Energy Solutions INC
natural gas buying advisors

# Natural Gas Issues: Prices and Potential Regulation of Speculators

# About Energy Solutions, Inc.

- An INDEPENDENT consulting company since 1996
  - No affiliation with any marketer, broker, agent, utility, pipeline or producer.
- More than two decades of natural gas experience.
  - Experience in all aspects of the natural gas industry.
- We specialize in one area – natural gas buying advice and strategic proactive purchasing plans.

# Regulations: History

- Futures market was created to serve the direct needs of buyers and sellers of commodities.
  - A tool to manage risk.
  - Position limits established by NYMEX for any player which is not "exempt".
    - Natural Gas: 12,000 net futures contracts and 1,000 in the last three days prior to expiration

- In 1999, Goldman Sachs convinced the CFTC that they were entitled to the same regulatory "hedge" exemptions as market participants genuinely hedging their physical requirements.

- In 2000, the Enron Loophole allowed over-the-counter trades and electronic trading to be exempted from government regulations.
  - Over-the-counter (OTC) trading is trading of financial instruments between two parties vs. exchange trading, which occurs via facilities constructed for the purpose of trading.
    - Allowed players to avoid NYMEX position limits.
      - The 2008 Farm Bill tried to fix the Enron Loophole by allowing the CFTC to regulate exempt contracts. CFTC <u>first used</u> that authority in July 2009 relative to the ICE natural gas swap contract. The ICE swap contract is a 2,500 MMBtus contract settled at the Henry Hub in Louisiana (the physical trading point for the NYMEX natural gas contract).

# Regulations: The Problem

- Speculators spent a lot of money on lobbying and campaign contributions.
- Classification by CFTC not diversified enough.
  - 1990's: Two new types of financial investors arose – hedge funds and Exchange-Traded Funds (ETFs).
    - Use the futures market as a profit making tool.
    - Distorts commodity values because investments exceed physical supply value.

# Regulations: The Abusers

- UNG
  - Estimated that in August, UNG held the equivalent of 125,000 natural gas contracts (10,000 MMBtus each).
  - Rollover dates.
- Amaranth Advisors
  - Over-extended positions and collapsed in September 2006.
  - Held 40% of open natural gas contract positions prior to collapse.
  - October 2006 NYMEX price fell to $4.201 per MMBtu ($2.40 less than Sept 2006).

# Regulations: Signaling Change

- CFTC and SEC working together to prepare a Sept. 30 report.
  - Working on harmonization as part of Obama Administration reform plan released in mid-June.
- CFTC very vocal in the need for position limits.
  - In August, the CFTC withdrew relief that allowed some ETF's managed by Deutsche Bank to take positions in corn and wheat futures that exceeded federal speculative position limits.
  - Recently broke weekly traders report into four categories from two.

