5 Reasons Natural Gas Is Poised for Upside

Gas and Oil Investments Bulletin

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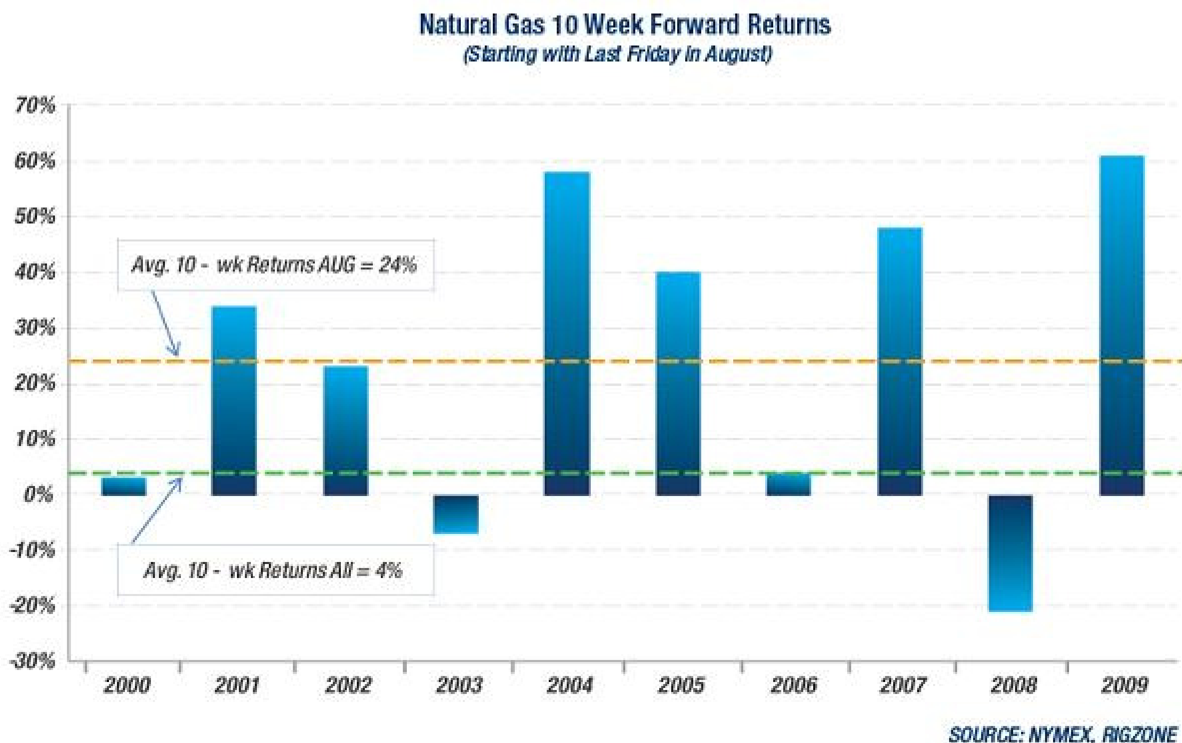
This last week before Labor Day marked the 2009 low for natural gas prices. Both the natural gas price and natural gas stocks had a big run through to January 2010, creating great wealth for investors.

Could that happen again this year? How real is the seasonal trade in natural gas? And how does the natural gas market compare this year over last?



This chart, published by www.rigzone.com (they have one of the best daily *free* e-letters in the industry) shows how well the big seasonal trade worked last year, and how it has fared for the last 10 years.

Looking at this year, 2010, we have on the positive side:

1. **Storage is Trending Lower**:

- The EIA reported that for the week ended August 27, 2010 working gas in storage was 3,106 billion cubic feet (bcf), only 54 bcf larger than the prior week. U.S. storage is now 208 bcf less than last year at this time and 169 bcf above the 5-year average.
- More importantly, storage injections have been below the 5-year average for 11 consecutive weeks and this trend is set to continue. Gas storage could end the refill season on November 1st at approximately 3,500 bcf. This level of storage heading into the winter heating season supports substantially higher natural gas prices.

2. Demand Continues to Strengthen:

- According to the EIA demand for the first 6 months of 2010 was approximately 4.3% greater than the first 6 months of 2009.
- Given the strong prices for coal this year, many utilities have stepped up their purchases of gas to run their usage of their natural gas fired power plant fleet.
- Additionally, despite the weak economy in the U.S., industrial demand for natural gas has is higher this year compared to 2009.
- Also, as we head into the winter heating season, demand for natural gas always picks up and should we have another cold winter storage could be drawn down very quickly.

3. Oil/Gas Ratio is Bullish:

- While oil and gas on an energy equivalent basis should trade at a 6:1, the two commodities currently trade at approximately 19:1.
- Many natural gas focused exploration and production companies have turned their attention away from natural gas and towards oil. Chesapeake Energy (NYSE:CHK), the most active driller of shale gas wells in the U.S., has dramatically reduced its natural drilling in favor of a dozen new oil focused projects. Other companies have pursued similar paths.

4. Production Starting to Roll Over:

- Monthly U.S. natural gas production which showed production fell 1.2% from May 2010 to June 2010,
- Due to falling production in the Gulf of Mexico, which accounts for nearly 11% of U.S. production, and several big producing states like Texas, Wyoming and New Mexico, overall U.S. production is headed downward for at least the next two years. Production growth from shale plays can no longer offset declines from the Gulf of Mexico and conventional areas.

5. Pressure Pumping Chokepoint: Due to increased demand for fracture stimulation services from the nearly dozen unconventional oil and gas plays currently under development in the U.S. and Canada, many operators are now having to wait weeks and even months for fracturing services. Once gas prices pick up and operators step up the pace of natural gas directed drilling, limited availability of fracture stimulation services will keep U.S. gas production from reversing its recently begun downtrend.

6. The forward curve for natural gas prices is much lower this year, which is to say the futures price for gas in 2011-2014 are lower than they were last year – this is bullish because it means producers can't hedge big profits. It has also helped create the huge negative sentiment around natural gas prices, which we believe to be bullish.

On the negative side:

1. Producers are still being forced to drill to keep/earn land leases

2. Which is causing a continuing high rig count

3. And to pay for all this in the face of low cash flow, several large natural gas producers have formed joint ventures with big international companies – oftentimes National Oil Companies (NOC). This is BIG free money for these cash starved producers, and gives them the ability to keep drilling in the face of low prices.

4. Producers are now choking back production on prolific horizontal wells, reducing the steep (and highly publicized) decline rate of production in shale gas plays

5. Increased LNG capacity in both eastern Canada and the eastern US (though Liquid Natural Gas has been a non-factor in the North American market this year, and supply has been soaked up by Japan, Taiwan and China).

6. ETF (UNG-NYSE) buying continues to support prices. If low prices are the cure for low prices, investor buying in natural gas ETFs doesn't help.

One of the last points for investors to consider – and this is neither bullish nor bearish – is that large commodity producers should not be relied upon as great gurus of their own pricing. In the last decade, some of the largest uranium, copper and gold producers, were caught completely by surprise when their commodity price spiked upwards, and were saddled with highly unprofitable hedges for years, at great cost to their shareholders.

The market will tell us within 60 days or less if the large seasonal run in natural gas prices will happen this year. We will be watching very closely.

With the fundamentals for natural gas greatly improved over the last couple of months and investment sentiment towards the commodity and gas-weighted equities very negative, contrarian investors may consider getting positioned for a sharp rebound in gas prices