U.S. Natural Gas Markets: Looking for a Spring Fling for Price Satisfaction? February 19, 2009

What seems to be a near regular occurrence of a natural gas price rally just prior to the start of the spring in each year, a so-called Spring Fling, may be what natural gas price contrarians are looking for, especially when the whole world seems to be bearish on natural gas prices. We take a closer look at this phenomenon, and conclude that there may be some merit in taking a short-term contrarian price view, despite current price bearish fundamentals.

Key conclusions from this research note include:

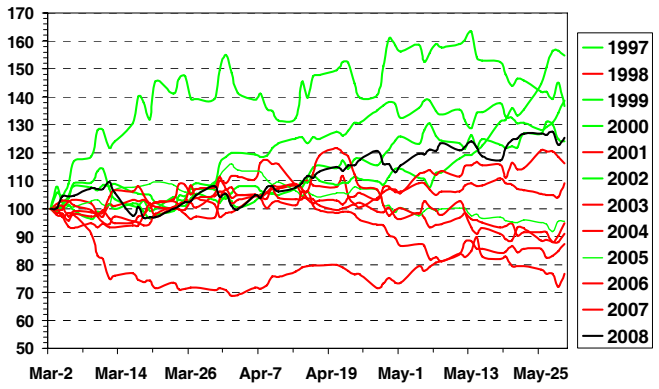
- Over the past 12 years, there has been virtually no connection between the absolute level of natural gas in storage and relative near month natural gas price performance at the start of the storage injection season.
- Eleven of the past 12 years have generally seen natural gas prices flat to higher between the start of March and mid-April. The only true down year, 2003, was one in which U.S. gas storage started the injection season at a record low level (contrarian in its own right).
- The start of the injection season is when storage refill uncertainty is at its highest and price downside conviction is at its lowest.
- Despite what is shaping up to be a very bearish looking year for natural gas prices in 2009, those that are looking for a contrarian short-term view on natural gas prices have previous relative price performance and some basic short-term fundamentals to suggest a short-lived natural price rally is possible this spring.
- Ultimately, the bearish fundamentals over the course of the 2009 injection season will cap any price rally, should one occur.

Thinking the Opposite? We have had a number of questions from our client base regarding the possibility of taking a contrarian view on natural gas prices (and natural gas levered equities) since everyone on planet Earth seems to be bearish on North American natural gas prices. Ultimately, **we remain bearish for 2009, seeing high and very comfortable storage levels throughout the year as weighing on natural gas prices and preventing any kind of sustained rally from taking hold.** The reasons for our price bearish view for 2009 include record high gas storage levels in Western Canada, slowing but still positive U.S. domestic supply growth in the first half, more LNG imports as the year progresses, and soft domestic demand.

Putting that aside, is there any real connection between short-term movements in natural gas prices and storage levels as the injection season gets underway?

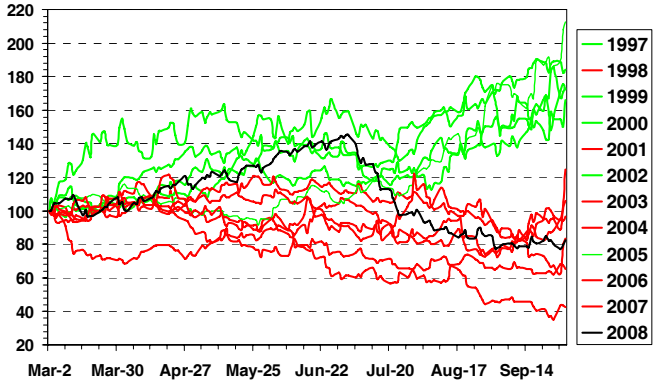
Relative Performance. We have plotted in Figures 1 and 2 the relative performance of the near month Nymex natural gas futures contract from the beginning of March to the end of May, and to the end of September, respectively, for the years 1997 to 2008. This would roughly capture the contracts that would trade for the start of the annual natural gas storage injection season (April contract trading in March and the October contract trading to late September). We have plotted a red line for those years where prices ultimately ended lower at the end of the injection season than where it started, and green for higher finishes.

Figure 1: Relative Performance of Natural Gas Prices During the Injection Season - March to May



Source: FirstEnergy Capital Corp., Bloomberg.

Figure 2: Relative Performance of Natural Gas Prices During the Injection Season - March to September



Source: FirstEnergy Capital Corp., Bloomberg.

