Outlook for UK winter gas market 2006

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Heren Energy

What Heren does

- Publishers of daily gas, power and carbon market reports, the weekly LNG newsletter *HLM* and bi-monthly magazine *European Gas Markets.*
- Publishers of the Heren Index for NBP, Zeebrugge and TTF (day-ahead, weekend and monthly benchmarks for all 3 markets).
- Independent and impartial.
- UK spot gas price series from January 1994 to the present.
- Primary OTC gas price index at NBP.

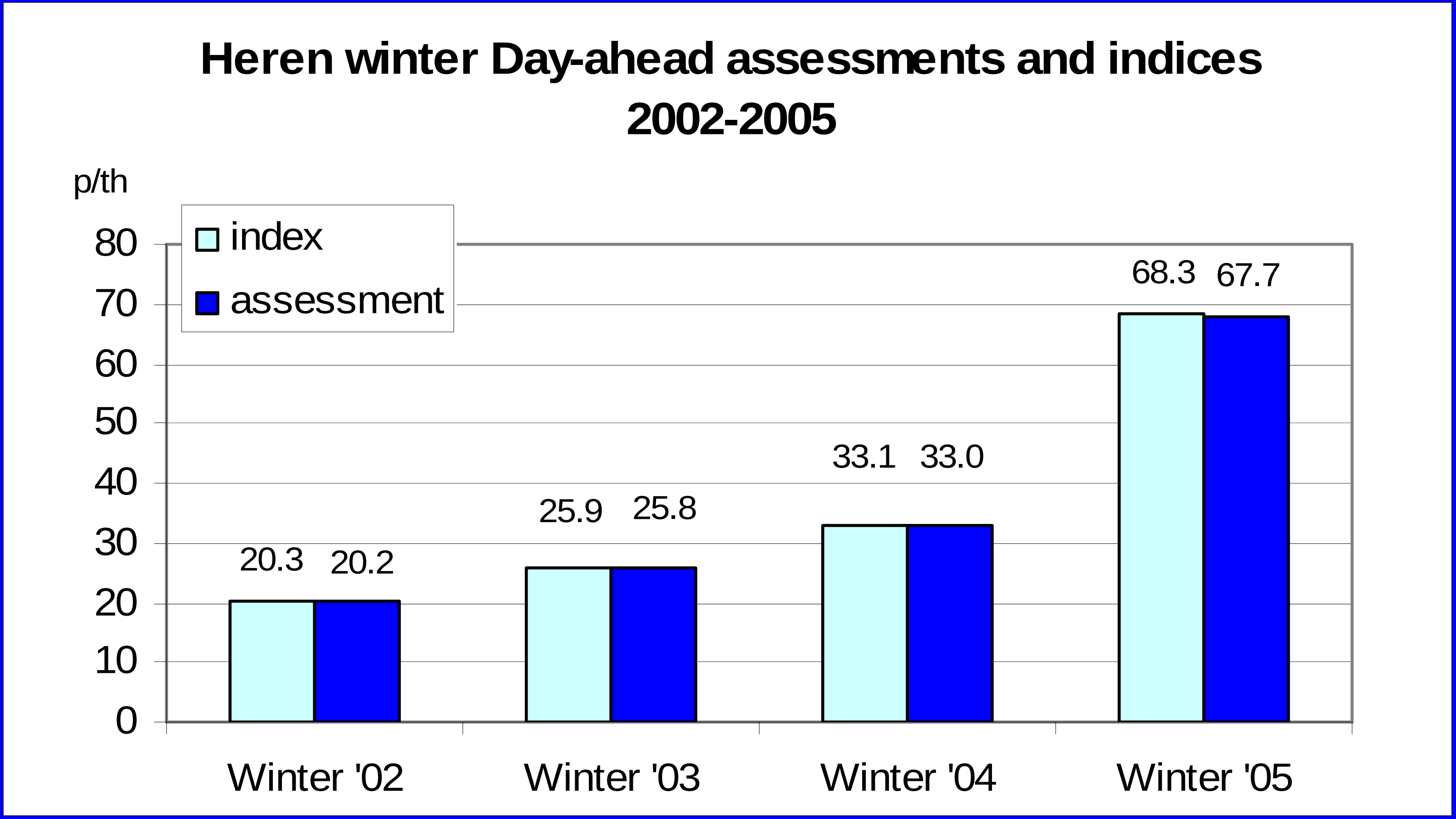
Heren methodology

- Old-fashioned: we talk to people (10-25 traders per day per market).

