



Winter 2005 - 2006 Natural Gas Market Update

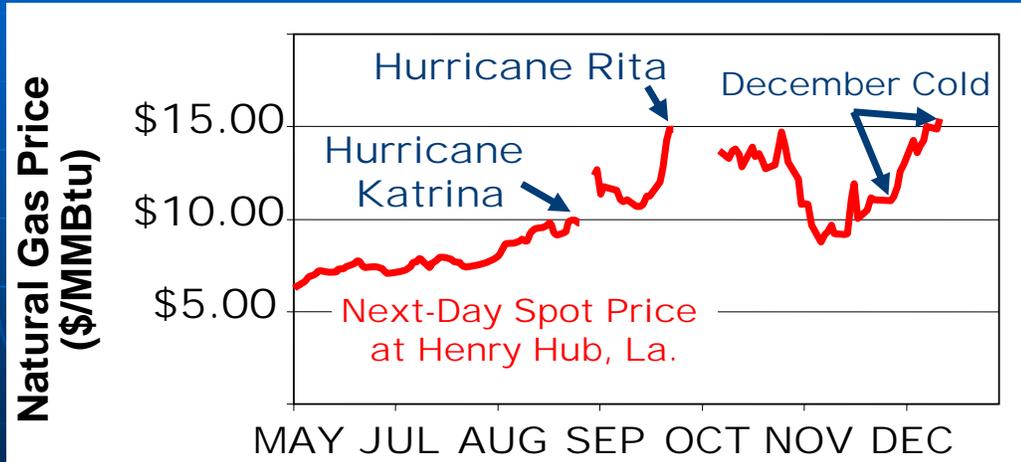
Item No.: A-3
December 15, 2005

Good morning Mr. Chairman, Commissioners.

Today, I'd like to update you quickly on conditions in U.S. natural gas markets as we finish the fall of 2005 and enter the winter itself, and then Jeff and I would welcome your questions.

At the time of the last Commission meeting, we were enjoying what the National Oceanic and Atmospheric Administration has found to be the 9th warmest November since 1895, with temperatures averaging 3°F above normal.

Gas Prices Respond to Colder U.S. Weather

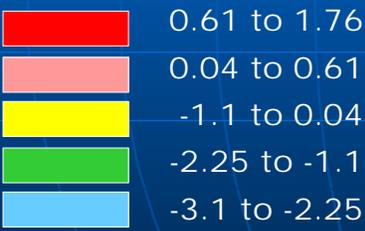


SOURCE:
Intercontinental
Exchange

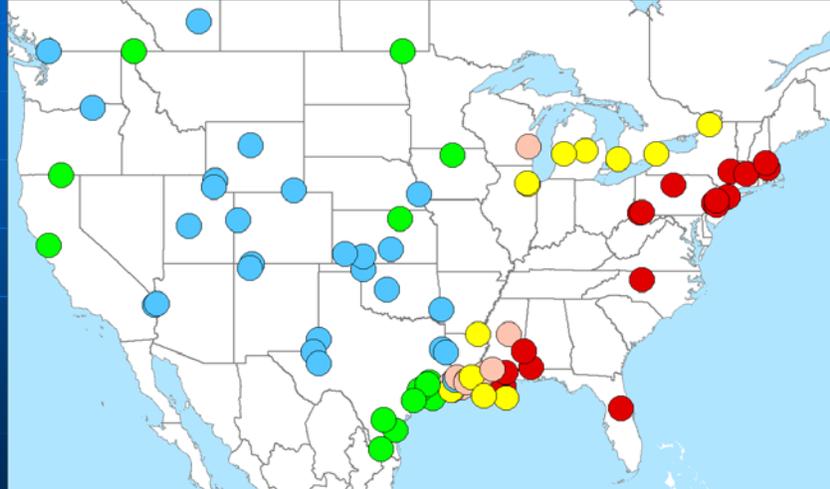
Over the past few weeks, however, we've seen a shift: colder-than normal temperatures across much of the U.S. Consistent with this weather pattern, recent U.S. natural gas prices have increased to post-hurricane highs, which you can see on this graph of next-day spot prices at Henry Hub, Louisiana. Overall, prices appear to be reacting much as we indicated they would in prior briefings; with cold weather resulting in immediate, sharp increases in spot prices.

