Daily Oil Bulletin

Weak Natural Gas Prices A Challenge For Producers And Their Hedging Strategies

BY PAUL WELLS (/AUTHOR/PAUL-WELLS/) – JAN. 9, 2018 – VIEW ISSUE (/HEADLINES/2018-01-09)

With uncertainty and volatility the hallmarks of the current natural gas pricing environment, many western Canadian producers faced with continued weak AECO prices and a less than enticing forward strip are grappling with determining their hedging strategies.

Ed Kallio, principal at consultancy **Eau Claire Energy Advisory Inc.**, said that while much of the activity in the Western Canadian Sedimentary Basin (WCSB) is liquids focused and the new petrochemical and export projects will help to clear some of the propane glut, the natural gas price outlook isn't promising if a company is looking to lock in volumes.

“Natural gas is another matter, and forward prices are in the tank — $1.30ish for calendar 2018, and $1.50ish for calendar 2019. It would require a lot of guts for a producer to hedge at these levels after missing higher levels not so long ago,” he said.

“The strategy would be to lock in a higher price/hedge when/if we see a move up. Prolonged cold this winter could help. Or, if one could find AECO to Dawn transport, lock in forward Dawn pricing which nets back higher at AECO,” Kallio added.

“To clear more gas out of WCSB we really need LNG exports but those projects don’t help short term. Oilsands demand will tick up slowly as will Alberta power demand as coal is retired, but the lure of liquids is strong and gas comes with it, prolonging the glut. None of this is good news for gas-weighted producers.”

Gary Leach, president of the **Explorers and Producers Association of Canada** (EPAC), said that for western Canadian gas producers, prices have been a continuing painful story so far in 2018. Especially in contrast to global crude oil benchmarks where optimism has been growing about the direction of oil prices.

“With natural gas transmission lines out of Alberta pretty much full, the prices at which gas is trading hands at AECO and secondary price hubs in the WCSB have been punishing for gas producers, and the futures market for at least 2018 is not offering any comfort despite recent short-term upward spikes due to cold weather,” he said.

“If access to markets boasting better prices has not already been secured through firm transportation contracts, producers have to turn to hedging opportunities to improve cash flow. But that strategy carries some risks and only works until the hedges start to come off into a relentlessly lower price environment.”

Leach added that EPAC has also observed that some natural gas producers are responding to prices by limiting capital spending in 2018, thereby restricting future supply growth as they refuse to sell gas into an oversupplied market.

“However, even disciplined producers who have been regarded as highly efficient and low cost operators will suffer in a North American market where large new supplies of gas continue to enter the market seemingly without much regard for the prevailing gas price, such as associated gas from Permian oil producers and liquids-rich gas production here in Canada,” he said.

“This dynamic seems to have dented the old commodity market aphorism that the ‘best cure for low prices is low prices.’”

A ‘mug’s game’

Bruce Edgelow, managing partner and founder of **EdgeMark Capital and Advisory Services Inc.** and former vice-president of strategic services for **ATB Financial**, said that some natural gas producers are in tough when it comes to hedging in the current market reality.

“There’s still the larger firms that just stayed the normal course because they have a portfolio policy that they have to have ‘X’ per cent of the book hedged and they have an ongoing hedging program and those things just come to market — as the old ones roll off, the new ones come on,” he said.

Edgelow said some producers are in a precarious position, especially if they are waiting for natural gas prices to improve.

"For the producers, some are regular rolling hedgers because they do that all the time. They're just in the market and they just want the hedge protection," he said.

"Then there's a good portion that are waiting for a better day. But to be fair, that's really a bit of a mug's game because no one wants to experience what we experienced through Station 2 pricing or AECO pricing in the summer of 2017."

It's best to be 'nimble'

Bill Gwozd, founding board member of **The Centre for Gas and Liquids Monetization** and former senior vice-president, natural gas services at **Solomon Associates LLC** and **Ziff Energy Group**, has long been a proponent of a strong hedging program. However, with the plummeting natural gas prices endured over the past year or so, it isn't as easy a call as it had been in years past.

"Five years ago **Paul Ziff** [founder of Ziff Energy] wrote up a paper on hedging which we issued for free at that time. We recommended hedging on a regular basis — that producers should take advantage of the higher price today and the lower price in the future by locking in a portion of their gas portfolio," he said.

"That way they will always have some locked-in at a certain price that keeps them viable. And if gas continued to fall, as we predicted at that time, they would be better off."

Fast forward five years and it's a much different scenario facing producers.

"Once gas prices reached some dismal level — 25 cents or 50 cents — then hedging at 25 cents or 50 cents makes no sense at all. So they have to be nimble and be able to lock in volumes of gas on short notice," he said.

"So the best practice we offered was that the traders or the marketers have to be authorized to literally hedge in on 30-seconds notice. [What happens] if they have to go back to a board and say, 'Hey, there's an opportunity to lock in gas at $4, and lock in 50 per cent of our gas at $4.' And it's a Monday at 9:59 a.m. and the board meets a month later and gets back to them eight weeks later and says, 'Yeah, that sounds good.'

"The trader says, 'Well, that opportunity already expired 30 seconds after 9:59 a.m. on that Monday two months ago.' So if they don't have authorization to do it, they will miss out on those opportunities."

While there has to be entrenched protocols to allow traders to lock-in volumes on short notice, Gwozd said many company's don't and can be short changing themselves as a result.

"You have to have some special guidelines set up where they can literally lock in on very, very rapid notice because these deals pop up and then they're gone,' he said.

"And the companies that don't have these best practices in place where they've gone through the financial structure could be losing out because you could be locking up tens of millions of dollars in gas with one click of the button. And for some companies that may be half of their company's value in literally seconds," Gwozd added.

"So your marketers and traders have to have authorization to lock-in on instantaneous numbers for day trading and to take advantage of deals that come through that are just once a week or once a month opportunities. And they happen. Not very often, but they happen."

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