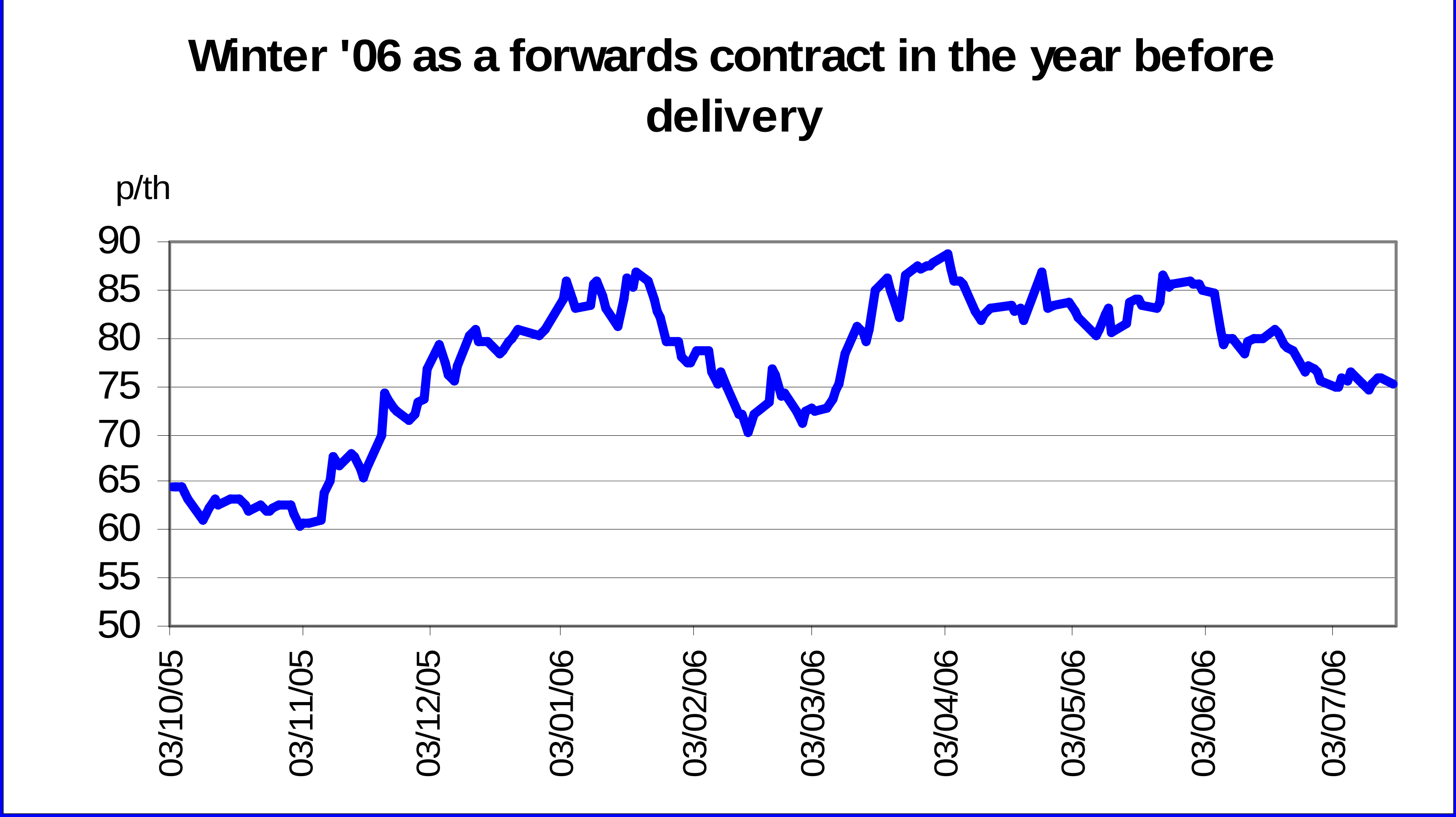
Two types of pricing point:

1. Price assessments: market-on-close (bid-offer at 1630 hrs), from D-1 to 5 years out.
2. Heren Index: volume-weighted average of deal prices.

Day-ahead winter prices



Development of Winter '06 contract



But does this mean anything?