Geographic Differences in Gas Prices Reflect Supply

Average Basis From Henry Hub after Rita



SOURCES: Bloomberg, Platts



Before discussing the drivers of these high prices, I'd like to consider regional variations in natural gas prices across the U.S. We tend to use the Henry Hub price as a national standard, particularly for the production area; but gas prices vary geographically. The colored dots on this map represent how much higher or lower average prices at those locations have been compared to the Henry Hub price on average for the two months after Hurricane Rita. Rita was particularly disruptive of gas delivery facilities in the Gulf area, and this map shows the implications of these disruptions on prices:

Red dots represent prices that are the highest compared to Henry Hub. Since the hurricanes, they dominate the east coast of the U.S., including Florida and even areas in Alabama and Louisiana. Most of the prices in producing areas of Louisiana are orange, the second highest pricing level on the map.

In contrast, the lowest prices relative to Henry are shown by the blue dots. These cluster in the producing areas of the Rockies, the Southwest, the Mid-continent, and in western Canada.

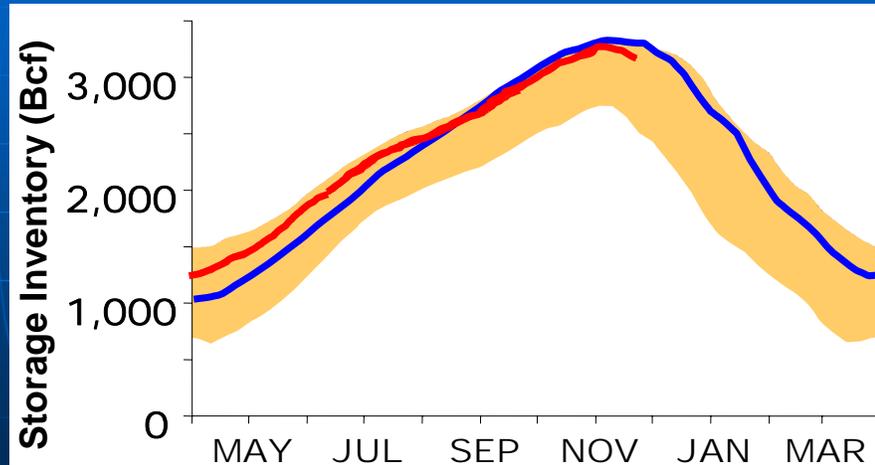
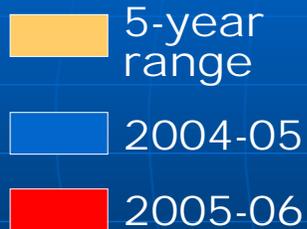
Intermediate prices are colored green and yellow on the map. They cover consuming areas in California and the upper Midwest, as well as producing areas on the coast of Texas.

The price distinctions between East and West are significantly more pronounced than before the Hurricanes – particularly in the striking difference between prices on either side of the Texas/Louisiana border.

The market appears to be signaling, as markets will do, a difference in supply and demand balances as they have been affected by the facilities disruptions due to the Hurricanes. In effect, what prices are showing us is more tightness in that balance in Eastern U.S. markets and significantly less tightness in the West, with the demarcation defined in the Gulf region by where the Sabine River separates Texas and Louisiana.

Staff is spending considerable time and energy to understand how gas is flowing in the Gulf producing region in order to verify that prices there are the result of legitimate post-hurricane facilities outages. To date, the prices do appear to be related to these outages.