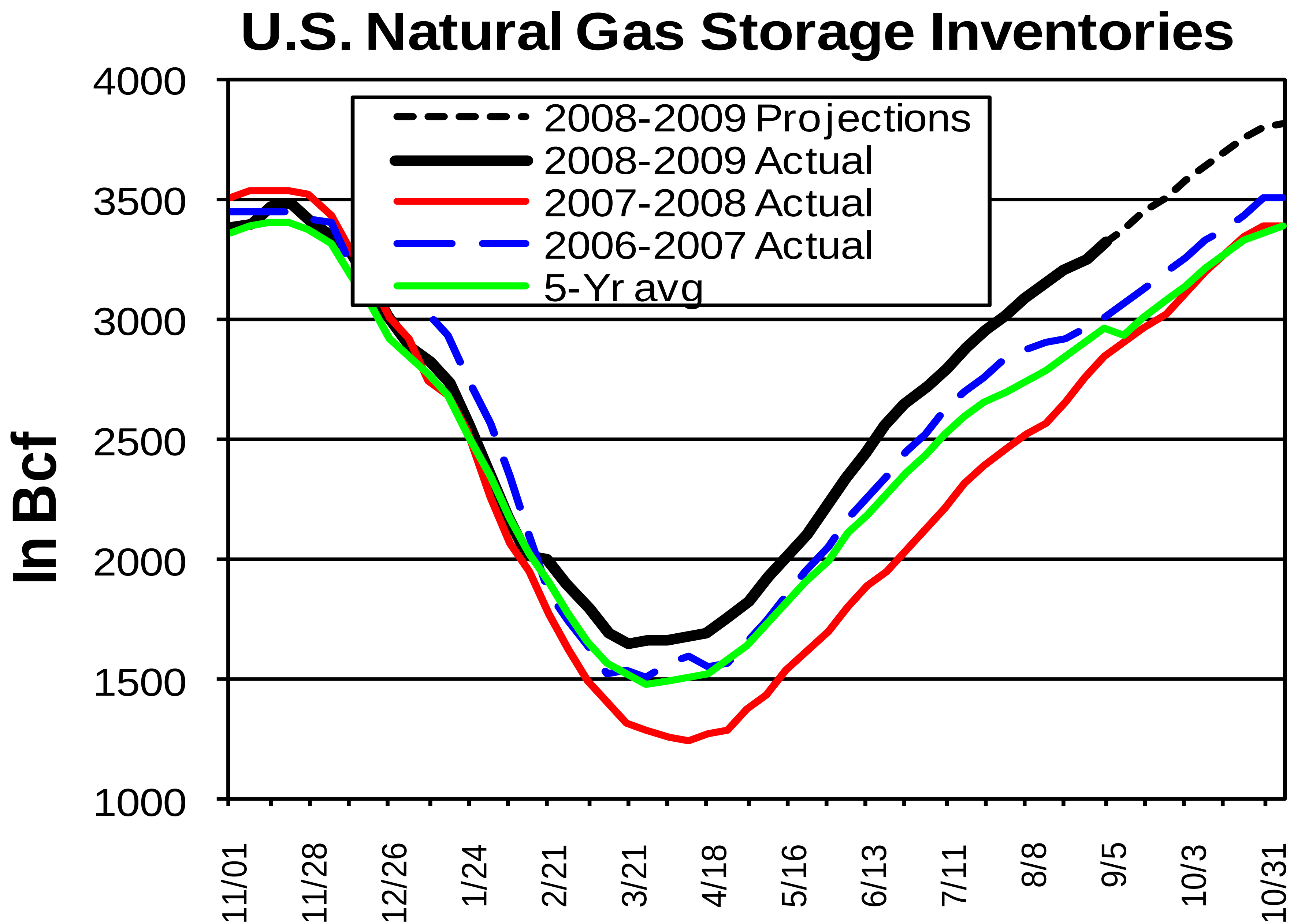
# Regulations: What We Think Will Happen

- Modification of Position Limits
  - Authority changed to CFTC versus the NYMEX.
  - Daily trading limits and/or aggregate position limits across all exchanges and OTC trades.
    - Will require additional data to be reported to the CFTC.
    - Position limits expected to be stricter on monthly contracts near expiration.
- Tighter proof of exemption requirements and a reduction in exemptions granted.
  - Better accountability of position limits.
  - Revised system on how to classify players.
    - Breaking trades into the appropriate category.

# Regulations: The Impacts

- Positives:
  - Gradual implementation vs. “all at once.”
  - Reduction in speculative influence.
  - Better market transparency.
  - Less market volatility.

