Ferguson: Energy Matters

September 29, 2006

Natural Gas Price Swoon Continues

If you have room for a few billion cubic feet of natural gas in your backyard, now's the time to buy. The spot price for gas traded at Henry Hub, which reflects prices paid for immediate delivery there, closed Thursday on the NYMEX at $4.17/MMBtu. That's a bargain.

Thanks to a surfeit of gas in storage, prices haven't been this low in many years.

The fall has been dramatic to watch. On August 2 the spot price was $8.65/MMBtu. Five days later it had dropped to $7.01/MMBtu. By August 29, it hit $6.23/MMBtu and three days later $5.18/MMBtu. Rebounding only slightly, gas prices have continued to soften during September, dropping another dollar by yesterday.

Prices at regional hubs are even lower. One report shows spot gas prices in Colorado and Wyoming at around $2.50/MMBtu.

These prices indicate convincingly that the U.S. is awash in natural gas. No producer can make a profit at these prices. If they aren't selling gas under contracts with higher prices and haven't hedged their revenue with financial instruments such as options, they are losing money. According to recent reports, producers are shutting in production of unhedged gas.

None of this should come as a surprise to loyal readers. As I forecast last spring, the U.S. now has much more gas than usual in storage. One week ago, gas storage facilities in this country were more than 80 percent full with six weeks left before the start of the heating season, which is around the first of November.

The U.S. Energy Information Administration reported Thursday that as of September 22 there were 3,254 billion cubic feet of gas in storage. Over the previous five years, additions to storage after that date averaged 331 bcf. At that rate, we would end up with 3,600 bcf of gas in storage before levels begin to decline as heaters fire up around the country.

U.S. gas storage levels this year should easily be the largest since 1994, when my records begin.

Media reports continue to mistakenly credit the large volume of gas in storage to warm weather last winter. As I reported earlier, my data indicate that this accounts for only a third of the glut. The other two-thirds resulted from demand "destruction" due to last year's hurricanes and the resulting record prices last winter.

What about the future?

Although the spot price has crashed, the average contract price for delivery over the next 12 months is still over $7.00/MMBtu. Many buyers have contracts with much higher prices. The market appears to understand that current spot prices are an aberration.

Nevertheless, it's difficult to see how gas prices can recover much next year. Data indicate that over the last four months, supplies have been lower than usual by about 10 bcf per week. In other words, if things continue as they have, we would burn off about 500 bcf of the current storage glut over the next year. That would leave us with more than 3,000 bcf in storage by November 2007, an amount considered adequate to get us through a winter.

Lots of things can happen in the meantime, of course.

Producers are not going to drill as many wells if prices remain low, and consumers are going to burn more gas. If that happens, the current 10 bcf/week deficit could grow substantially and supplies could be stretched thin a year from now.

But that's the way the laws of supply and demand are supposed to work, right? Well, perhaps not.

One of the country's largest natural gas traders, Amaranth, made the news recently by losing $5 billion in one week. Amaranth traded heavily in natural gas hedges. These financial instruments, such as options, are intended to provide protection to producers and consumers by reducing exposure to swings in gas prices. But speculators can use them to bet on the price swings, too.

Apparently, Amaranth was betting on the price spread between gas contracts for delivery next March and April. It appears that they were attempting to corner the market for March gas in order to control the price and thereby ensure that their bets would win. Their play collapsed as prices continued to fall and they had to cover their bets. Not surprisingly, cries are already being heard for better regulation of the international electronic markets where these games can be played.

Take my advice and stick to betting on the weekly football pools. The natural gas game is the most fascinating one around, but it's safer to watch from a distance.