Initial Storage Inventories Begin to Face Cold

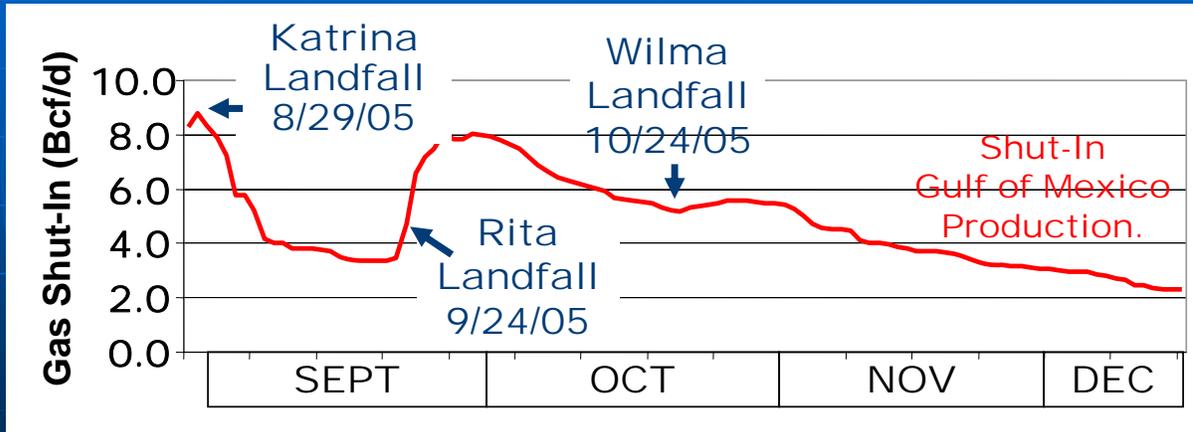


SOURCE:
Energy Information
Administration

Switching now to some of the key metrics we use to assess the gas supply/demand balance, we see on this graph that U.S. storage inventories – the end of the red line – have begun to drop due to the withdrawals reported over the past few weeks by the Energy Information Administration. The grey band is the range between highs and lows for the last 5 years, and the blue line shows inventories for last year. Until today, we've been close to 5-year highs and last year's inventories. While there are some variation, this is generally true for all regions reported by the EIA.

The colder weather of last week [is expected to result in/has resulted in] a significant additional withdrawal [to be reported later this morning/just reported as ____]. Expectations for the report today [are/were] a little below 200 Bcf. With colder-than-normal weather expected for the Northeast and Midwest over of the next two weeks, we should expect large withdrawals to be reported for the near future.

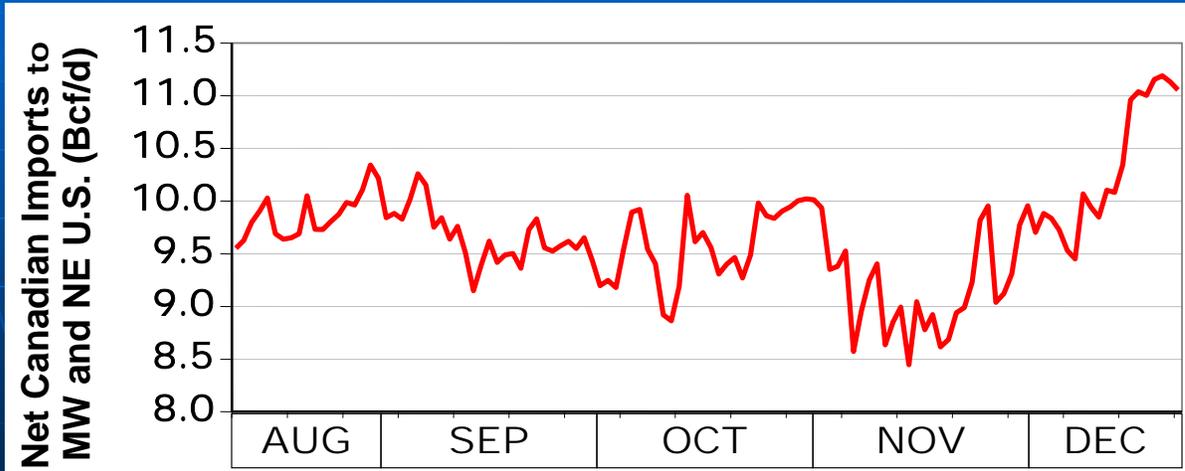
Gulf Production Continues Strong Recovery