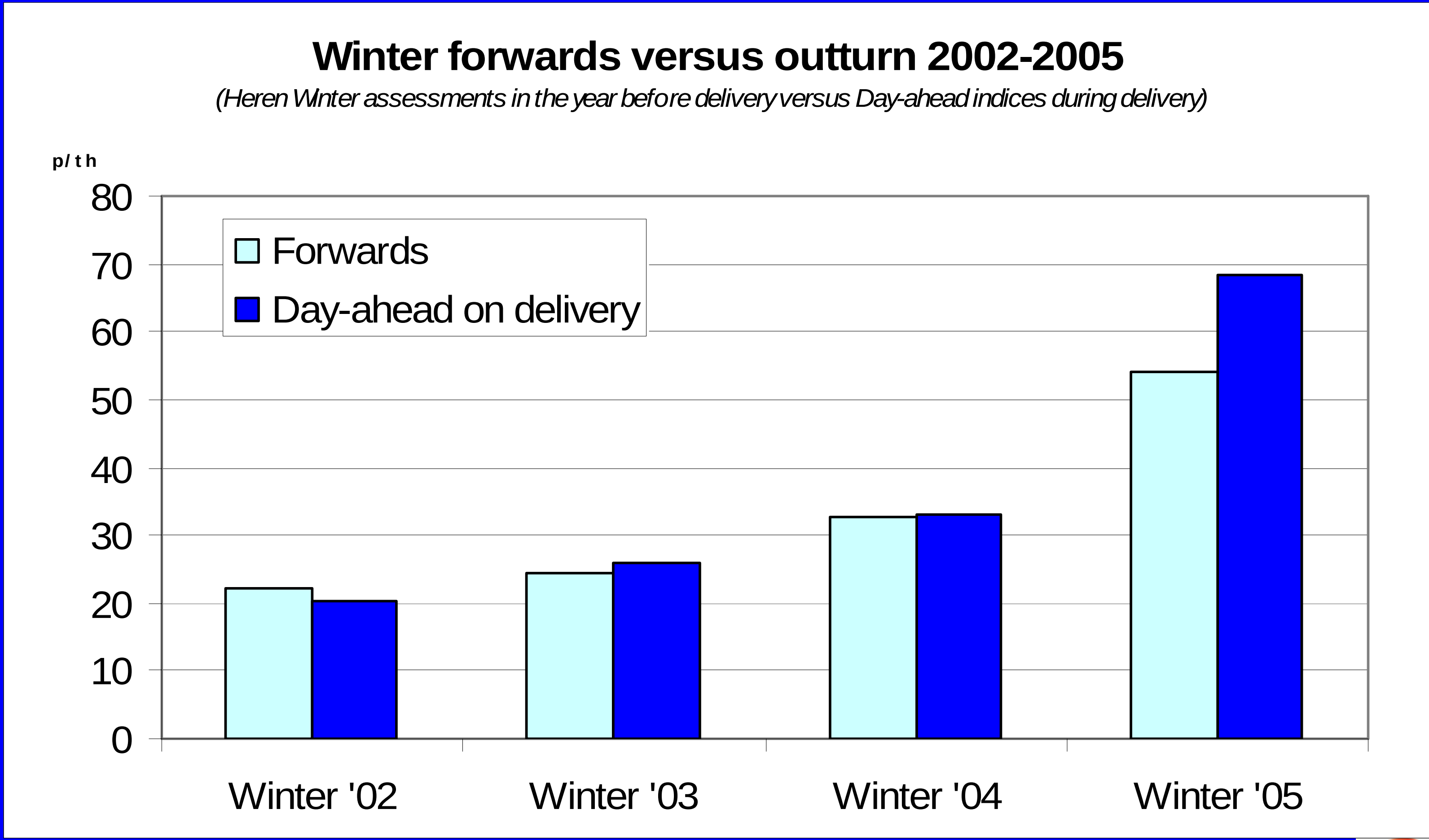
The forwards price is not a forecast.

- The forwards market is extremely volatile and subject to squeezes.
- The market is immature (compared to oil markets for example) with relatively thin liquidity.
- Sentiment can lead to bull runs and sell-offs not based on market fundamentals.

Take it or leave it, but correlation good until 2005

- Sudden fundamental changes in the UK gas supply/demand situation have undermined value of historical analysis.
- But for the past few winters the forwards market has not **overstated** eventual outturn for the season.
- The correlation was very close until 2005, when the forwards price significantly UNDERSTATED actual outturn.

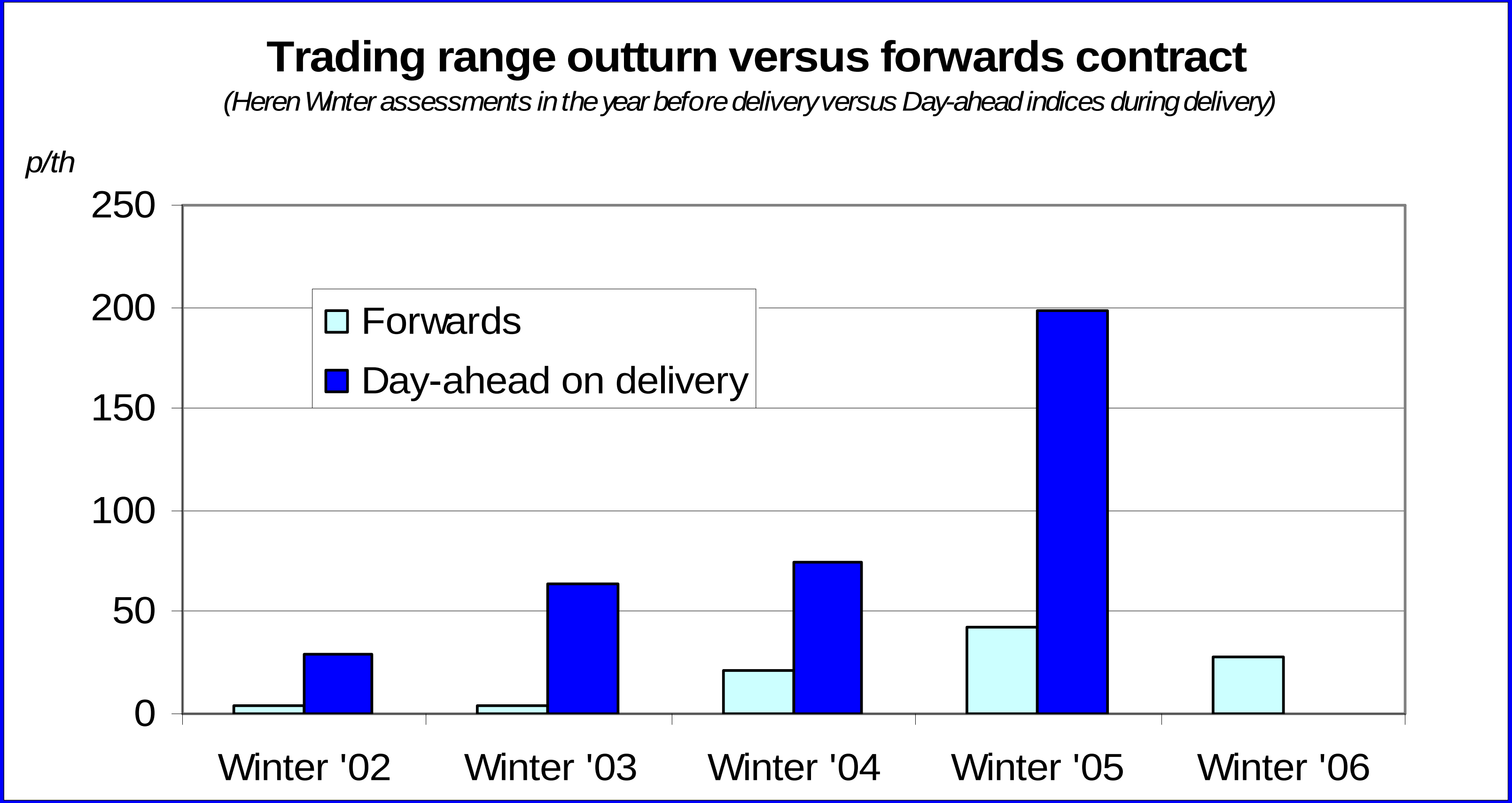
Winter '05 delivery outstrips forward price



