US natural gas prices have been dragged up by crude oil prices despite having different fundamentals. *Eric Fishhaut* at GlobalView Software charts the trend

Natural gas caught by an energy price wave

★ As US presidential elections draw near, the price of energy is a front and center issue not only there, but globally. Record high crude and petrol prices in conjunction with greater economic woes are impacting the majority of Americans and spreading globally. Crude oil prices peaked in July after shooting up as much as 45% since the end of February, dragging natural gas prices up as well.

The debate is on between the conservatives and the liberals with opposing views on how to reduce foreign dependency on energy sources and set environmental policies. The Republicans generally support increased domestic exploration and drilling while Democrats favour conservation and reduced demand. Public sentiment seems to favour any action that will reduce the escalating energy costs and the accompanying pain being felt.

There are significant differences between oil and natural gas development. Historic oil spills in Alaska and California spurred environmental protection policies that placed major restrictions on new drilling. Concerns for the environmental impact remain but are now being overwhelmed by price shock sentiments. While natural gas would have to be carried by pipelines that pose the potential for leaks, advances in drilling and transport techniques are touted as having low environmental impact.

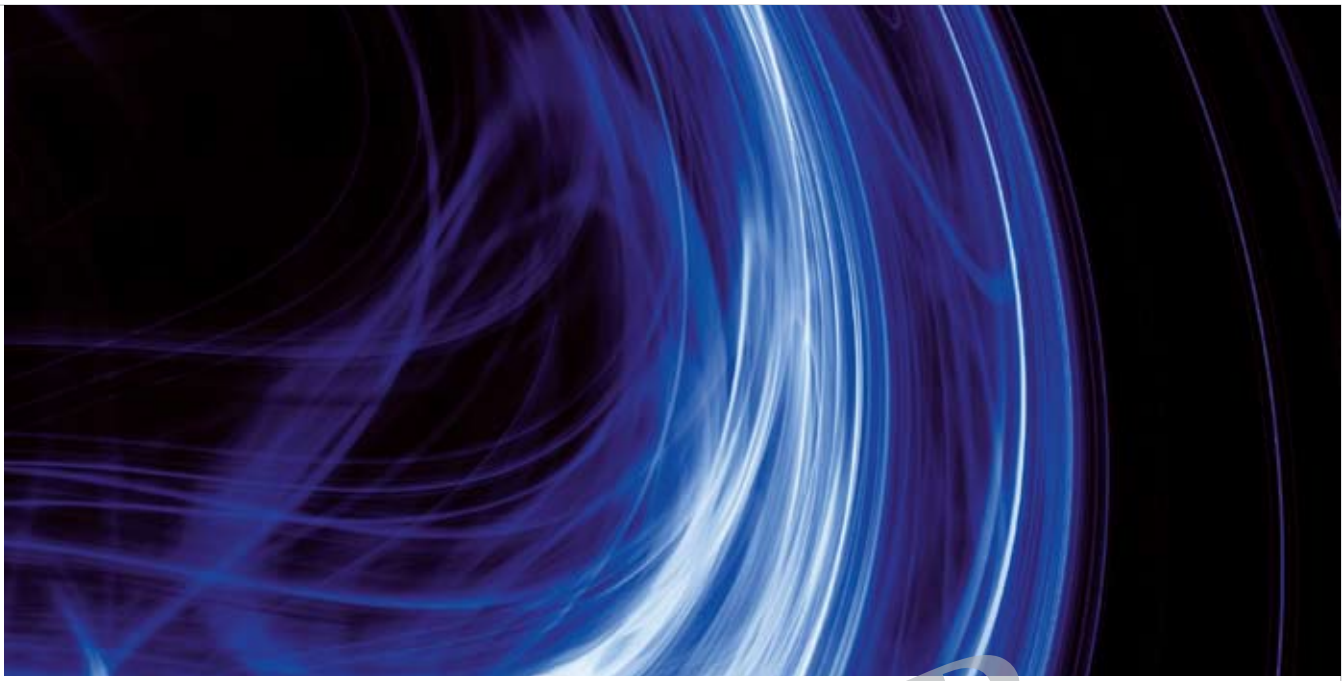
The natural gas industry asserts that gas exploration is environmentally safe in comparison with that of oil. The American Gas Association states that new production "will increase our nation's domestic energy supply and lower prices from today's record-breaking levels, providing much-needed financial relief for consumers". According to their estimates, up to 420 trillion cubic feet of natural gas could be developed from the Outer Continental Shelf of the US, which has been off limits for drilling since 1982.

