

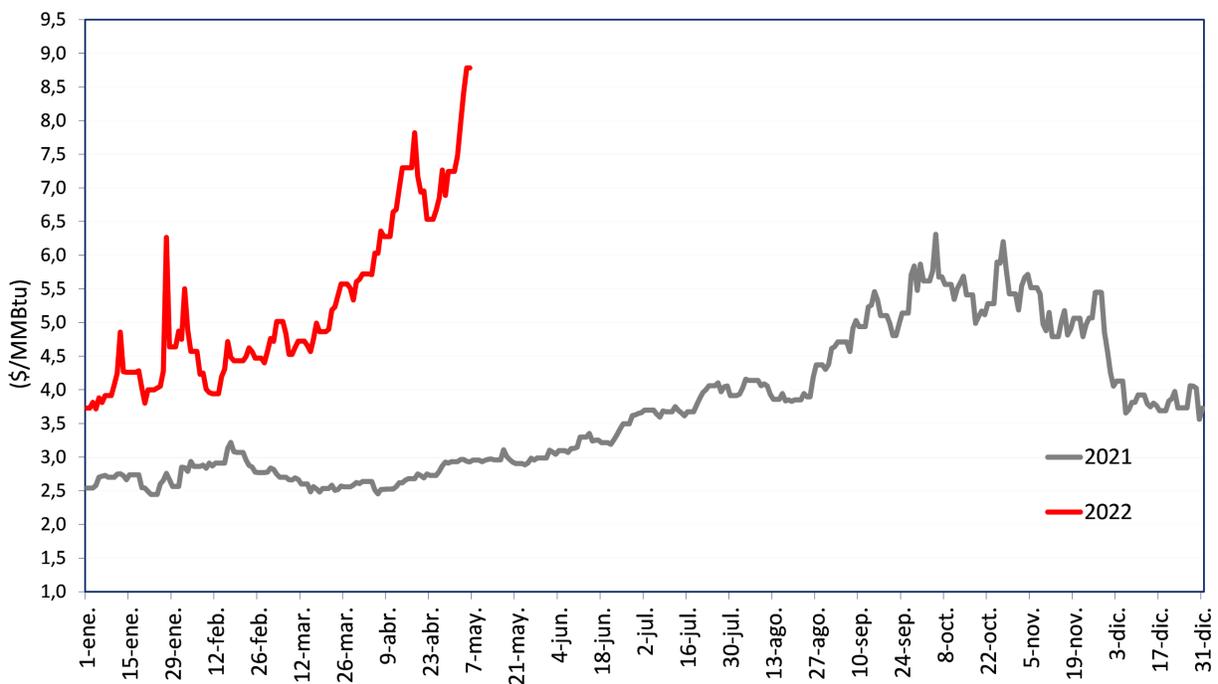
HENRY HUB SKYROCKETING: MARKET IMPLICATIONS

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Since May 2nd, the future price of Henry Hub (HH) has increased by more than 14%, reaching levels around \$8.8/MMBtu and marking highs not seen in the shoulder season since 2008.

Graph 1. HH price evolution vs 2021

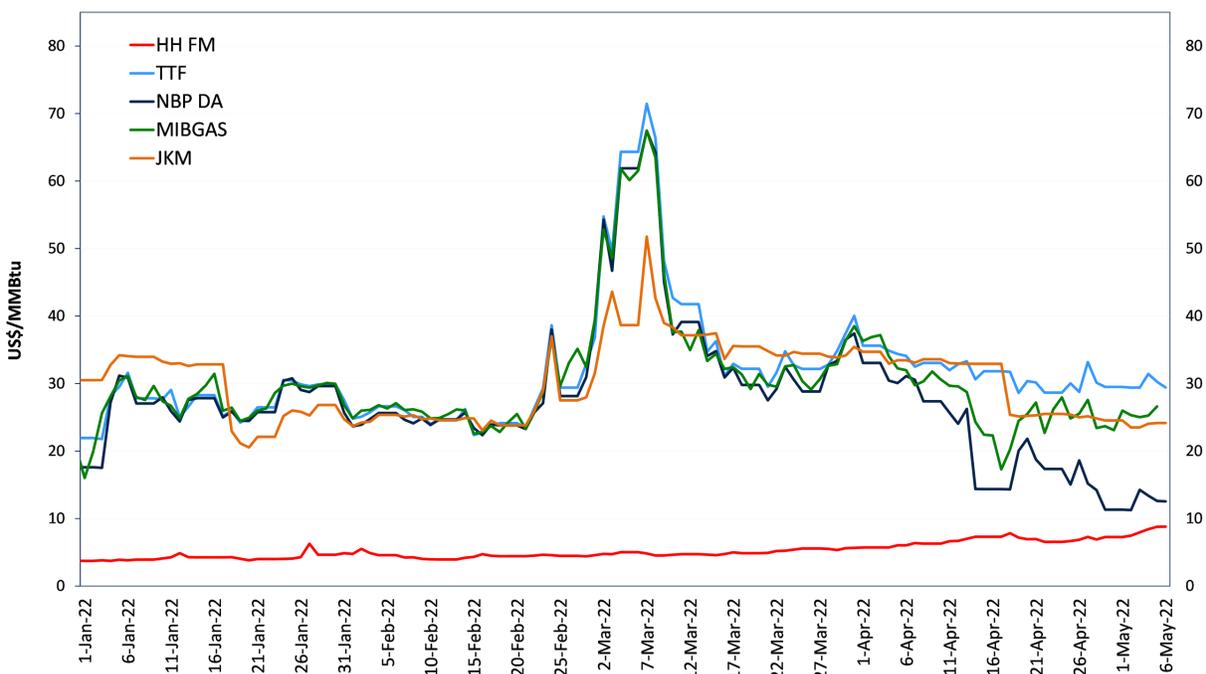
(Source: Refinitiv & author)



