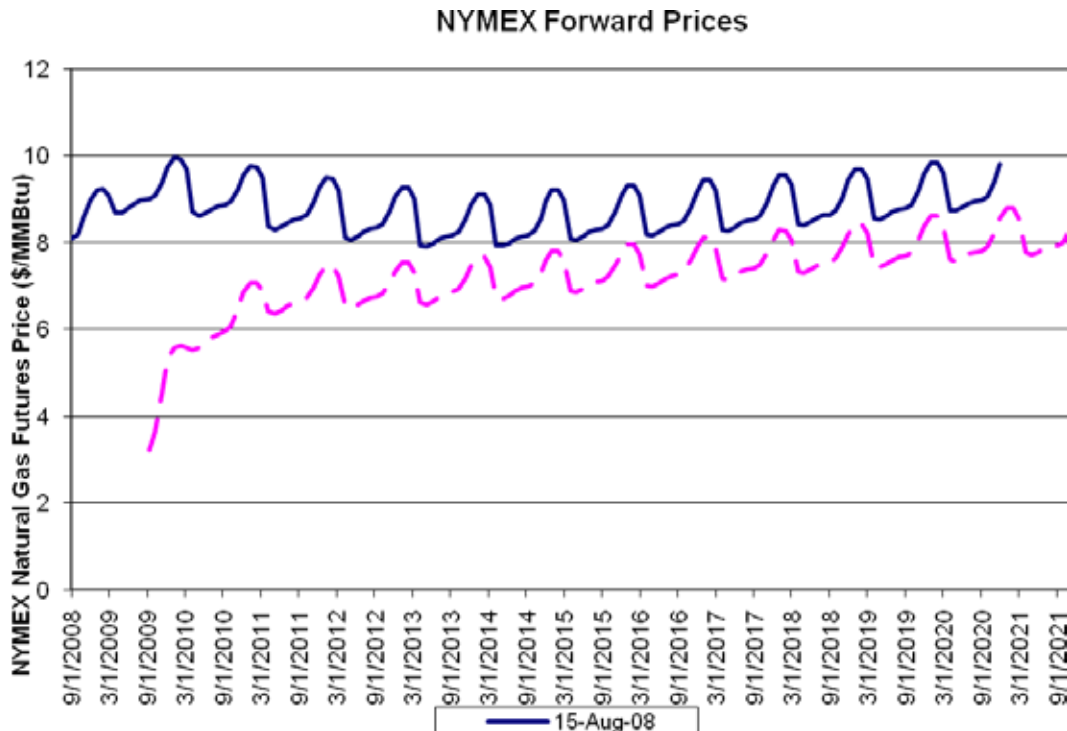


THE DEPRESSED NATURAL GAS MARKET CREATES OPPORTUNITIES
FOR LONG-TERM PRICE HEDGES

As the chart shows, despite the sharp decline in natural gas front month NYMEX prices over the past year, the out-year prices have remained relatively steady. This is an expression of the traders' expectations of future values compared to the current depressed prices. To the large natural gas consumers currently acquiring supplies for the upcoming peak period, the current prices provide a respite from the higher prices of recent years. However, in addition to the lower current prices, the current-future price differential creates an unusual opportunity for the large consumer to hedge forward prices by taking a position on the supply side and locking in the lower market values.



The current market prices are at levels not seen for seven years, driven significantly by the recession-depressed natural gas demand, especially in the industrial sector. Still, some other

factors have contributed in forcing down the current values, as well. For example, lower fuel oil prices have deterred some customers from switching to natural gas which might have occurred in earlier markets. Although natural gas drilling has declined by approximately 50 percent compared to the peak in the last year, any impact on production has not offset declining demand. Lower finding and production costs and production from shale deposits contribute to maintaining more than adequate supplies at current prices. Additionally, the hurricane risk premium appears to be lower than in recent years if it currently exists at all.. Gas-in-storage has reached unprecedented levels and continues to depress the spot market prices prior to the forthcoming heating season.

Obviously the financial market participants taking longer-term positions believe that these market influences are short-lived. Expectations of worldwide economic recovery, potentially higher oil prices and the delayed production effects from reduced drilling are surely among the influences supporting longer-term forward prices. Nevertheless, to one who expects these price expectations to materialize, the current low natural gas prices create an unusually attractive, probably temporary, physical hedging opportunity. This is an exceptionally attractive forward acquisition alternative for large credit-worthy natural gas end-users. That is, the physical forward market hedge can be especially attractive for well-capitalized end-users that need gas supplies for the foreseeable future.

Ironically, taking a longer-term physical position for some portion of estimated future consumption can mitigate price risk by diversifying the longer-term portfolio. This distinguishes the long-term end-user from a speculator buying gas in a depressed market with the intent of liquidating when prices move toward historical levels. Instead, the current-future price differential affords an opportunity to diversify the forward purchase of a portion of a known

future gas requirement at current relatively low prices. This is a relatively low-cost price risk mitigation of the natural gas portfolio.

One can take a supply side position at the current market values at several points in the physical supply chain. For example, acquiring reserves, participating in a drilling program or buying future production are alternative vehicles to lock in current values. Of course, any physical supply investment takes on supply side risks, which are probably new risks for end-users. This is the principal trade off in locking in current market values for the future, and depending on the investment choice, the risks differ. For example, investing in reserves or drilling programs are likely to embody risks of achieving the estimated ultimate recovery, drilling and production costs and gas quality. Also, the investor need can use the reserves as a physical hedge without taking direct delivery of the gas supply. This poses a basis risk, which is the changing price spreads between regional trading hubs. Although carefully structured production contracts may mitigate many of the risks of recovery, drilling, production and gas quality, they are likely to result in prices that compensate suppliers for assuming those risks. As with any investment alternative longer-term gas supplies require a risk-return evaluation.

Each longer-term physical hedging opportunity is unique because of the physical locations of the end-use facility and the potential gas supply, the end-user's gas requirements and risk profile and tolerance. Nonetheless, under the right circumstances a long-term forward physical hedge can be an effective low-cost diversification of natural gas supplies and a form of future price risk mitigation.

