8/29/08 Globe & Mail (Toronto Can.) B1
2008 WLNR 16326144

Globe and Mail

August 29, 2008

Section: Report on Business Column

How the summer of shale changed the natural gas game

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OTTAWA

As natural gas prices soared last spring, Ontario government officials contacted the province's gas distributors, looking for assurances about price and supply.

Ontario relies on natural gas for 16 per cent of its power, and expects to increase that share significantly to replace coal-fired generation and complement the growth of renewable sources like wind and hydro. But as prices climbed to near-record levels, officials began to fret their natural gas bet would leave the province vulnerable to dramatic price hikes and potential shortages.

In response to these concerns, the province's two biggest gas distributors offered two words: **shale gas**.

It wasn't so long ago analysts were anticipating declining North American gas supplies. But those gloomy forecasts are being revised to reflect booming development of unconventional gas reserves, notably those trapped in hard-to-tap shale rock.

Driven by sharply rising **shale gas** volumes, U.S. production of natural gas is on track to rise by more than 6 per cent this year. In a jointly funded report, the gas distributors say North American production is now expected to increase 16 per cent by 2015, and 30 per cent by 2030. The prospect of booming production has triggered a dramatic selloff in natural gas futures, bringing prices 40 per cent below their July peak.

The steep decline may be tested this weekend by the prospect of a hurricane hitting the Gulf of Mexico, but prices are expected to settle in a lower range.

'The shale production story is certainly a good news story,' said Malini Giridhar, director of energy policy and analysis at Enbridge Gas Distribution, a unit of Enbridge Inc., which delivers gas to more than 1.9 million residential and business customers in Canada and the United States.

'In 2008, we had some important announcements [regarding discoveries and production of shale] ... and certainly the expectation is that all these unconventional sources will allow for net increases in production, despite what we know is the decline of conventional production in Western Canada and the U.S.'

Earlier this year, natural gas users were spooked when prices followed crude oil into the stratosphere. As crude topped $145 (U.S.) a barrel in early July, natural gas prices moved in tandem, breaching $13.50 per million British thermal units (BTU) and approaching the record $15.38 hit in 2005, after the devastating hurricane Katrina.

Then the market appeared to catch up with the industry's 'good news story' this summer. After topping out in early July, natural gas prices fell more than 40 per cent to a low of $7.61 per million BTU at the beginning of this week.

But in the past few days, prices have started creeping higher as tropical storm Gustav approached the Gulf of Mexico, where a quarter of U.S. oil and gas production is located. Yesterday, gas futures on the New York Mercantile Exchange closed at $8.05 amid forecasts Gustav would gather strength to hurricane level.

While gas prices rose in tandem with soaring crude through the first half of the year, that connection has been broken, with the gap between crude and natural gas prices at its greatest on an energy-equivalent basis.

A barrel of light crude oil supplies six times the energy of a million cubic feet of natural gas. Typically, prices for the two fuels have moved roughly in tandem, with a barrel of oil costing about eight times more than a million cubic feet of gas.

Now, crude oil futures are trading 14 times higher than the natural gas contract – a yawning gap that reflects the tight supply-demand fundamentals and higher political risk in the global oil markets, and the more balanced natural gas market, which is essentially North American in scope.

'There is this disconnect between the two prices compared to what historically has been the case,' said Greg Stringham, vice-president with the Canadian Association of Petroleum Producers.

'Natural gas prices are reflecting a much stronger supply picture, and oil prices are reflecting a much greater degree of uncertainty and tighter fundamentals.'

The natural gas market got a pump-priming boost three years ago, when hurricanes Rita and Katrina knocked out some 25 per cent of U.S. oil and gas production, sending prices soaring.

The higher prices sparked a North America-wide drilling boom and, in the United States, the targets were shale deposits that had long been known to contain large quantities of gas but were considered too costly to develop.

Now, producers in Texas's prolific Barnett shale can make a profit at prices as low as $6.50 per million BTU.

'When you start to drill the holes in the ground, you start to improve the technology – all the techniques you need to get at the gas – and costs start to come down,' said Kenneth Medlock, an energy economist at Houston's Rice University.

Other shale plays also look promising. They include the Fayetteville deposit in Arkansas, Woodford in eastern Oklahoma, **Marcellus** in western Pennsylvania and even the Montney/Horn River basin in northeastern British Columbia.

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Language: EN

Other Indexing: (CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS; ENBRIDGE GAS DISTRIBUTION; ENBRIDGE INC; FAYETTEVILLE; NEW YORK MERCANTILE EXCHANGE; RICE UNIVERSITY) (Driven; Greg

Stringham; Katrina; Kenneth Medlock; Malini Giridhar; Ontario; Pennsylvania; Rita; Typically; Yesterday) (Ontario; Canada; United States)

Keywords: (natural gas industry); (oil); (exploration); (prices); (statistics)

Word Count: 1008

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