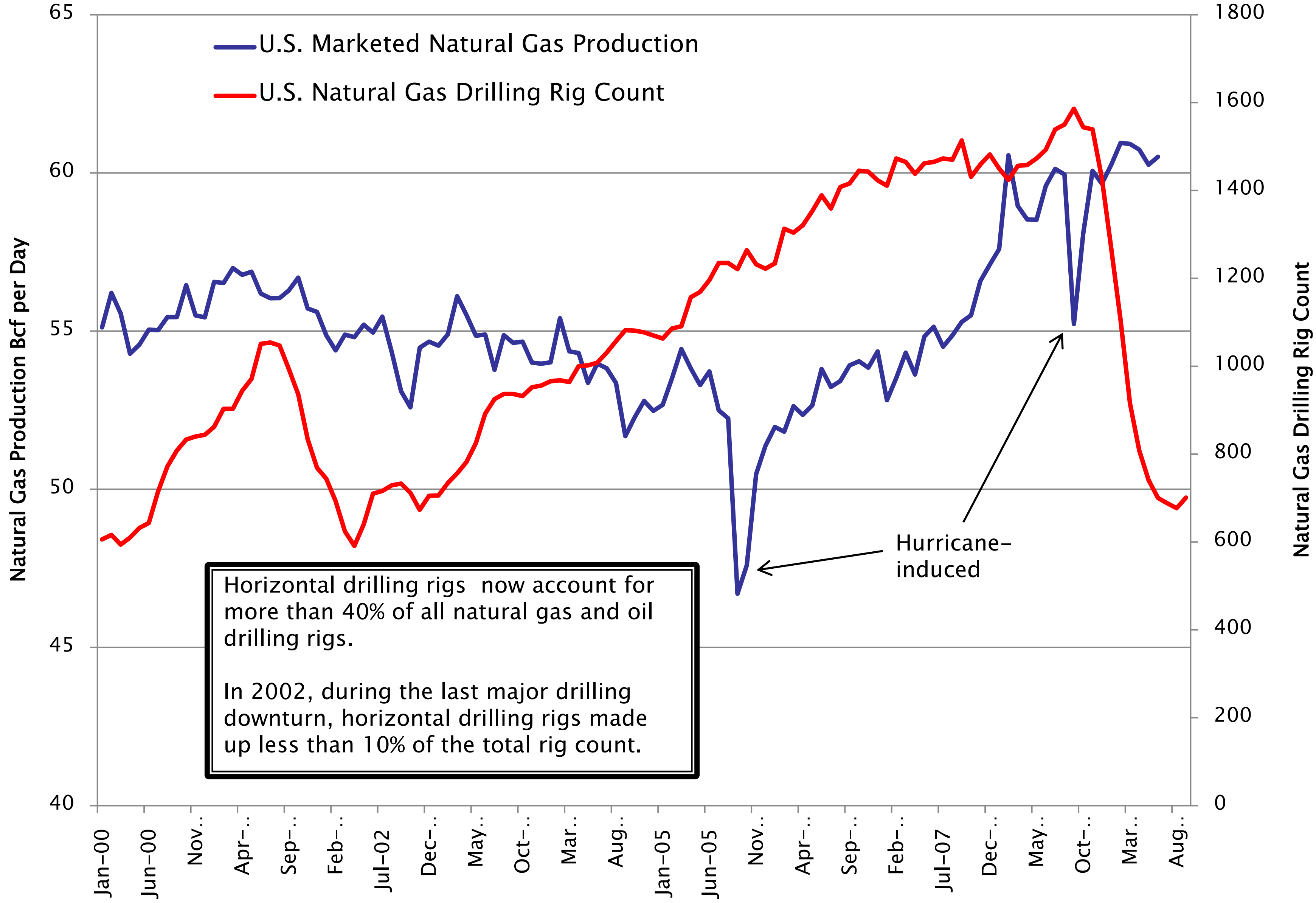
- Negatives:
  - Reduced liquidity.
  - Severe elimination of speculative players.
  - A mass exodus from positions due to new regulations could cause rapid price move.


U.S. Natural Gas Storage Inventories
2008-2009 Projections
2008-2009 Actual
2007-2008 Actual
2006-2007 Actual
5-Yr avg
In Bcf
4000
3500
3000
2500
2000
1500
1000
11/01
11/28
12/26
1/24
2/21
3/21
4/18
5/16
6/13
7/11
8/8
9/5
10/3
10/31

# Pricing: Storage

- Max working gas capability is 3,889 Bcf.
- Inventories estimated at 3,395 Bcf.
  - Average Sep-Oct injections are 500.
  - Easily on pace to reach maximum levels.
  - Highest level ever is 3,565 hit in Oct. 2007.
- Potential pricing impacts.
  - Winter starts out cold.
  - Winter starts out warm.
  - Winter of 09-10 priced at $4.70 vs.
    - Apr-Oct 2010 priced at $5.25.
    - Winter 10-11 priced at $6.50.
  - Involuntary producer shut-ins due to OFOs.

# Natural Gas: Production vs. Rig Count



# Pricing: Why Produce?

- 2009 supplies were likely hedged.
  - Better efficiencies and lower costs.
  - Production costs vary.
- Need to drill to maintain mineral lease rights.
- Hanging on for winter.
  - Estimates that \$5-\$6 prices provide a 20% return for shale development.
- Response from Chesapeake.
  - Involuntary shut-ins this fall due to storage.