SOURCE: Minerals Management Service

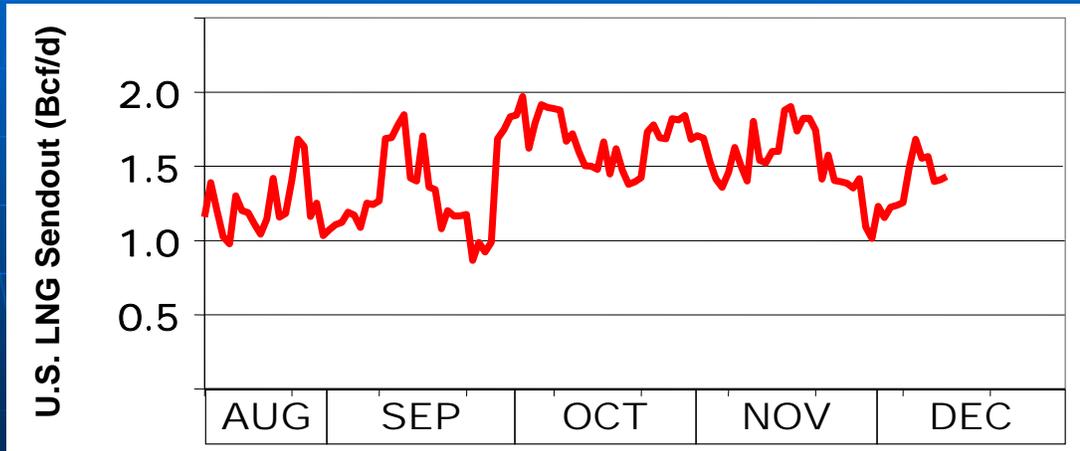
Recovery in Gulf production continues to be steady and strong, with remaining shut-in gas reaching 2.3 Bcf/d this week – as you can see on the red line on this graph. This pace of recovery is well ahead of the 3 Bcf/d we initially anticipated would be shut-in at this point. Continued improvements in reducing Gulf shut-in gas are the single best thing that can happen at this point to moderate prices, short of mild weather.

Canadian Imports Have Increased With Demand



Also on a positive note, with recently increased, weather-related demand and higher prices, we have seen a supply addition of a different type – increased imports from Canada. This graph plots recent imports from Canada into the Midwestern and Eastern U.S. Over the past few weeks, we've seen these Canadian imports surge by 2 Bcf/d. Western Canadian imports are down, but as I explained earlier, the demand in the West is already in far closer balance with supply, and additional Canadian imports are not needed there. Overall, for December to date, Canadian imports to the Eastern and Midwestern U.S. are up by approximately 1 Bcf/d – a substantial help at this time. In addition, U.S. exports to Mexico to date in December are down by approximately 300 MMcf/d – also helping the overall balance.

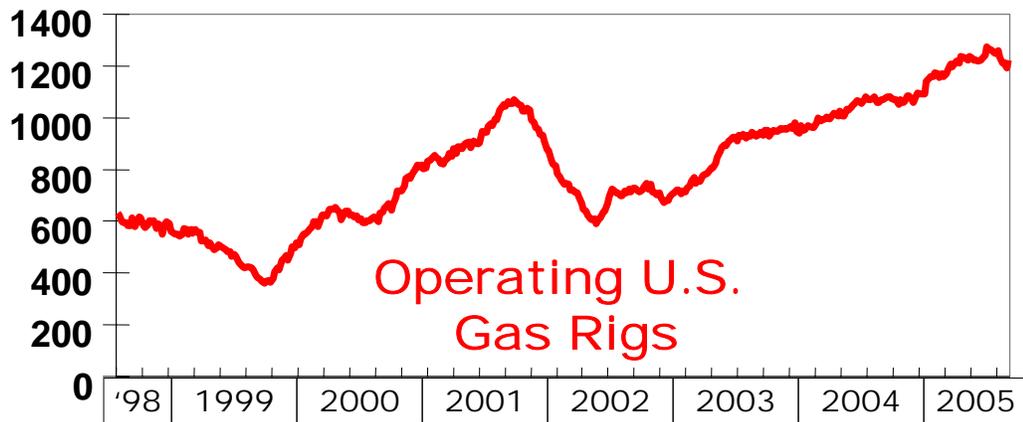
LNG Deliveries Somewhat Lower Than Expected



