the current high energy prices prevalent globally, could be found in the classic content of Economics101.

ENERGY PRICES ROCKET HIGHER
Primary energy prices by source



BrenthurstWealth / economistscoza base sources EIA/EEX/HWW1 indices converted to USD

During Q1 2020 amid the worst economic lockdowns ever experienced, energy demand tumbled to unprecedented low levels globally, given that demand for air travel dried up, industrial demand came to a near standstill and leisure travel was limited. According to the International Monetary Fund (IMF), global GDP contracted by 3.1% in 2020. Prices subsequently tumbled in all energy markets to reflect the lower demand. Brent oil price averaged $23.3/bbl in April 2020.

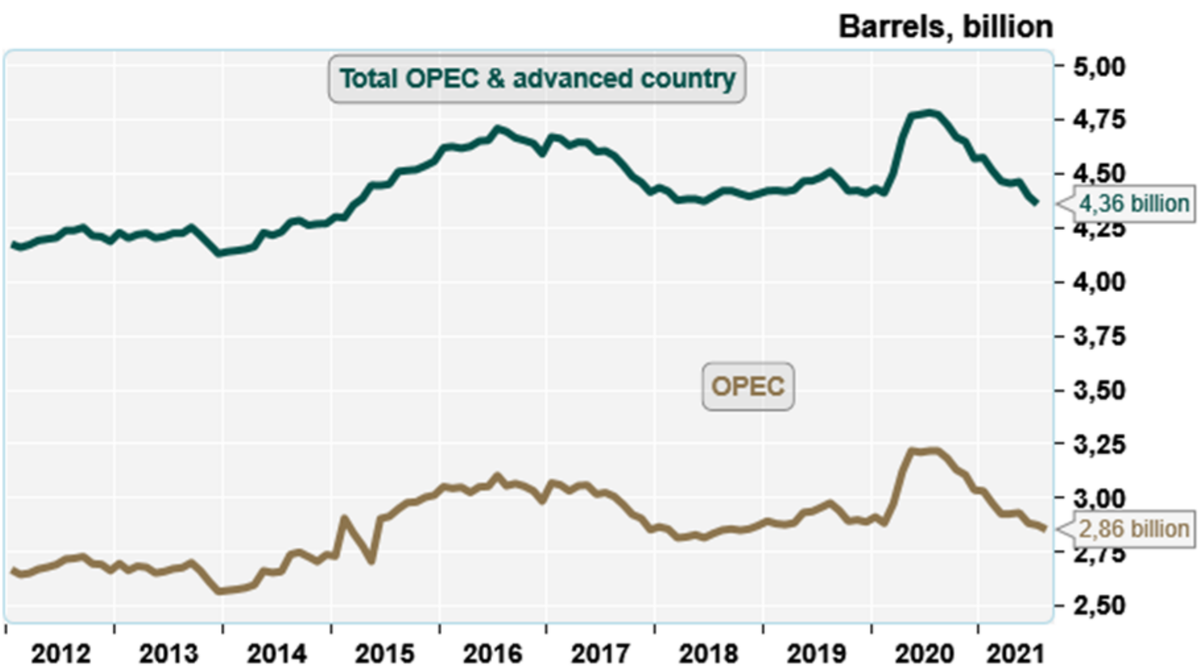
In early 2021, as the vaccines became viable and available, especially in the developed world, economies started bouncing back strongly. With restrictions being lifted, economic recoveries gained momentum and so did the demand for energy.

ENERGY SUPPLY GROWTH HAS NOT KEPT UP WITH HIGHER DEMAND GROWTH…

The low demand and low price environment that prevailed during the worst of the Covid-19 pandemic (large part of 2020), resulted in global energy companies effecting large cutbacks on capex projects, while taking some production facilities offline. When prices started to increase in response to higher demand, supply growth was lagging and has been a contributing factor in the extent of energy price increases. OPEC also intervened by aggressively cutting oil supplies amid low demand and low prices, but have opted to only gradually return the barrels to the market, thus adding to tight oil balances and pricing pressures. This can be seen in the decline of crude and petrol stock levels in the rich countries and OPEC, which are at six-year lows.