The relative performance of the front month contract seems strangely compelling in the very short-term (Figure 1). Other than in 2003, contract prices were generally flat to higher from the beginning of March to mid-April. This happened **regardless of the absolute starting point for natural gas storage** as seen in Figure 3, in which we have

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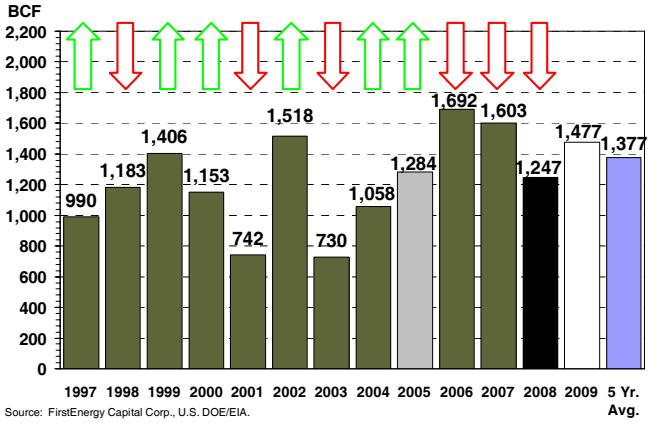
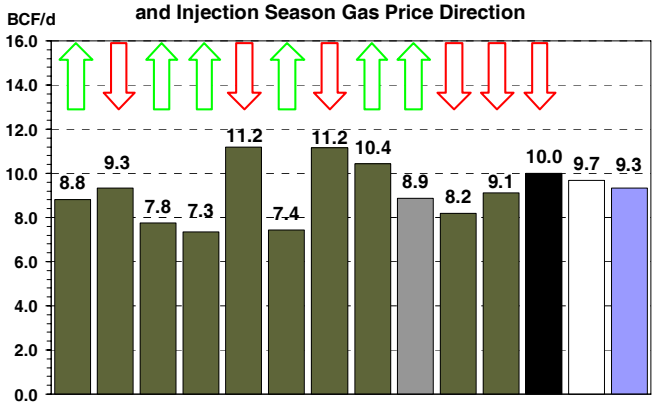
Figure 3: U.S. Natural Gas Storage Levels at the End of March and Injection Season Gas Price Direction



Source: FirstEnergy Capital Corp., U.S. DOE/EIA.

Figure 4: U.S. Natural Gas Storage Injection Rates and Injection Season Gas Price Direction



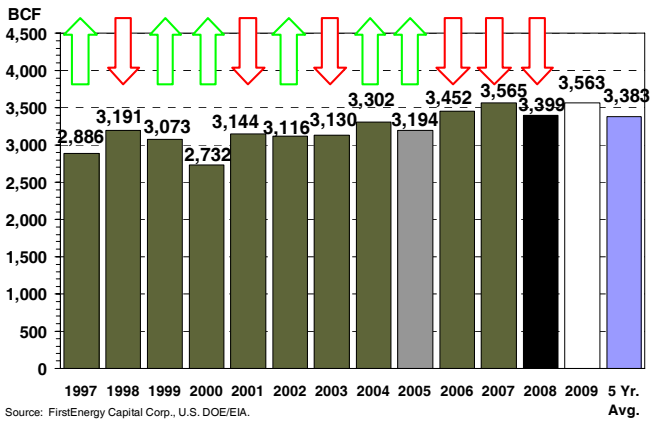
Source: FirstEnergy Capital Corp., US DOE/EIA.

matched the previously mentioned up and down direction for prices with green and red arrows, respectively. Taking into consideration 2003, it was a year in which injection rates were the highest seen in the past 12 years (Figure 4). Early average injection strength quickly undermined prices even though March 2003 began the storage injection season at the lowest level on record (a contrarian price result!).

The reason for prices generally holding flat to moving higher at the start of the injection season (i.e. April contract trading in March) regardless of the level of storage, is simply that no one knows what will happen over the course of the injection season, where storage levels will ultimately finish at the end of October, and what weather events may derail storage injection activity. **Uncertainty is at its highest and overall conviction for lower prices at its lowest when the injection season and April contract trading get underway.** Hence, prices hold steady or rise in anticipation what may lay ahead for the injection season.

Over the course of the injection season to the end of September (the expiration of the October contract), **the winners and losers become much more clear with up and down years being clearly segregated by the end of July** (Figure 2). By this time, summer heat begins to peak for the

Figure 5: U.S. Natural Gas Storage Levels at the End of October and Injection Season Gas Price Direction



Source: FirstEnergy Capital Corp., U.S. DOE/EIA.

