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THE US AND THE UK GAS MARKETS: FROM INDEPENDENT REGIONAL MARKETS TO CLOSELY LINKED CAN THE MARKETS BE DE-LINKED AGAIN?

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OVERVIEW

Initially the US and the UK gas markets were physically de- linked. Their price levels and price movements should therefore develop independent of each other.
However, actually the markets have displayed some similarity with regards to price movements and price levels.

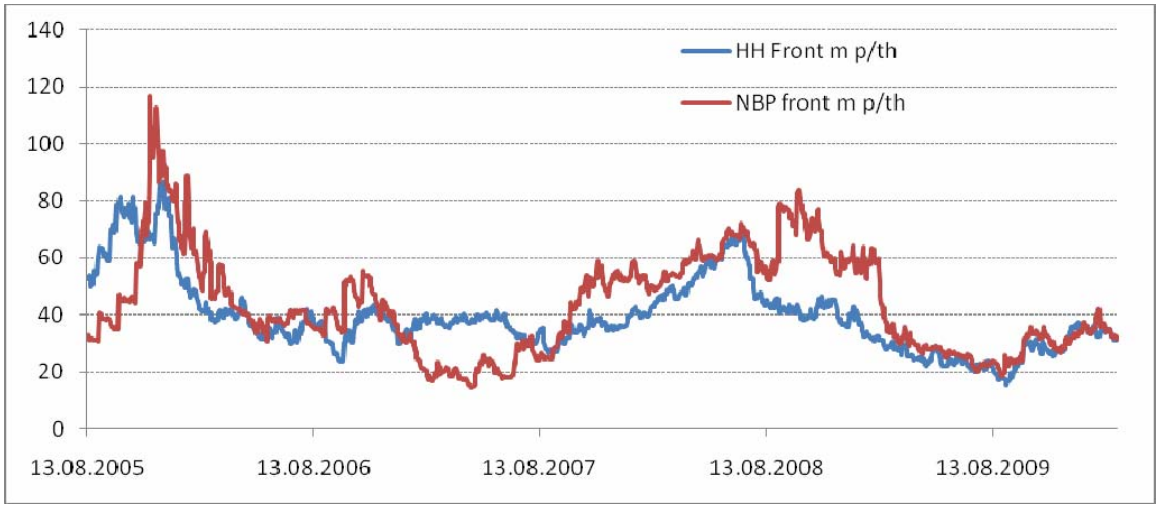

Fig. 1. US and UK gas prices since 2005: relatively high correlation

The US gas price is the Henry Hub for the front month (Source: Comstock /Nymex) while the UK gas price is the NBP front month (Source: ICE).

The reasons for the similarities in price patterns are assumed to be:
Both gas markets have a seasonal pattern with peaks during the winter season and troughs during the summer. This creates some price correlation (but not necessarily the same price level). In addition, both markets are somewhat receptive for oil price changes and at least periodically the oil price has made these two markets move in the same directions. Third, macro economics plays a role in gas demand and since the UK and US macro economy tend to move in parallel, it may also contribute to price similarities.
The US and UK gas market wholesale prices have been particularly closely linked over the last 12 months (March 2009-March 2010), probably as a reflection of the recent pick up in spot LNG trade. What does that mean for future development of US and UK gas markets?

METHOD

We compare the price spreads between the UK and US markets (US= Henry Hub quotations) with the development of LNG arbitrage possibilities in the Atlantic basin. We observe price spreads and correlations. We observe that to achieve close to full price equalization, the amount of spot LNG to the highest priced area needs to be “sufficient” which again is dependent on sufficient re-gasification capacity.

The assessment of future price linkage is based on a bottom up assessment of available capacities over the next years. A complete global gas balance is not put up, partly because sufficient supply and demand information is not available and partly because it would not be meaningful since so much supply capacity in any case is underutilized (for various reasons).

CONCLUSION

The US and UK gas market wholesale prices have been particularly closely linked over the last 12 months (March 2009-March 2010). This should be understood on the backdrop of the marked increase in the flow of LNG spot cargoes to the Atlantic basin, particularly to the UK and the arbitrage opportunity between the markets that this development has created.

When the two gas prices are following each other, it is natural to ask which price is the leader and which is the follower. It looks like the US has been driving the UK market and its bearish tone over the last year market has been contagious for the UK market.

Then we ask the question if these two markets can be de-linked again.

If the physical link between the UK and US gas market is removed (meaning sufficiently few spot LNG cargoes in the Atlantic basin), we will be back to the "old spread", before 2009 or even before 2006 with no gas arbitrage possibilities between these markets.

However, the prospects for a de-linking is very low for the next couple of years since a number of new liquefaction facilities are under construction during a period of low demand growth. A particular aspect of the new capacities recently added and under development is that most of it is not based on long term contracts, but could be available for the evolving spot LNG market.

The conclusion is that except from daily price adjustments, including peak price outbursts in UK during winter seasons, particularly for the prompt prices, the UK gas market will more or less be driven by the US gas development for the next couple of years.

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