Graph 2: Crude and petroleum stock levels decline to six-year lows

Monthly stock levels for oil and petroleum products



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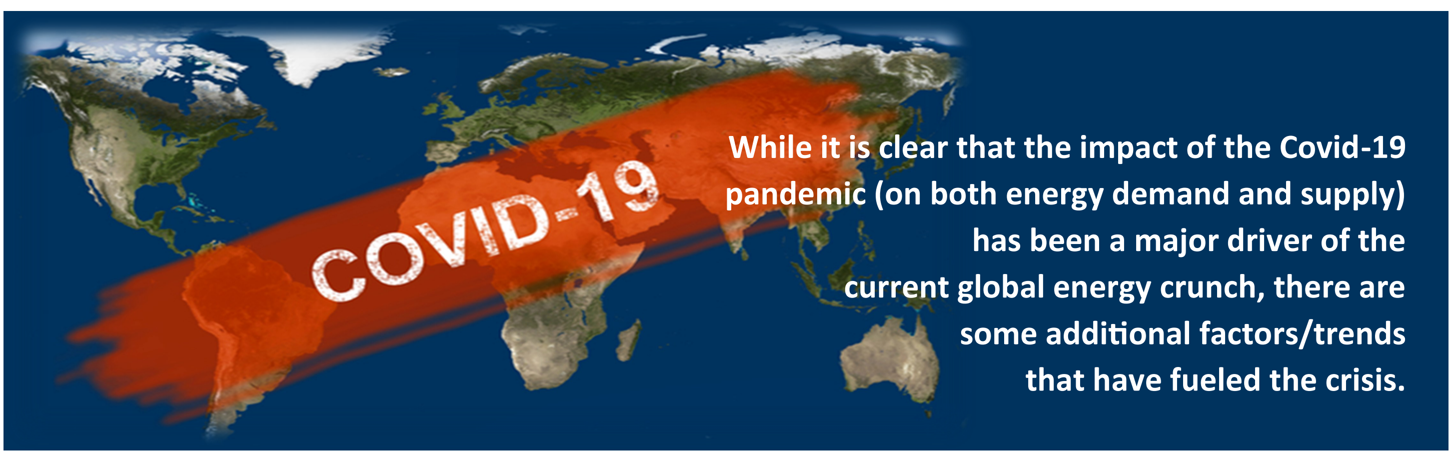


WEATHER PATTERNS

An unusually cold winter in 2019/20 in the Northern Hemisphere resulted in natural gas inventory levels being depleted, especially in the European market. Higher-than-normal gas prices during the summer months subsequently acted as a barrier the replenishment of gas reserves, thus entering the winter season 2021/22 with inventory levels notably below the 5y-average which has placed immediate upward pressure on global gas prices. Near-term gas prices are very dependent on how the weather plays out in the next 4-5 months.

If this winter is mild, record high prices could subside, but if the winter turns out to be exceptionally cold, prices could spike even higher. In Brazil, low rainfall has drastically curtailed hydroelectricity production, resulting in a much greater need for LNG imports to balance its needs. This has resulted in increased competition for the available LNG cargoes, thus pushing prices higher.

CLEAN POWER TRANSITION

While there is global consensus that economies should move away from fossil fuels as the dominant feedstock, given its adverse impact on the environment, the reality is that the migration to cleaner fuels and renewable generation is too slow and the world will remain dependent on fossil fuels for some years to come. However, policies adopted by many financial institutions in the recent past, for example not to finance coal projects, have led to underinvestment and reduced available supplies, resulting in notable spikes in prices. The high price of thermal coal will probably, in itself, be a driving factor towards the migration from coal to green energies, but some pain will be inflicted in the interim phase.

In the UK, renewables supply more than a third of electricity generation, which could be applauded, but the system is now more fragile and easier to shock. There is no easy way to store the energy generated from renewable sources, thus low stock levels could trigger extreme volatility.

Storage costs are often not included when promoting clean energy neither are the losses from oversupply that currently cannot be stored.

A HIGH TECH WORLD NEEDS MORE ELECTRICITY TO POWER IT

Electricity demand is forecast to increase strongly towards 2050, not only due to economic growth and population growth, but also due to the trend of digitisation. As the trend of digitisation gains momentum in the world, it simply means that people need reliable power more than ever. Thus, the heightened vulnerability of the energy system comes at a time when the world could least afford it. The trend towards replacing gasoline-powered vehicles with electrical vehicles is also gaining popularity and will further increase the demand for electricity.

The bigger picture thus suggests that this will not be the last energy crisis that the world will experience as the underlying themes that have contributed to the extent of the crunch are likely to remain present for some years to come.

NOW THE QUESTION BEGS, HOW WILL THIS FALL OUT IMPACT ON THE SOUTH AFRICAN ECONOMY?