The reasons explaining the uptick are diverse. While domestic gas consumption is no longer extremely high compared to previous years (although it has been significantly higher for almost all the winter and it remains above last year level), LNG exports and the attractiveness that US gas represents for the European and Asian markets are supporting prices. Attractiveness that, given the situation of the global market, is expected to last in the medium term.

However, if we make a comparison with global prices, we observe that HH continues to trade at levels well below the rest of them, protected by the condition of being the price of the most relevant gas producer, meaning that US can meet domestic demand, no matter how much global prices rise.

Graph 2. Recent evolution of global gas prices
(Source: Refinitiv & author)

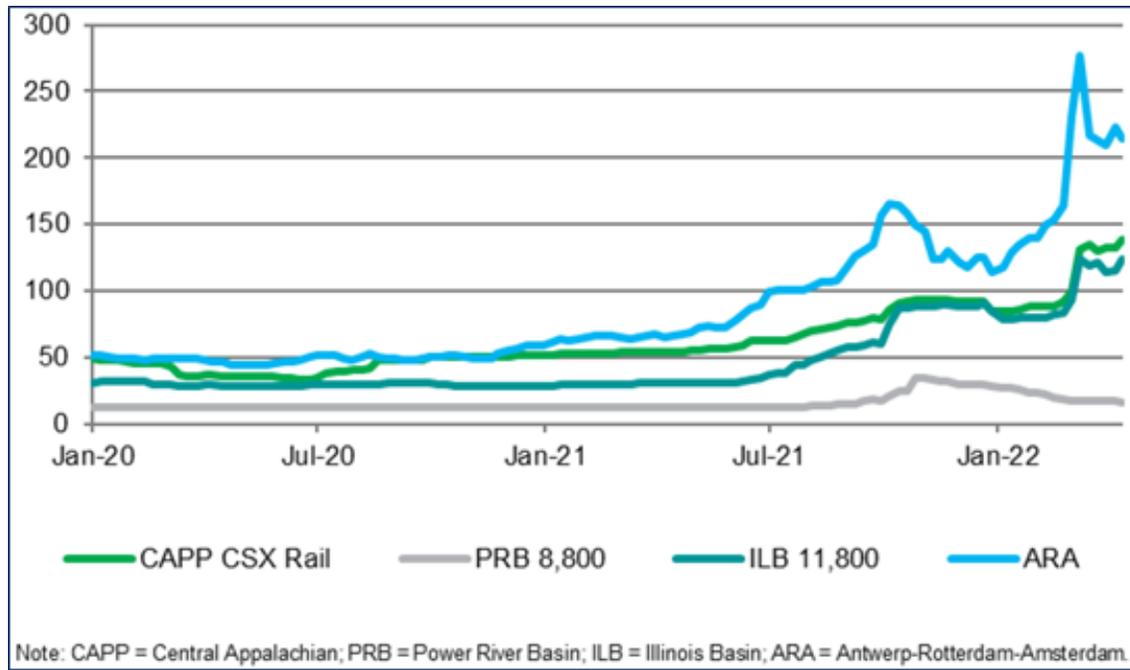


But apart from exports, there are more reasons explaining what is behind the increase of HH price, as we will see below.

Rising coal prices: International coal prices started to rise during the summer of 2021, as demand recovered after the pandemic. But after the beginning of the war in Ukraine and once the European ban on imports of Russian coal was announced (coming into force next August) international coal prices have also reached unprecedented levels.

Graph 3. Recent evolution of coal prices (\$/tn)

Source: IHS MARKIT



The increase in coal prices limits the "switch gas-to-coal" and pushes gas prices up. That is, instead of putting a ceiling on gas prices by offering a lower-cost fuel alternative in the electricity sector, coal and gas prices would rise together, in response to an unexpected increase in demand. This is exactly what has been happening so far.

In the US, the progressive increase in the price of HH since the beginning of the year has led to greater generation with coal. This coal has been taken from storage due to the difficulty of increasing domestic production or importing it (very expensive and under restrictions).

