Gas prices may have seen their trough, but 2017 should not be too painful

Drivers across the planet took full advantage of the decline in oil prices, which started tumbling in mid-2014. Much like oil prices, gas prices started to pick up again in 2016 and everything indicates that their cyclical low is now behind us. Our forecasts for oil prices do not point to a significant gas price increase in the coming quarters. Quebec’s taxes on gas have stabilized after spiking at the end of the 2000s, but the carbon cost could continue to exert upward pressure on fuel prices.

2016: A milestone year for drivers

Our last Economic Viewpoint on gas prices published in the spring of 2014 was not very encouraging for drivers. Our review concluded that, given the sharp rise in gas taxes, oil prices would literally have to crash if ever we were to see gas prices in Quebec return to the levels seen before the 2007–2008 crisis.

Much to everyone’s surprise, in mid-2014 oil prices suffered a violent correction with the cost of West Texas Intermediate (WTI) oil plunging from just over US$100 a barrel to close to US$26 in early 2016. Gas prices followed suit. The cost of regular gas in the United States fell from US$3.70 a gallon in early July 2014 to early 2016. Gas prices started to fall sharply as of mid-2014, drivers

More limited, but a still significant drop for Canadian drivers

Gas prices in Canada also started to fall sharply as of mid-2014, from a cyclical peak of $1.41 a litre to a low of $0.88 by mid-February 2016, a decline of about 38%. This decline, not as steep as in the United States, is partly explained by the higher gas taxes in Canada, which, like refiner and retailer margins, do not fluctuate as much as oil prices.

Regardless, a more than 30% drop in gas prices cannot be overlooked. We thus estimate that weak gas prices in 2016, compared to the average gas prices paid in 2013 and 2014,

Significant recovery over the last year

The low point in oil and gas prices reached in early 2016 reflected deeply negative investor sentiment that seemed to be focused on permanent stagnation of the global economy. It was hard to believe that prices so low could linger since they led to widespread cuts in investment across the oil industry and a steep drop in U.S. output (graph 2 on page 2). The concerns that were rife in early 2016 dissipated quickly and investor pessimism even gave way to optimism last fall after the U.S. election, and after China and other advanced countries released more upbeat economic data. This boost in investor confidence drove

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up commodity prices and stock markets sharply, including the S&P/TSX, which took full advantage of the positive run. The agreement reached by the Organization of the Petroleum Exporting Countries (OPEC) and other major oil producing nations, including Russia, to cut their oil production, also helped oil prices recover.

Combined, these factors allowed oil prices to double from their cyclical low points to more than US$50 a barrel. Not surprisingly, this recovery also pushed gas prices back up to about US$2.30 a gallon in the United States and C$1.10 a litre in Canada. As was the case when gas prices fell, the recovery was not as spectacular in Canada.

**Oil prices should stay close to current levels in 2017**
The past few years have once again shown that oil prices are the main factor in determining gas prices, since they are such important and volatile components. While forecasts are by their nature uncertain and the oil markets have surprised us in the past, there are good reasons to believe that oil prices could stay close to their current levels for the next few quarters. On one hand, growing global demand and the agreement reached with OPEC (graph 3) have absorbed the surplus that made oil prices collapse as of mid-2014—a sharp drop in oil prices is not on the horizon. On the other, U.S. output is already trending up and a sharp spike in prices could accelerate this trend and prompt OPEC to ramp up production in the second half of the year.

In this context, we expect oil prices to rise only slightly in the coming months, with the price of Brent and WTI generally staying below US$60 a barrel. The oil component in gas prices should thus rise by no more than US$0.10 a gallon in the United States and no more than C$0.05 a litre in Canada by the end of 2017 versus their January levels (graph 4).

**Influence of refiner and retailer margins usually erodes over time**
Besides the price of oil, the margins of refiners and retailers are two other important factors in the gas price formula. The data gathered by the Régie de l’énergie du Québec show that, in the last few years, these components have added about $0.20 to the cost of a litre of gas pumped in Montreal. We must stress that these margins are not pure profit; they are also used to cover the refiners’ and retailers’ costs.

The daily fluctuations in retailers’ margins, which can suddenly spike from next to nothing to more than $0.10 a litre, can have big impact on day-to-day gas prices. However, retailers’ margins tend to return close to their historic averages fairly quickly, and their impact on gas prices in the medium term is thus generally low. Nonetheless, retailers’ margins in Montreal have been rising a bit in the past few years; they have even declined slightly in Quebec City (graph 5 on page 3).

Refiners’ margins may suffer from more persistent shifts when imbalances arise on the oil market (graph 6 on page 3). In one example from a few years ago, the margins in the U.S. Midwest soared when the area was awash in an oil surplus. Refinery closures can also inflate margins temporarily. That said, sky-high margins usually translate into a surge in output that rebalances the market. Besides the usual seasonal fluctuations, nothing on the horizon points to a major change in refiners’ margins,
as gasoline inventories are quite high. Overall, we forecast that refiners’ and retailers’ margins will not have much impact on North American gas prices this year.

Surging gas taxes in Quebec have stabilized
The cost of gas in Quebec cannot be discussed without raising the issue of taxes. Our study in 2014 found that the surge in gas taxes a few years earlier was instrumental in pushing gas prices back to their historical peak, despite much lower crude prices than during the summer of 2008. The silver lining for drivers is that this uptrend is now over and no new government increases have been announced. And since sales taxes are affected by price levels, the total tax collected on gas has even fallen a bit since mid-2014 from about $0.50 a litre in Montreal to about $0.47. Nothing on the horizon points to a short-term change in sales taxes or specific gas taxes in the near term.

The above paragraph should have ended with an asterisk: If gas taxes have stayed the same in recent years, the Quebec government and more recently the Ontario government have decided to require fuel distributors to participate in the carbon market. In the end, this mechanism is much like a carbon tax paid for by drivers, especially in Quebec where any increase in retailers’ acquisition costs automatically bumps up the floor price. At the present time, a carbon cost of slightly over C$17 per tonne adds approximately $0.04 to the cost of a litre for drivers. This cost has not fluctuated much in the past few quarters; we can thus assume that it will remain near this level in 2017. In the medium term, the carbon cost should become more of a burden to drivers: the minimum price rise by 5% each year, plus inflation, and the Trudeau government wants a minimum, cross-Canada carbon cost of $50 per tonne by 2022. This would add a direct cost of $0.11 a litre, before sales taxes. Combined, gas taxes and the carbon cost could, in a few years, eat up almost US$0.60 of the cost of a litre in Montreal.

2017 should see a consolidation in gas prices
After reviewing the main factors, calling for gas prices in North America to rise slightly in the next few months seems appropriate. We estimate that in 2017 overall, the average price for regular gas in the United States will be around US$2.35 a gallon and about C$1.15 a litre in Canada. These levels still represent a significant increase compared to the depressed levels recorded in 2016.

If today’s gas prices may seem relatively high for many drivers, they have to accept the possibility that, one day, they might be much higher. Our forecasts for oil prices are fairly encouraging; we do not expect prices to move much beyond US$60 a barrel in the current cycle. But this is a forecast, and we have to keep in mind that oil could potentially creep back up to US$100 a barrel. With high direct taxes on gas and the growing weight of carbon costs, Quebec’s drivers could very well see gas prices reach new heights in this situation.

Mathieu D’Anjou, CFA, Senior Economist