SOURCES:
U.S. Pipelines,
Bentek

By contrast, LNG imports remain below earlier expectations as well as last year's experience. This graph shows recent LNG send-out in the U.S. on a daily basis. As you can see, send-out is averaging only about 1.5 Bcf/d – far less than the 2 to 2.5 Bcf/d indicated in the forecasts by CERA and the Waterborne LNG Report that we showed you in the Winter Assessment. So far in December, LNG is delivering about 160 MMcf/d less than last year. There are many reasons for this level of LNG delivery, but a major driver over the past few weeks has been weather-related demand in Europe. Recently, however, prices for gas in England due to cold weather have fallen back below U.S. prices.

Rig Counts Show Price Effects on Drilling

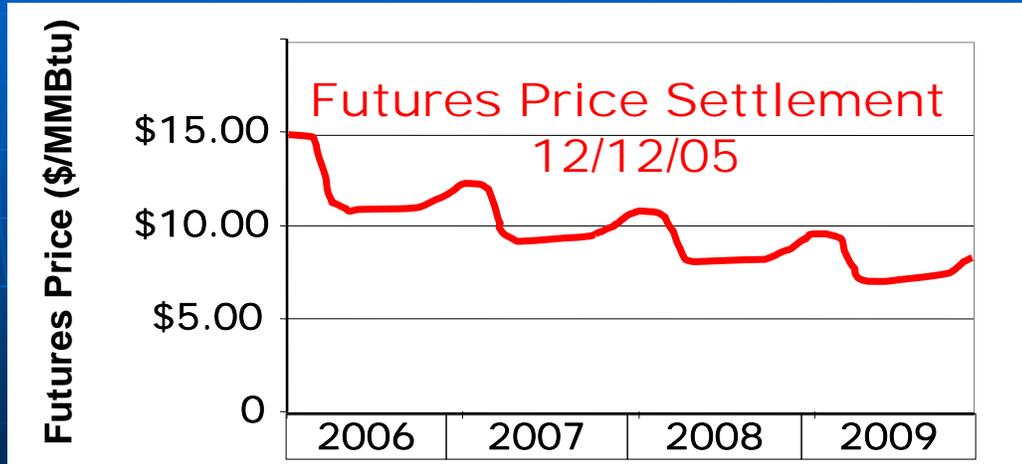


SOURCE:
Baker Hughes,
Inc.

Consistent with prices and market conditions over the past few years, natural gas drilling rigs operating in the United States remain at recent highs. This graph shows the number of gas rigs operating in the U.S. since 1998. Note that the hurricanes disrupted drilling to some degree, but overall rig usage remains quite high and has grown in recent weeks.

This rig graph helps underscore an important point – in markets there are both supply and demand responses over time to high prices. Today in the U.S., supply responses require investment in drilling and, increasingly, in import capacity like LNG terminals. The importance of supply responses to the prices we face cannot be overstated at this point – and staff will continue to monitor available information related to these kinds of investments.

Futures Prices Anticipate Market Response



SOURCE:
NYMEX

I'd like to close with this slide, a graph of forward prices as of the close of the NYMEX futures market last Monday. What you see is prices for delivery at Henry Hub by month running into the future until December 2009. This pattern of prices falling, on a seasonally adjusted basis, over time is known as "backwardation." While no one should ever use futures prices as a forecast, they do indicate certain current market expectations. In this case, expectations appear to be that the current tightness in supply and demand will fall over time. That conclusion is consistent with the belief that there will be continued progress in reducing shut-in gas from the Gulf as well as, for example, that additional LNG capacity will be built in the more distant future.

That concludes my presentation. Jeff and I would be happy to take your questions.