# Pricing: Other factors

- Weather forecasts
- LNG Outlook
- Crude Oil price support
  - Weakness in the U.S. dollar

# Pricing: Short-Covering Impacts

- Non-commercial Sector (speculators)
  - 12/07: Net Short 112,541 / Price $7.39
  - 06/08: Net Short 65,000 / Price $12.69

  - 09/09: Net Short 169,846 / Price $2.84
  - Have held extreme net short position for more than one year.
- Speculators are Trend-Followers
  - Nothing to do with supply and demand and fundamentals.
    - Price “stops” can create market momentum.

# Our Outlook:

- Seasonality:
  - Four times during the year where end users should consider proactive buying.
    - 3rd quarter low
    - 1st quarter low
    - 4th of July holiday
    - When April trades at a higher level than March
  - 3rd quarter low to date is $2.409 per MMBtu
    - This equaled the five-year average decline from the 2nd quarter high to the 3rd quarter low.
    - Points to 4th quarter rally of $5.15 (114% of 3rd quarter low)
    - 1st quarter decline is typically a 47% decline from the 4th quarter high.
- Price spreads are historically high
  - January 2010 is trading at a $2+ premium to October 2009
- Indicators don't point to a change in sentiment.

# Our Outlook:

- Should end users be buying?
  - Yes on price weakness.
- How far out?
  - Budget requirements.
  - We favor prices through May 2010 right now.
  - We anticipate an eventual rally to attract additional sellers, which will be needed to move toward the first quarter low.
- Long-Term?
  - We expect prices for 2010 and beyond to weaken by another $.50-$1 per MMBtu before year-end.
    - Larger price moves down in second half of 2010.
    - Cautious about the impact of involuntary shut-ins.

**DOWNLOAD**
*An In-Depth Look at Natural Gas Prices (published in March 2009 newsletter)*

# Natural Gas Price Update

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Wednesday, September 9, 2009 -- After a long holiday weekend, energy prices were very strong yesterday. Crude oil prices rallied by more than $2 per barrel, and the strength flowed over into natural gas. But, the price strength may be short-lived. The fundamentals haven't changed, and this week's storage injection is expected to be on par with last year's weekly injection. More and more operational flow orders are being issued by pipelines as storage inventories refill, and this means ... Click here for full story

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Average Natural Gas NYMEX Strips (as of Sept. 8, 2009)

| | |
|---|---|
| Oct 2009: | $2.81 |
| Nov-Dec 2009: | $4.22 |
| Nov 09-Mar10: | $4.65 |
| Jan-Dec 2010: | $5.35 |
| Jan-Dec 2011: | $6.39 |

Natural Gas NYMEX Price Data

Storage Statistics

Drilling Rig Counts

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# Natural Gas Price Report:

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## By Valerie Wood

## Wednesday, September 9, 2009 -- 8:00 a.m. CST

After a long holiday weekend, energy prices were very strong yesterday. Crude oil prices rallied by more than $2 per barrel, and the strength flowed over into natural gas. But, the price strength may be short-lived. The fundamentals haven't changed, and this week's storage injection is expected to be on par with last year's weekly injection. More and more operational flow orders are being issued by pipelines as storage inventories refill, and this means there is only going to be more natural gas available in the spot or physical market. As this occurs, cash prices will be pulled lower again, likely to below $2 per MMBtu, and that will only put downward price pressure on the front-month natural gas futures contract, which at this time is October 2009.

Tropical storms have remained a far distance from the Gulf of Mexico, and weather is moderate. Nothing has really changed, so the day-to-day price moves appear to be the result of profit taking more so than an actual change in market momentum. While today's prices are very attractive relative to historical levels, we continue to focus on the wide spreads between the front-month contract and other contracts. For example, the $2 per MMBtu premium for next winter is just way too wide. Are the fundamentals really going to change that much in the next 60 days? Is winter going to be so cold by early December that there will be a fear that the record level storage will be depleted? In our opinion, the answer to these question is "no" and that means eventually we expect more downside price movement for particuarly December 2009 and beyond.

**OUTLOOK:** The trend has been as each month expires, future months are pulled lower. We expect that trend to continue until there is some definitive information showing that demand is rebounding. We're cautious about whether the third quarter low is in, but deep down, we don't believe it is. Following the third quarter low, we do expect a fourth quarter rally, but that rally is likely to be pale in comparison to historical fourth quarter rallies. So, overall, we're still bearish on natural gas as a whole. When we say bearish, it isn't necessarily directed solely at the front-month contract. Rather, we expect a price dip in the front-month contract to eventually have

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# Thank You !!