Is uncertainty the only certainty?

- Volatility of the forwards contract has increased massively.
- The step change came in 2004.
- This has reflected the increasing volatility in price on delivery as North Sea flows have become less reliable.

Volatility rise on forwards market outstripped by day-ahead



Winter ’05 forwards volatility reflected real uncertainties

- Volatility has so far been lower for Winter ’06 than it was for Winter ’05 on the forwards market.
- The volatility of the Winter ’05 primarily reflected real uncertainty over fundamentals.
- In the 6 months before delivery it averaged 63.3 p/th, 5.00 p/th below outturn.

Why has Winter '06 been more stable?

- There are arguably even more supply uncertainties this year.
- BUT traders have become more used to the high price environment – the fear factor is lower now we have got through the first really tight winter.
- Last winter showed the demand-side response working on high price days.

…continued

- Buyers getting wise – seem to be spreading buying across summer months so no big buying sprees.
- This has also limited opportunities for speculators to squeeze these buyers.
- Speculators were able to exploit this as producers sold forward less (first noticeable in 2004). There has been more equity selling of Winter ’06.

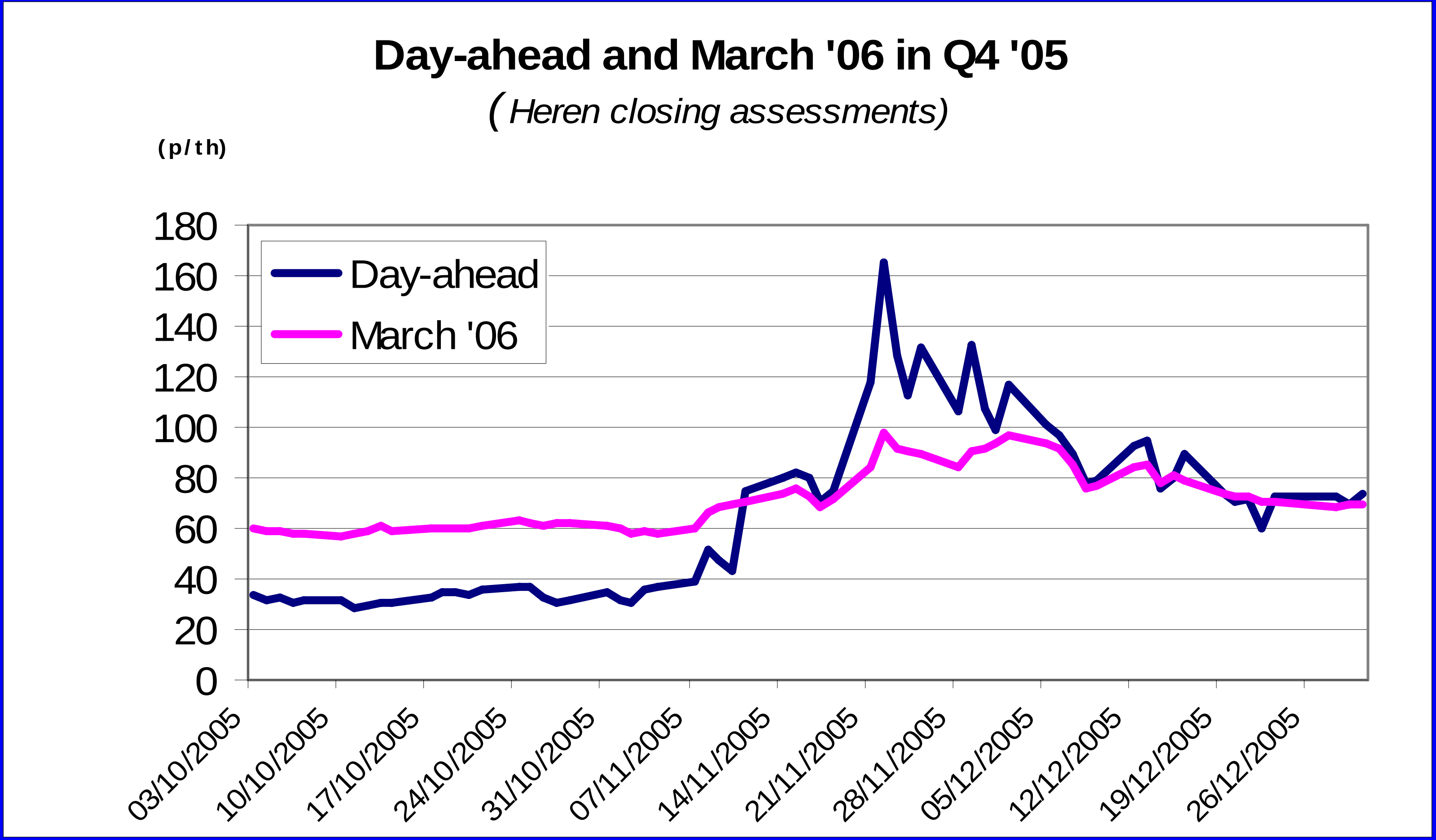
Is there actually more risk in Q4 than Q1?

