

Ferguson: Energy Matters

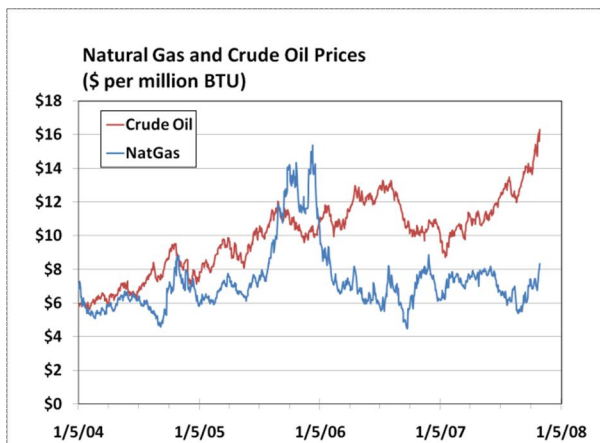
November 2, 2007

Plentiful; Not Cheap

November marks the beginning of the heating season. As the weather continues to cool in the next few weeks, natural gas will be taken from storage as consumers fire up their furnaces.

The good news is that there is plenty of gas in storage, more than 3,500 billion cubic feet—a record amount according to the Energy Information Administration. FYI, 3,000 bcf is considered more than adequate to supply the U.S. until spring when storage begins to build again. The nation has plenty of natural gas for the time being.

The bad news is that gas prices are higher than they have been since Hurricanes Rita and Katrina ravaged the Gulf Coast.



One would think that with a surfeit of gas in storage, prices would be at rock bottom levels. However, as I write this on November 1, the December contract is trading above \$8.50/MMBtu. Apparently the market does not anticipate prices dropping any time soon, since the 12-month futures

strip is also well above \$8.00/MMBtu.

As the chart shows, gas prices began falling last spring, as I forecast. It became evident that by the end of the summer storage levels would be well above 3,000 bcf. In the last two months, however, the price of gas has increased \$2/MMBtu for reasons that are unclear.

Given the continued meteoric rise in oil prices, one might think that gas prices are just going along for the ride. This seems unlikely, however.

In ordinary times, gas and oil prices are coupled because some consumers can switch fuels. If the price of gas gets too high, they can switch to oil. However, the price of oil now is twice the price of gas on

an energy basis, as the chart shows. No one in their right mind is going to switch fuels from gas to oil at these prices.

A more likely explanation for the recent increase in natural gas prices is that gas supplies have contracted. During the months of April through July gas supplies were considerably higher than average U.S. consumption. Storage levels increased rapidly and prices began to fall. As a result, producers apparently cut back on production.

Since August, my computer model indicates that average gas supplies dropped about 40 billion cubic feet per week from the earlier period. Such a decline, approximately 10 percent of total U.S. consumption, is quite remarkable. If it continues, it will have serious implications for energy policies.

As the chart shows, natural gas prices generally have remained in the \$6-\$8/MMBtu range since 2004, except during the spike caused by the hurricanes. The behavior of gas prices this summer indicates that producers have chosen to limit production rather than accept prices at the bottom of this range. If so, \$6/MMBtu has become the floor for natural gas prices.

Daily fluctuations continue to occur as traders make their calculations. The "causes" for these fluctuations cited by the media are often comical. A recent column by a respected organization was headlined "Gas Prices Rise on Expectations of Cooler Weather." Hello! Does the coming of winter really catch the market by surprise? I think not.

The current situation in oil and currency markets makes predictions hazardous. The Canadian dollar, the currency needed to buy Canadian oil and gas, has jumped to record levels. The euro is approaching \$1.50. Recent actions by the Federal Reserve to lower interest rates will continue to put downward pressure on the dollar and increase U.S. energy prices.

No one doubts that oil prices could exceed \$100/bbl in the very near future. The recent increase in gas prices should boost national production and limit price increases, but given the turmoil in oil markets, who can say what will happen? OPEC has vowed to increase oil production this month.

If global oil becomes more plentiful, energy markets should stabilize. If not, predicting future oil and gas prices will remain a crap shoot.

—Dr. Rich Ferguson, Research Director, CEERT, rich@ceert.org.
*Opinions expressed by DrF are not necessarily those of any organization
with which he is affiliated.*