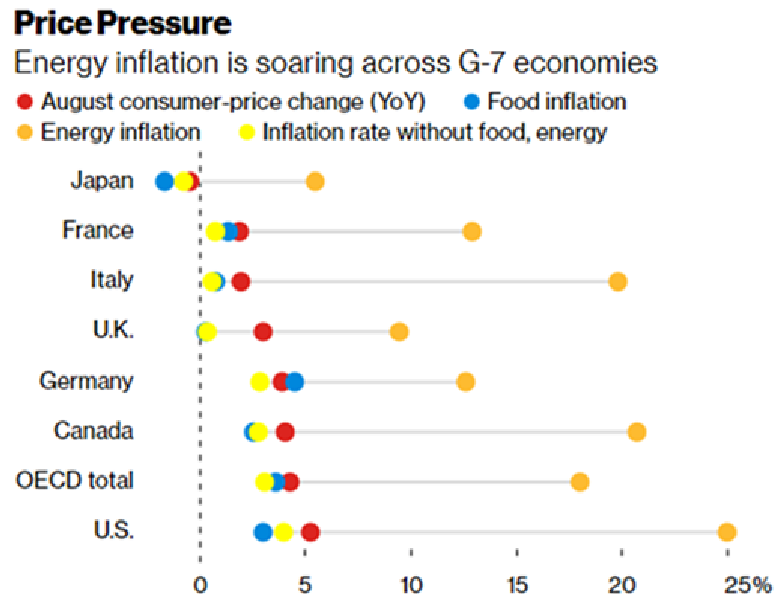
ENERGY DRIVEN INFLATION AND MONETARY POLICY IMPACT

With the extent of the increase in energy prices, not only the oil price (thus fuel prices), but also gas and coal prices, there will definitely be upward pressure on producer and consumer inflation rates.

This is already evident in developed economies (see graph below) and also in South Africa. In South Africa, the latest headline CPI print was 5% y/y for September 2021, while fuel inflation in the same month was recorded at 19.9% y/y.

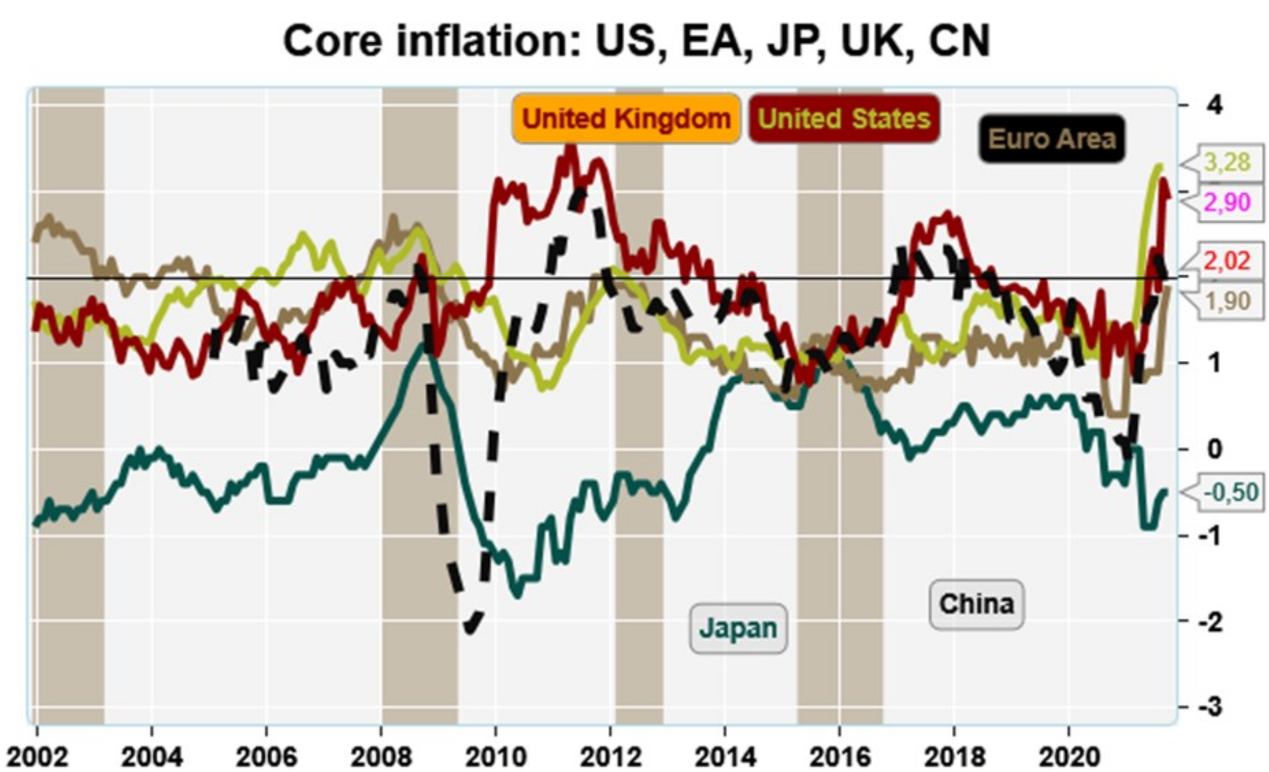
With fuel prices forecast to increase to all-time highs in November 2021, driven by the spike in international oil prices, fuel inflation is forecast to spike to around 33% y/y.