- Last winter the UK relied upon storage withdrawals to balance in November.
- Although the Day-ahead averaged 91.7 p/th from 11th November to end December, Interconnector nowhere near full.
- It's not just continental companies but UK suppliers that need to hoard storage until Q1. This is unlikely to change this winter.

The Q4 vicious circle

- If the NTS needs storage gas in Q4 the prompt price will have to come above March for Rough to come out and probably February for medium range.
- As the prompt goes up, the Q1 goes up, starting a vicious circle of rising prices (see next graph).
- This is one reason why forwards traders are unlikely to sell Winter ’06 aggressively before delivery.

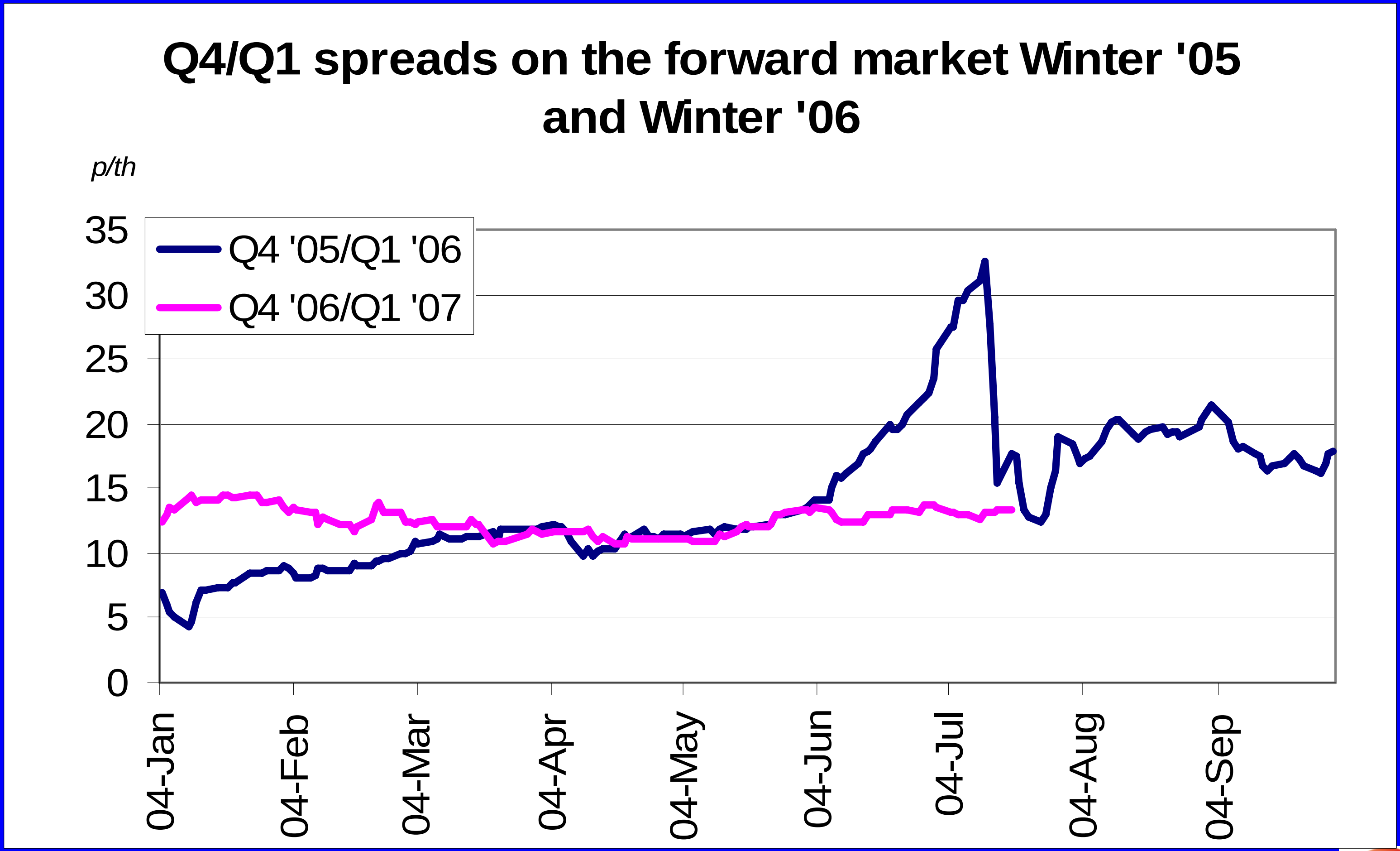
Last November Day-ahead rose above March