Political landscape

President Bush and the Republican Party nominee John McCain are now pushing Congress to amend the Outer Continental Shelf ban that has been in place for over 25 years. Factors and events may very well be aligning to convince US lawmakers to open the gates to the forbidden areas, returning natural gas to a preferred energy source. Opponents respond that increased US production would be years away and would do little to affect prices in the short run. But the argument follows that it would send an immediate psychological signal to current and potential foreign suppliers that the US will not be held hostage.

With the push towards carbon constraints and adoption of cap-and-trade regulation to limit emissions, natural gas becomes very appealing. Natural gas is a sound choice, given that its greenhouse gas emissions are half that of coal. It is environmentally cleaner, having no associated mercury releases and far less nitrogen oxide and sulfur dioxide emissions. Because of this, the US Energy Department predicts that natural gas demand will rise 11% by 2020. In contrast to alternative fuels, natural gas needs no subsidies. The industry is looking for increased access to areas for exploration and a predictable regulatory environment.

According to independent oil and natural gas producers, 279 million acres of federally owned land have oil and natural gas potential. More than half of that is either closed to leasing or access due to environmental concerns. At the same time, 27% of US oil production and 15% of the natural gas production are from offshore supplies. Advocates of greater drilling rights say that an additional 18 billion barrels of oil and 76 trillion cubic feet of natural gas will be available in the Outer Continental Shelf if the ban is lifted.

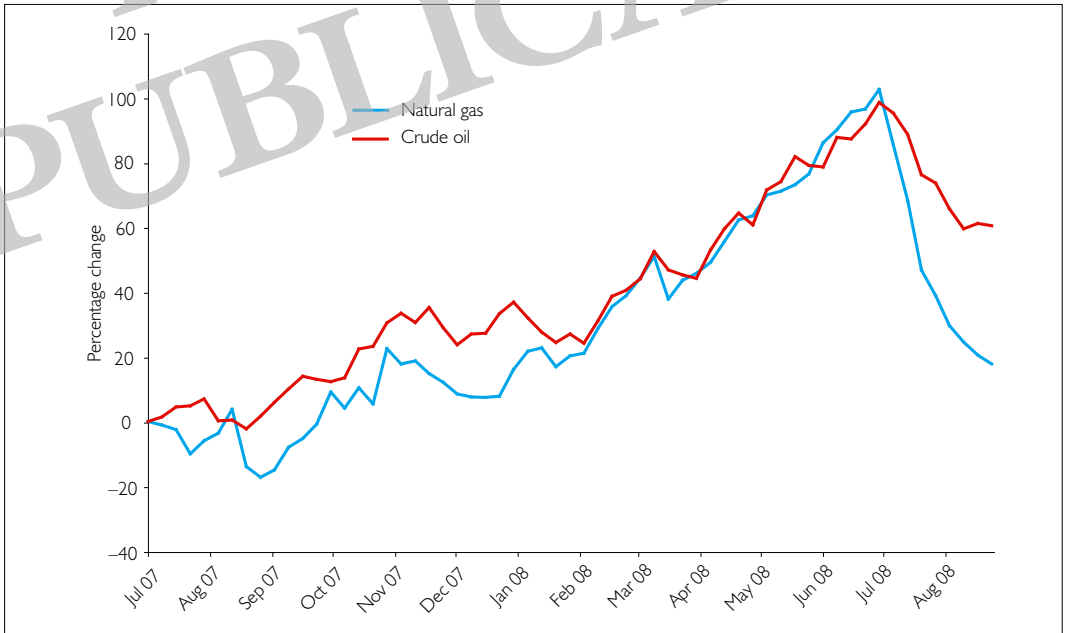


Price outlook

Natural gas prices have risen over 450% in the last eight to ten years, making energy costs for industrial facilities as high as 80% of their production costs. The Henry Hub natural gas spot price averaged $7.17 per thousand cubic feet (Mcf) in 2007 and the US Energy Information Administration (EIA) expects it to average $10 per Mcf in 2008 and $9 per Mcf in 2009. The prediction is that price pressure has been reduced and the trend is now downward.