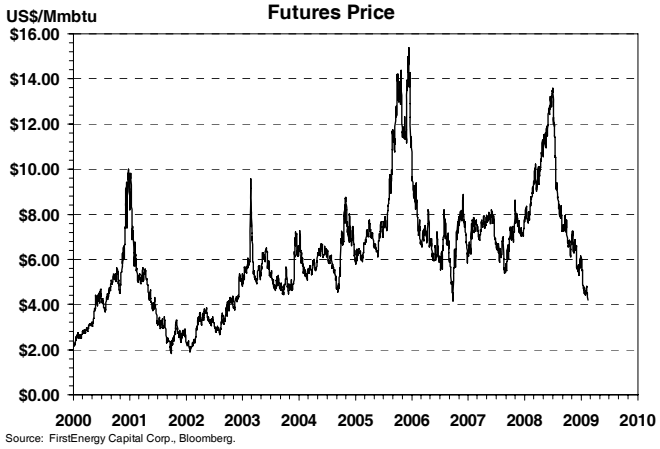
air conditioning/power generation season and the market has some early sense for how active the hurricane season might be. Furthermore, as shown in Figure 5, **end of October gas storage levels have proven not to be a hard and fast rule as it relates to price direction over the course of the injection season.** Of course, the relatively high storage levels of the past few years have tied in well with ultimate price direction even though these years did have upward price momentum in the early going of the injection season.

We have deliberately highlighted 2008 with a black line and black column in Figures 1 to 5 as it is a somewhat special case. After having one of the best relative price performances to the end of June in the past 10 years, prices later succumbed to the end of the credit bubble and were pulled down into the selling frenzy of H2 2008.

Storage Activity. Some additional comments are worthwhile for our three storage plots in Figures 3 to 5. **2001 was a recession year** (mild), **but followed the first major gas price spike in 2000**, in which industrial natural gas demand took a major hit (both price and economy related). It also explains why storage injection rates hit a record in that year, even though gas storage levels started April 2001 at a very low level. **2005, highlighted in grey, was another exceptional year in which Hurricanes Katrina and Rita wrought never-before-seen damage** upon natural gas producing infrastructure in the Gulf of Mexico. 2006, was the year following the massive hurricane-induced price spikes of 2005, further blunting industrial demand and came on the heels of what was one of the warmest winters on record in the past 100 years (2004-05).

We have deliberately highlighted 2008 because it was also an unusual year, with a massive price run in the first half, followed by an even more massive price implosion in the second half. Prices ultimately finished much lower than where they had started the injection season. As for **storage activity in 2009**, we have highlighted our forecast

Figure 6: Near Month Nymex Natural Gas Futures Price



Source: FirstEnergy Capital Corp., Bloomberg.

with the white column using our monthly U.S. gas model produced for January 2009. We are clearly looking at relatively healthy storage injections and healthy exits for storage levels at the end of March 2009 and the end of October 2009. Keep in mind that 2009 will be a year, at least in the first half, marked by recession in the United States, but is also a year in which natural gas prices may be starting the injection season at some of the lowest levels seen in more than six years (Figure 6).

Conclusions. What can we conclude from this analysis? **The absolute amount of natural gas in storage has virtually no bearing on natural gas price direction at the start of the injection season.** The market simply has too little information at its disposal to know how fast storage will rise and to what level by the end of October. **Maximum injection season uncertainty, generates the lowest conviction for price downside during March and early April in nearly every year.**

Only one year in the past 12, 2003, has seen prices make an immediate sharp drop from the start of March and it was a year in which storage started the injection season at the lowest level on record! All other years finished flat to higher by mid-April. In this sense, **there may be a short-term trading opportunity for those looking to go contrarian on natural gas prices and gas-levered equities at a time when it seems everyone and their goldfish is price bearish on 2009.**

Adding to that potential short-term opportunity are some basic fundamental reasons. Natural gas prices in most basins in North America are currently at or well below marginal supply cost and drilling economics have been severely negatively impacted. A reduction in U.S. domestic supply growth and negative trends are likely on tap by the middle of this year. Economic recovery is possible in the second half of this year, at least according to some views on the Street. Natural gas prices are currently low enough to potentially fend off any real challenge from oil-based competing fuels and are actually competitive against coal in some markets, especially with maintenance season approaching for the power sector and its coal-fired and nuclear units. This is supportive of gas burn in the power generation sector. **For the contrarians in the room, this just might provide some ammunition to make a case for a short-term rally in natural gas prices, even when all seems lost.**

Ultimately, fundamentals will rule the day. On that basis, our view that natural gas storage levels in Canada and the United States will remain very comfortable and will set the bounds for any natural gas price rally, should one actually occur. For that reason, **any short-term price upside should be capped over the course of 2009. Of course, that doesn't mean that a rally can't occur, even a short-lived one.**