Q4 ’06 to Q1 ’07 spread

- This spread has traded in a range of 10.65 p/th to 14.55 p/th this year and is now at 13.30 p/th.
- Last year’s spread traded in a range of 4.25 p/th to 32.55 p/th.
- It outturned at 5.90 p/th.
- The spread is traditionally a bull play in a rising market.

Next winter spread much less volatile



Is the spread overdone?

- The weather risk for January and February seem to be outweighing the likelihood of more storage availability in Q1.
- The market also remembers the late winter cold snap in Q1 ’05.
- Some trading companies may just not have changed habits – always buy the Q1 when Winter goes up.

Winter ’06 is now 7.00 p/th above the previous winter outturn

Is the premium unjustified given extra import routes due onstream?

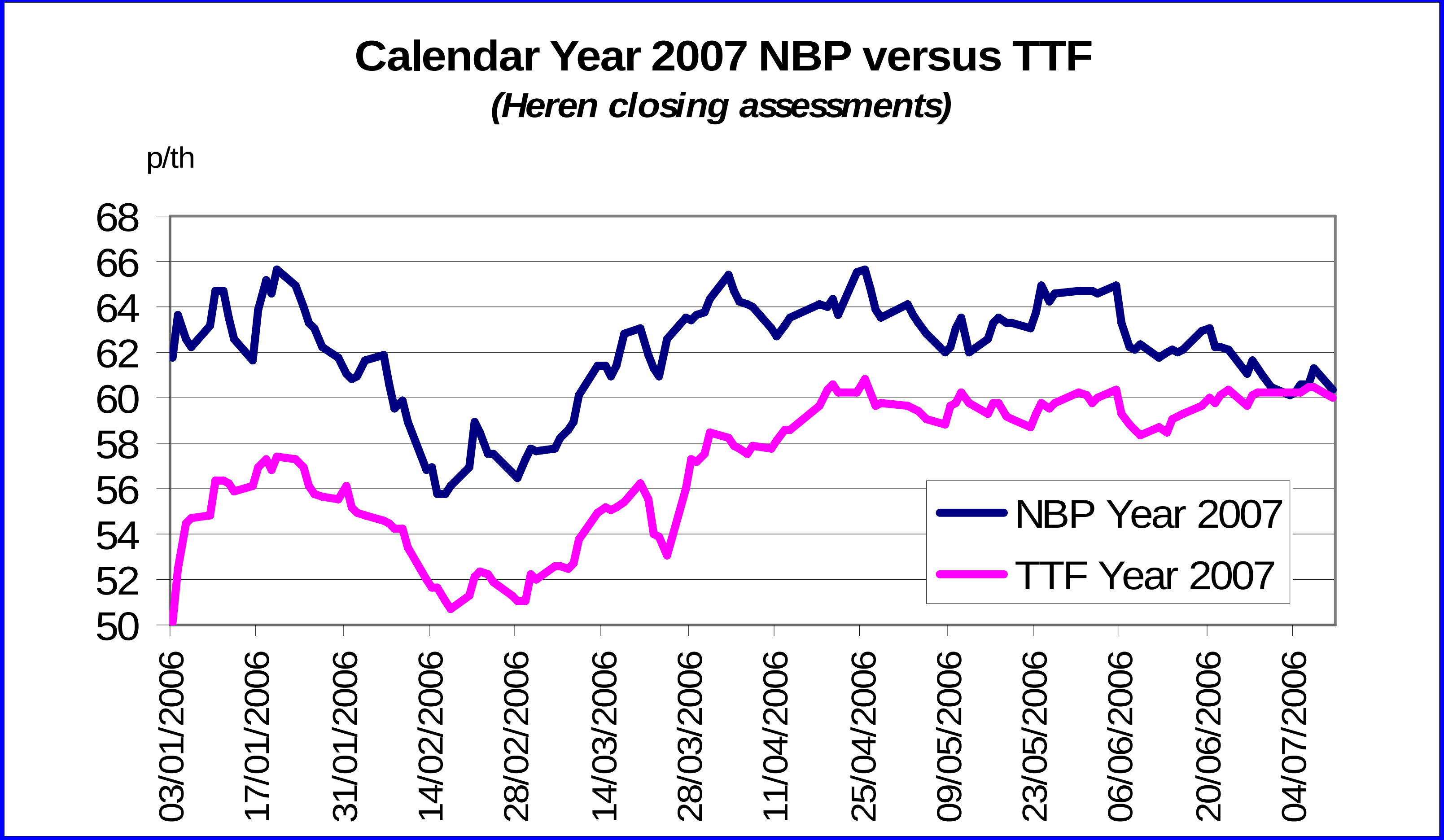
The bullish arguments