Picture 1. Energy prices drive inflation



Source: Organization for Economic Cooperation and Development

Graph 2: Crude and petroleum stock levels decline to six-year lows



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As much as this could be described as a first-round effect on inflation (fuel price or gas price increases direct effect on inflation), the extent of the fuel price increase in November (±R2.1/l for petrol and ±R1.48/l for diesel) is unlikely to be fully absorbed by industry or retailers for which fuel is a notable input cost. Upping prices of a wide range of products to recoup such input cost increases will result in broader upward pressure on prices, which could put the South African Reserve Bank's Monetary Policy Committee on high alert and potentially result in an earlier interest rate hike, than would otherwise have been the case.

The SARB's MPC meets again mid-November and at least one or two MPC members are likely to vote in favour of an interest rate hike, signalling that the inflation trajectory and potential negative impact on inflation expectations need to be addressed, while simultaneously starting a process of monetary policy normalisation, following aggressive interest rate cuts in response to the impact of the Covid-19 pandemic on the economy. Time will tell, but the next move in interest rates will be upwards and the spike in fuel prices could just be a trigger.

PRESSURE ON PERSONAL DISPOSABLE INCOME; PRESSURE ON INDUSTRIAL ACTIVITY

With a growing chunk of available disposable income being absorbed by higher fuel costs, less funds will be available for discretionary expenditure by households, thus having a dampening impact on local GDP growth. Similarly, spiking energy costs will dampen companies' profitability and/or result in higher product prices, that will along the line have a negative impact on the whole industry chain and also ending up in higher end-product prices. Many industries in South Africa, in particular the manufacturing sector, have been under pressure pre- and post-Covid (due to low local and global demand, supply chain disruptions and load shedding) and this is just another headwind that could make the recovery even more difficult, and could even result in closure of businesses or retrenching of workers.

UPWARD PRESSURE ON THE COST OF ELECTRICITY GENERATION

With the bulk of Eskom's generation capacity being coal driven, the recent spike in coal prices could have a negative impact. However, some long-term coal contracts are in place and the business will, to some extent, from the very high spot prices of coal. However, NERSA's current Regulatory Clearing Account regime that allows Eskom to recoup prudently incurred costs in following financial years' tariffs, if its estimates were way off the mark, could mean that some of this upward pressure could end up in higher electricity costs.

Also of interest, and having received a lot of media attention in recent months, is the Karpowerships project to which the bulk of government's Risk Mitigation Independent Power Procurement Programme (RMIPPP) was awarded. The RMIPPP was launched in July 2020 with the intention of supplying 2,000MW by no later than June 2022 to urgently assist in bridging SA's growing energy supply gap. However, the programme has been delayed and although the financial close was to be reached by no later than September 2021, an extension has already been granted until January 2022.

This, no doubt, offers relief to Karpowership, which won the lion's share of the 2,0000MW tender with its gas-to-power offering, but has so far failed to obtain environmental authorisations to anchor its ships at three of SA's ports. Of concern is that 60% of the Karpowerships price bid is linked to the rand/dollar rate of exchange, as well as the price of liquefied natural gas (LNG), quoted in dollars. The JKM LNG price has increased to all-time highs in recent weeks (S&P Global Platts forecast the average JKM LNG price for 2021 at $15.4/mmbtu (the oil price equivalent of $89.3/bbl) compared to $3.8/mmbtu in 2020, a five-fold increase!), and if these prices prevail for longer and this project does indeed go ahead, South African electricity consumers will pay a huge premium for the electricity generated from this LNG project.

ARE THERE ANY WINNERS IN THIS GLOBAL ENERGY CRISIS?

With energy users (both households and industrial customers) being the biggest losers, the winners can only be the energy companies supplying coal, oil and gas and those who participate in the renewable energy space in South Africa. In the South African context, for example, Sasol would be such a beneficiary. And hopefully government's coffers could be blessed with some windfall tax receipts from super profits made by large energy companies.

