Oil and Gas update Spring 2022

Sector overview

2021 saw oil price rises combined with supply challenges due to increased demand following the easing of COVID 19 restrictions. 2022 has, so far, continued in a turbulent and challenging manner with the Russia/Ukraine conflict highlighting Western Europe's reliance on Russian oil and gas. International sanctions and a desire to reduce Russian dependence have been key drivers behind significant price increases. The US has already implemented a ban on Russian oil imports, with the UK planning on phasing out all imports by the end of 2022. Germany, a country that purchased a quarter of its oil and 40% of its gas from Russia, have announced plans to halve Russian oil consumption by the summer, and reduce to zero by the end of the year; gas is then set to follow.

The gas market also remains a challenge in 2022 with record prices reached following a rebounding demand for commodities.

In addition to formal government policies and sanctions, companies are facing moral pressures to reduce their involvement with Russia. After posting record profits in 2021, the likes of BP and Shell, have announced they will divest their Russian holdings and cease partnerships.

Economic data

- **Oil prices reached a 14 year high during March 2022 ($139 pb for Brent crude):** Although prices have fallen (as at 11 April 2022 prices dropped back below $100 pb) following releases of strategic reserves by both the International Energy Agency (IEA) and the US, and decreased demand from China, prices continue to fluctuate and remain high (currently hovering around $107 pb). We anticipate supply could tighten again, potentially pushing prices higher as China reopens.
- **Opec+ produced 1.45m barrels per day** below its production target in March and recently voted not to increase production targets.
- **Transport and Storage** has seen faster growth of business premises than any other major UK industry, with the number of business premises classified as transport and storage, 88% higher than in 2011 and 21% higher than in 2019.
- **Fuel had the biggest impact on inflation in March 2022**, with average petrol prices rising by 12.6p per litre between February and March, the largest month rise since records began in 1990 (ONS).
- **There was a 54% rise in the energy price cap 01/04/2022:** this means that a household using a typical amount of gas and electricity will now pay £1,971 per year. Further increases to the price cap are expected in October 2022. Businesses are not protected by the cap and can see unlimited price rises, particularly those engaged in energy intensive industries.

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Strengths

- **Increased demand for warehousing and distribution network** due to an increase in online shopping and general storage needs.
- **Reduction of reliance on Russian Oil** will see opportunities to accelerate alternative energy sources (nuclear) and increase investment in the North Sea.
- **Large haulage firms** usually have several price escalators written into contracts, which help ensure rising costs are passed on to their customers.

Challenges

- **Rising energy prices, fuel costs and driver wages** are particularly hitting logistics firms margins. Those without pre-negotiated price escalators will struggle to maintain already very thin margins.
- **Low driver availability and subsequent wage increases** not only put pressure on the sector from a cost perspective but they impact a company's ability to fulfil contracts/scheduled deliveries – this is expected to worsen coming into the summer.
- **Brexit** and the associated administration, costs and delays continue to have an impact on the sector, with increased delivery times, more checks and inspections and additional licence requirements.
- **Passenger numbers on bus and train networks remain below pre pandemic levels** – the government has extended subsidies for a further 6 months, but challenges remain in the future. At the end of February 2022 FirstGroup plc said that bus volumes had improved to more than 70% of pre-pandemic levels overall.
- **Increased debt from COVID 19 loans** (£75bn) may put pressure on cashflow and liquidity as repayments commence and impact the ability to borrow further funds if required.
- **Change in the eligibility for use of red diesel 01/04/2022.** Previously red diesel (which attracts only 10.18ppl duty as opposed to 52.95ppl) could be used in vehicles and machinery which are not road vehicles. Eligibility has been significantly restricted requiring a switch to white diesel with duty charged at the standard rate. This is anticipated to hit several sectors such as construction, farming and haulage with some of the smaller players simply not able to absorb the cost increase.
- **Extended shut down periods across manufacturing.** It is possible that we will see plants idled to manage energy costs if heightened prices continue longer term.

Notable insolvencies

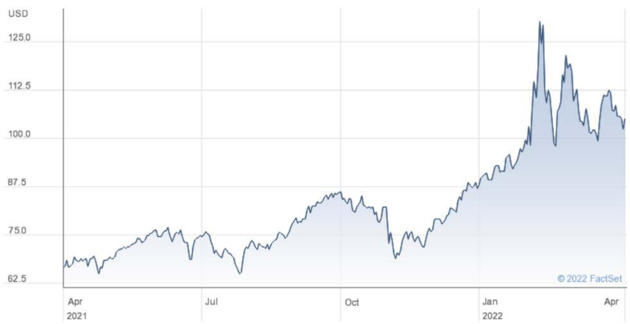
UK government initiatives that were put in place during the pandemic have helped to reduce the number of insolvencies within this market. Now the UK government have removed support measures and UK courts are fully functional again, we expect rising cost pressures on businesses within this sector to feed through into increased insolvencies this year.

There have been numerous small energy company failures noted recently with a lack of energy price hedging noted against increasing prices. The most notable of which is Bulb Energy, which entered special administration in November 2021 – they had 1.7m customers and it is expected to cost the taxpayer ca £3bn.

Underwriting approach

- Large logistics firms appear to be managing the challenging environment well, especially those that are benefiting from an increase in warehousing demand.
- We see particular challenges for SME businesses operating in the logistics sector. Margins remain slim and an inability to pass on cost increases, in what is a competitive market, will result in further margin erosion.
- Up to date financial information remains key. We are also actively arranging calls/meetings with key companies to better understand the intricacies of their operational performance, the sector challenges, and subsequent mitigants that are in place. Detailed understanding of cashflow and financial flexibility are also important components in our analysis.

Brent Crude Oil Price Chart



SOURCE - https://www.hl.co.uk/shares/trading-commodities/brent-crude-oil

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