1. Uncertainty is always bullish on markets. Some has dissipated as Rough has come back but the market is waiting for the new pipelines to start flowing gas.
2. Last year temperatures were above seasonal normal. The one in ten threat remains.
3. BBL start up delay. The market appears to have priced in the planned December start up to a large extent (see following graphs), any delay announcements will be bullish.

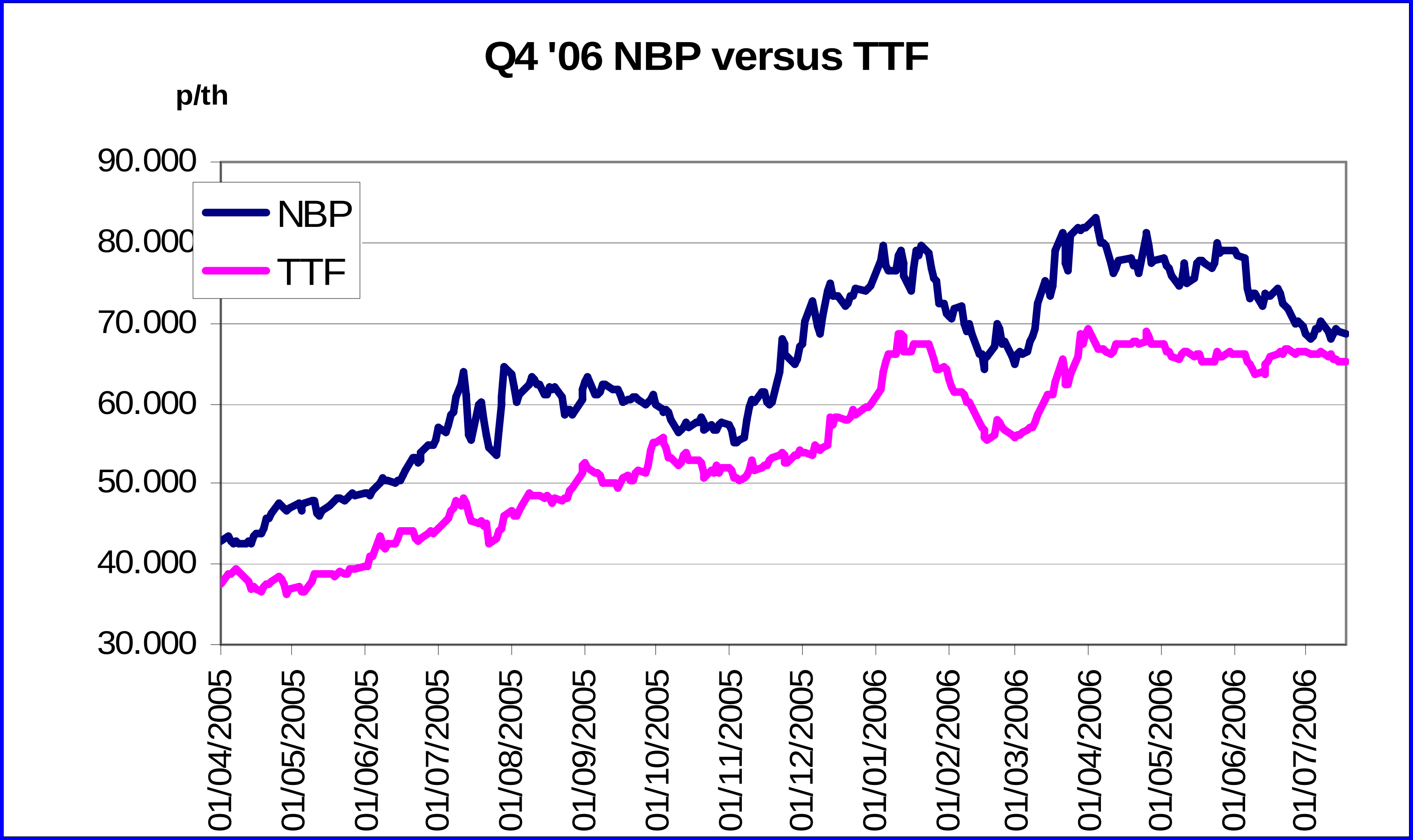
…bullish arguments continued (the oil effect)

4. Demand side response last winter but the majority came from CCGTs. Oil switching only kicked in above £1.00 /th – the oil price is higher this winter.
5. The continental contract price is already higher because of oil, meaning the theoretical floor for the NBP is higher this winter. And some of these contracts are still pricing in.