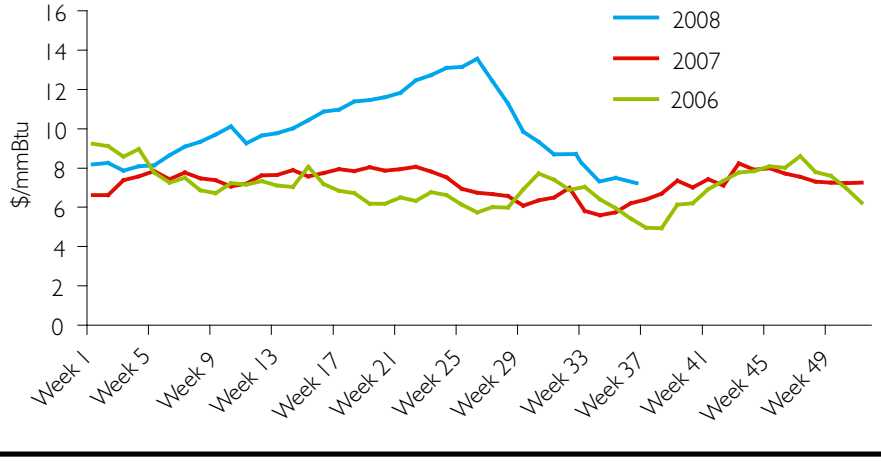
During 2008, natural prices have followed the relentless march of oil price increases, seemingly ignoring market fundamentals (see figure 1). Prices increased to a level of more than 66% since the beginning of the year, against normal seasonal low patterns (for example, the dip in heating required in summer months), before falling back to January levels in August (see figure 2).

The price of crude peaked in July at a point 50% higher than the start of the year only to retreat to below its original price



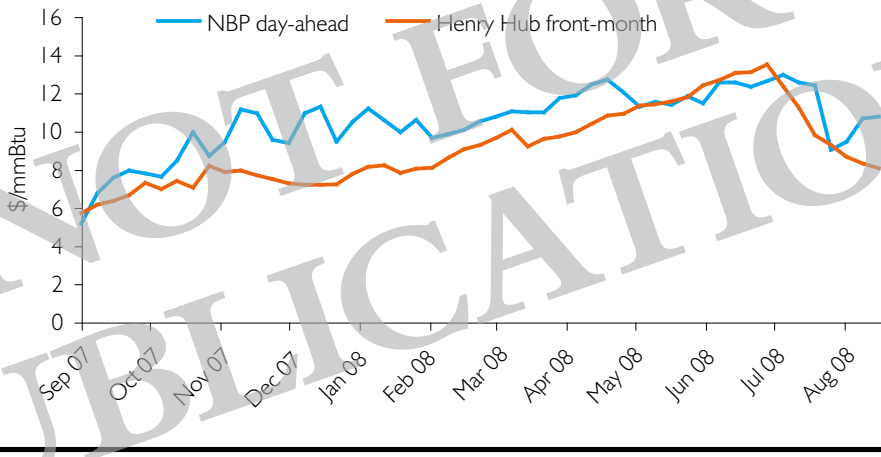
F1. Natural gas and crude oil – percentage change

By comparing the percentage change in the price of crude oil futures to that of natural gas futures over the past year, it is apparent that these markets are moving somewhat in unison *Source: Nymex*



F2. Henry Hub natural gas – seasonal prices

Decidedly different than previous seasonal patterns, the price of natural gas in 2008 rose dramatically in spring before nearing more normal levels during late-summer *Source: Nymex*



F3. Natural gas – US versus Europe

Comparing natural gas prices in the US to those in the UK shows that this pricing trend extends beyond just the US *Source: ICIS-Heren and Nymex*

only two months later. Natural gas prices in the UK have tracked a similar pattern (see figure 3).

As shown in the EIA's *Weekly Natural Gas Storage Report*, US natural gas in underground storage increased to 2,655 billion cubic feet (Bcf), registering a net injection of 88 Bcf. As of mid-August, volumes of natural gas in storage were 1% above the five-year average.

On the demand side, the EIA expects total natural gas consumption to increase by only 3% in 2008 and by 1.7% in 2009. While on the supply side, total US marketed natural gas production is expected to increase by 8.0% in 2008 and by 3.7% in 2009.

Study of these statistics presents a compelling argument that natural gas prices have, at least recently, been propelled by forces well beyond market basics, following a general energy price wave (i.e. the tendancy of energy commodities to rise and perhaps fall in unison). Whatever those forces may be, the influence of perception and, according to some, speculation, seem to carry over from the petroleum markets.

While one would expect the energy complex to have correlating relationships between products, it is of particular interest that non-fundamental factors can so readily transcend basic supply/demand factors while doing so. This pattern will be interesting to study as we continue to navigate the uncharted path we have been on for some time. ER

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