

Natural gas costs unlikely to remain low through 2011

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When Arthur Berman argues that natural gas is destined to have better prices in 2011 than it had in a mediocre 2010, he isn't talking about technical price charts, or historical correlations, or relative valuations, or even supply-and-demand balances.

No, his view is more down to earth. He's talking about geology.

"I'm a working petroleum geologist, I'm not a financial analyst," said Mr. Berman, a prominent Houston-based energy consultant whose controversial views on the North American shale-gas phenomenon have raised eyebrows in the industry. "We probably have a lot less natural gas resource than is commonly believed.

"So, what I see is that natural gas prices will not remain depressed. I'm not a price forecaster, but I have every reason to believe that a long position in natural gas [investing] is a smart position."

The natural gas pricing story has been all about shale gas in 2010, and its fate in 2011 is closely tied to this big wild card, too. Thanks to advances in drilling technology for extracting gas from seams in shale rock, there has been a rapid expansion of drilling in shale plays that were once considered impossible to economically exploit.

The resulting boom in production has unleashed substantial new supplies on the North American marketplace, outstripping demand and bloating inventories. Volumes of gas in U.S. storage facilities swelled to record levels last month – 40 per cent higher than they were 10 years ago, almost 20 per cent higher than five years ago – even as gas consumption has rebounded to near pre-recession levels.

That kept natural gas prices low and in decline for most of 2010. Even with the high-demand winter season approaching, prices struggled to stay above \$4 (U.S.) per million British thermal units on the New York Mercantile Exchange well into December – their weakest December prices in nearly a decade.

The majority of industry analysts believe the shale-gas boom will continue to keep supplies well above consumption levels in 2011, weighing down natural gas prices.

"The fundamentals of oversupply are not likely to change in 2011," said Peter Tertzakian, chief energy economist at ARC Financial Corp. in Calgary.

"Since we expect U.S. natural gas demand growth to come to almost a standstill in 2011 and supply growth to stay in positive territory, the inventory glut remains a concern," said analyst Dominic Schnider of UBS AG in a recent research note.

But a vocal minority – led by the likes of Mr. Berman and renowned long-time oil and gas forecaster Henry Groppe – believe shale gas may be a bubble that could begin to burst in 2011. They are concerned with both the extremely rapid rates at which production from new shale-gas wells drops off, and the high costs of development and production that suggest to them that producers won't be willing to keep up the high pace of drilling in shale plays at these unprofitable prices much longer.

"[Shale] is a great new resource. I don't dispute for a moment the size of the resource or its importance," said Mr. Berman, who, like Mr. Groppe, serves as a consultant to Toronto-based fund management company Middlefield Capital Corp. "What I question is, ultimately, what it will cost to produce the resource."

Mr. Berman's analysis tells him that North American shale-gas reserves have been exaggerated; that "more than half of the commercial reserves are produced in the first year" of each well; and that the full costs for producing shale gas work out to about \$7 per million BTU – far above the current selling price.

He believes companies have been encouraged to aggressively drill U.S. shale plays due to regulations requiring producers to either initiate drilling on their properties or lose them – they want to secure the land. But that won't continue through 2011, he said.

"As I listen to the comments of the executives of the companies that are most active in the shale plays in the U.S., they're all saying that they're going to continue to hold the land through the first half of 2011, and then you're going to see a big decrease in [drilling] rig count," Mr. Berman said. "They're smart people; they're not going to continue to do this beyond the time that they have to."

Instead, he said, companies will redirect their drilling rigs to oil properties, where the cost-to-price equation is much more profitable. That will slow natural gas volumes and change market perception of shale's potential, he said – and that will push up prices.

"It would not surprise me to see the end of 2011 start to see a notable recovery of price," he said.

Mr. Tertzakian acknowledges that natural gas prices must eventually revert to at least high enough to cover "the marginal costs of producing natural gas in North America," which he pegs at the \$5 to \$6 range. However, he doesn't see that happening in 2011 – and he doesn't envision a major drop-off in shale drilling or a serious hit to supplies over the next year.

"There's no shortage of gas in the ground. We can debate the technical nuances, but at the end of the day, it takes a certain amount of money to exploit these things – the only restriction is the availability of capital."

He expects some slowdown in natural-gas rig count in the second half of next year could moderate supplies, but that won't do much to make up for what should continue to be a weak market in the first half – making for another year of 2010-like prices.

"Prices in 2011 will be similar to 2010," agreed Bill Gwozd, vice-president of gas services at Calgary energy consulting and analysis firm Ziff Energy Group. "That's not a healthy price for producers – but it's quite nice for consumers."