The current capacity of most mines to produce coal was already subject to long-term contracts, leaving little additional capacity to replenish stocks. On top of that, the incentives to enlarge capacity are not enough due to energy transition policies that have cut them, adding upward pressure to prices. In 2022, therefore, we do not expect growth in coal production vs 2021, so any additional ton that is needed will have to be acquired by imports, competing in prices with other potential buyers.

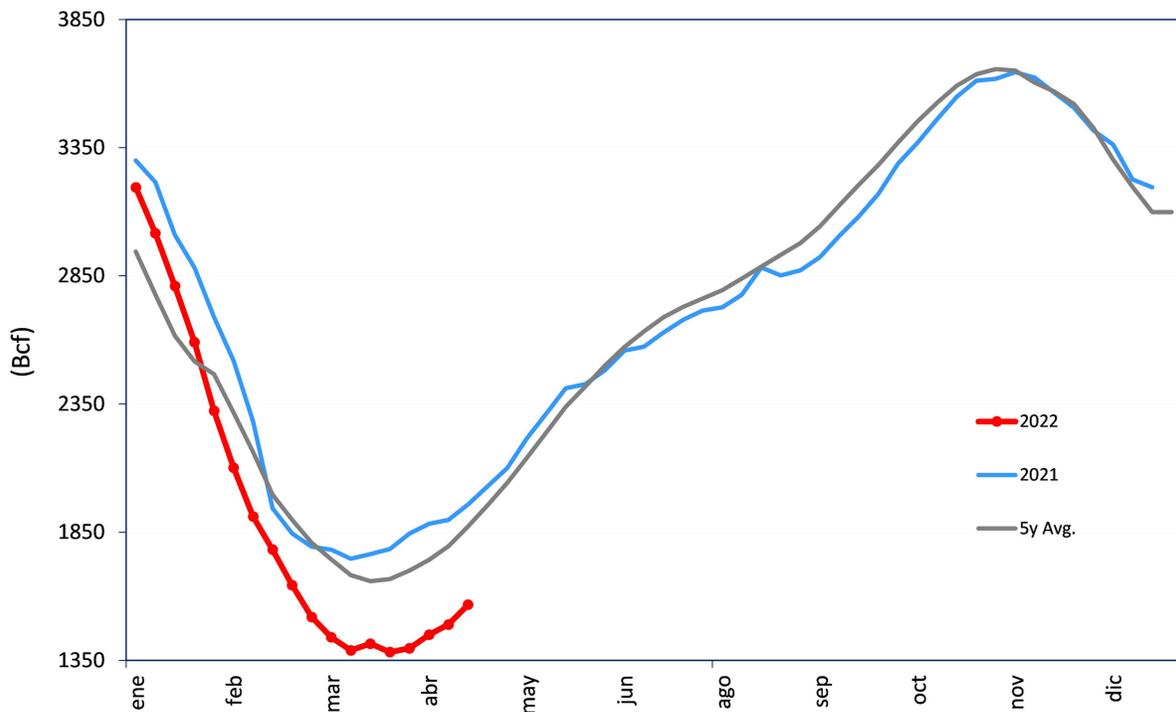
Summarizing, as coal prices have risen, so has the price of natural gas, switch flexibility in the power sector has been limited. In the case of the US, if the gas market needs to reduce its demand to balance market and relax prices, the power sector is not an option.

Capital discipline: with the increase in the price of HH and the appetite for LNG, it is weird that the drilling of new wells has not followed the same trend. This is because companies in the sector have been under pressure from investors to exercise capital discipline and get better returns, which has automatically increased the marginal cost of new production. Another bullish support for HH.

Low levels of natural gas inventories: storage level is important and is followed carefully because it provides the feeling of how the gas market is. Gas in storage in the US is (last data published 29/04/22) 1,567 Bcf, 20% below the level seen in 2021 and 16% below the average of the last 5 years

Graph 4. Evolution of US natural gas storage

Source: EIA and Author



Since the beginning of the year, gas withdrawals have been significantly higher than previous years. The strength of domestic demand and the succession of cold waves accelerated the withdrawal rate compared to previous years. Apart from this, the necessity of having greater volumes of gas to export, has reduced others to be stored. The persistence of low storage levels is another additional bullish driver supporting prices.

Conclusions

Low storage levels, prospect for solid domestic demand and the high rates of LNG exports should keep the HH at high prices. Generally speaking, this has implications, since the HH usually sets the "floor price" of the world gas price system. Thus, although the increases in other prices such as the TTF, respond to what happened with the conflict in Ukraine, in case of a price relaxation, with higher HH and the need to compete for US LNG, prices will have limited their fall, pushing potential minimum prices up.

Regarding to fundamentals, production is not expected to increase significantly, so what will really mark the evolution of the HH price will be the demand behavior (including the regular seasonal peak during the summer) and the rate of recovery of storage levels. The next couple of months will be crucial to define the price range for HH during the rest of the year.

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