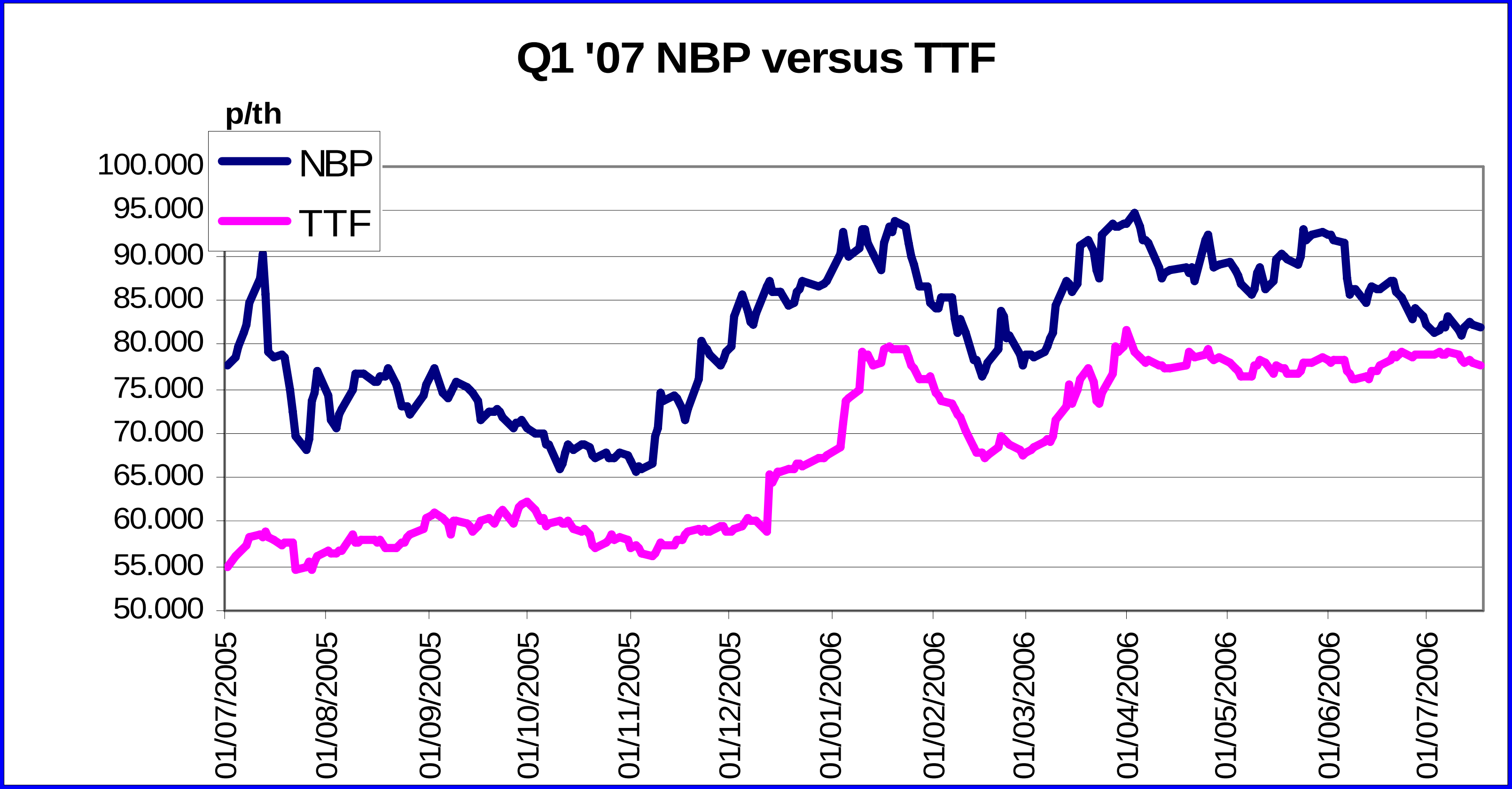
Cal '07 TTF and NBP near parity since June



Q4 '06 converged to near transport cost



Similar development on Q1 '07



The bearish arguments

- This winter shouldn't be above last winter as there is more import capacity.
- Companies have been able to plan better to reduce demand – expect more turn-down.
- The market has not priced in additional flows from the Interconnector – but they could arrive in theory.
- Companies nearly always overcompensate for tightness in a previous winter.
- There is more storage space (Humbly Grove).

Sentiment is bearish for outturn

The arguments for a lower price on delivery than the current forwards contract seem weightier.

WARNING!

Traders said the same thing last year and the market outturned higher. Good bearish arguments don't necessarily lead to a sell-off of the forwards contract. It's easier to lose money going short – lesson learnt.