

Record Natural Gas Glut Sends Prices To 10-Year Lows, Is It Time To Buy?

Where do prices go from here as inventory surplus continues to balloon?

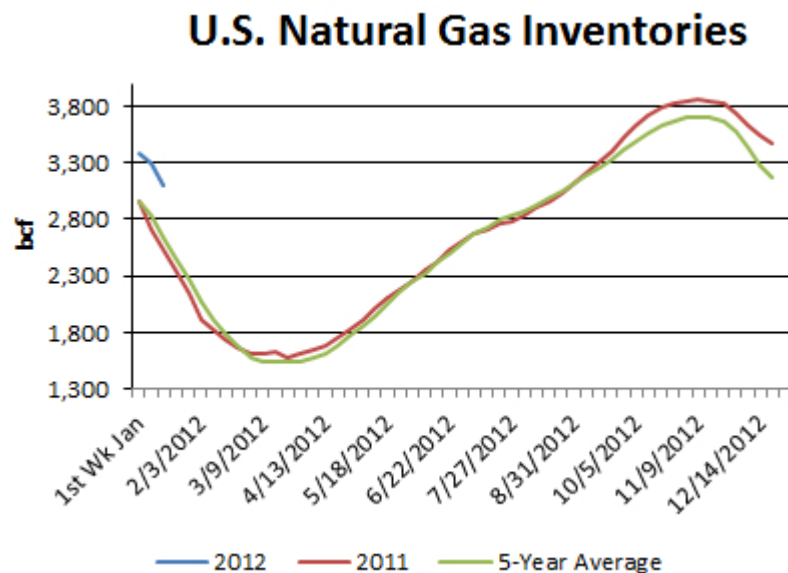
The Energy Information Administration (EIA) reported today that storage operators withdrew 192 billion cubic feet of natural gas from storage in the week ending Jan. 20. That was above estimates that were calling for a withdrawal between 171 bcf and 183 bcf, above last year's withdrawal of 174 bcf, but below the five-year average withdrawal of 200 bcf. After last week's withdrawal, the inventories now total 3098 bcf — by far the highest level ever recorded at this time of the year.

U.S. inventories are now 556 bcf above the year-ago level and 463 bcf above the five-year average (calculated using slightly different methodology than EIA).

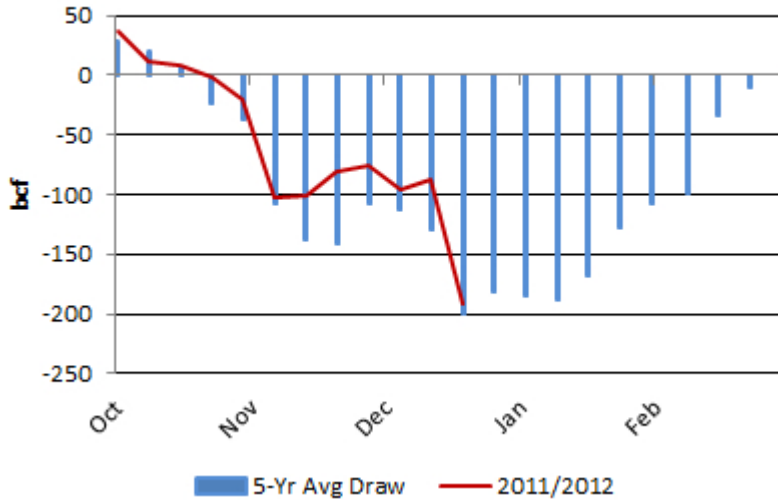
The natural gas market is facing the biggest natural gas glut in recent history. A combination of surging production and extremely mild temperatures this winter have led to record inventory levels. In turn, prices have cratered to the lowest levels in almost 10 years.

Operators have responded by cutting back future drilling plans, as evidenced by the decline in the rig count. Companies have also noted their intention to cut back in press releases and conference calls during the ongoing fourth-quarter earnings announcement season.

Many of these companies have to cut back. Cash flows are declining significantly amid the slump in prices. At current prices, drilling for natural gas is uneconomic in most cases.



Weekly Draws



Nevertheless, because cash-operating costs are still much lower than current price levels (once a well is already drilled and infrastructure already in place), we haven't seen many instances of producers cutting back production outright.

One notable exception was Chesapeake Energy, the No. 2 natural gas producer, which announced earlier this week that it was shutting in 0.5 bcf/d of production immediately. The company said it could increase that figure to 1 bcf/d if market conditions warranted it.

On net, Chesapeake produced 2.76 bcf/d of natural gas in the third quarter, though it is the gross operator of close to 6.3 bcf/d. In either case, these shut-ins are a significant chunk of the company's production. Relative to the entire North American natural gas market, however, these production cuts alone are not enough to alleviate the current natural gas glut.

Moreover, in the bigger picture, enormous production growth rates of upward of 7 bcf/d (the year-over-year increase in onshore output as discussed in the following pages) are the real culprit in the dismal performance of natural gas.

Granted, mild weather this winter has compounded the bearishness in the market. Arguably, the move below \$3/mmbtu is primarily due to the reduction in demand from the unseasonably warm temperatures.

In the medium term, operators hope that reduced drilling activity will lead to declining natural gas production as output from existing wells decreases.

In the short term, prices will likely continue to fluctuate at extremely depressed levels below \$3/mmbtu as natural gas attempts to compete with coal to alleviate the inventory glut. If the glut persists and the market begins to worry about the possibility of an overflow scenario next fall (much like was the case in 2009), prices could spike even lower, below \$2, to force producers to shut-in production.

Natural Gas Prices 1996 - Present:



Source: Bloomberg