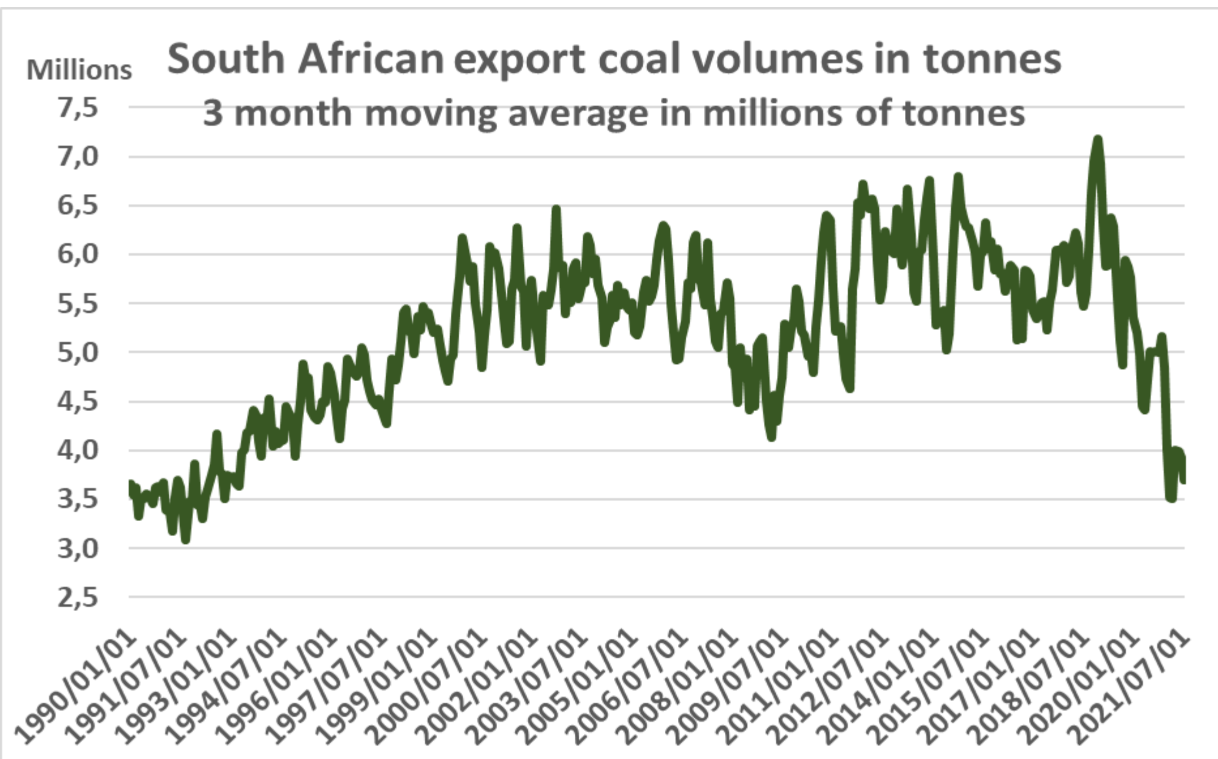
The one sad fact here is that South Africa should have had a boom in the coal industry, but the volume of exports is declining due to rail freight problems such as cable theft. Up until the 22nd of October Transnet lost 130 km of cable in just four weeks. Over 300 other thefts of rail infrastructure took place over the same 4 weeks. Trains are no longer electric trains, but diesel trains.

Diesel trains run at around 60 km an hour while electric sets can do 80 km an hour. A diesel train's running costs are higher and so too are the maintenance costs. Productivity declines by about one third on diesel train sets. Stealing rail tracks closes the line and signal theft also means even slower steeds and more stops. Transnet freight rail will have to work hard to get to 50% of normal potential.

Coal exports are down by about 45% from highs, but we believe about 60% below potential at present. There should be some improvement due to better planning and combating the theft, but it is unlikely that SA can export over 5 million tons, a month again, thereby missing out on at least 30 million tons over the course of a year. That is a massive earnings loss of around R60 billion a year at current record prices.

Ironically, one of the winners will again be the fossil fuel industry, as the focus on renewables creates unintended consequences and might lead governments back to the drawing board.

Graph 4: SA coal exports well below potential



MIKE SCHÜSSLER | BRENTHURST WEALTH CONSULTING ECONOMIST

Our consulting economist, Mike Schüssler, provides expert economic insight and analysis to the company's clients and advisory team.

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