

ZERO DOUBT: NATURAL GAS PRICES WILL GO HIGHER AGAIN

Sprott Analyst: Gas Storage Surplus Will Correct Itself

SUMMARY: We talked with Sprott Asset Management Research Analyst Eric Nuttall about the natural gas situation in Canada and the fate of many CBM gas producers and developers. Since our last conversation spot natural gas prices have dropped by 15 percent. Natural gas storage levels are about 2.5 trillion cubic feet, some 423 billion cubic feet higher than a year ago.

Eric Nuttall told us, "Nearly all small-cap natural gas producers have taken it in the teeth this year. The price decreases in their stocks have been absolutely brutal. There are now companies whose stocks are down 40 percent year-to-date, and yet are still strongly growing production on an adjusted share basis." How will the CBM and natural gas sector pan out through the end of this year?



Hurricane waves striking a seawall. Many natural gas analysts quietly have their fingers crossed for a major hurricane or two to quickly boost prices in the sector. Courtesy of the NOAA

By James Finch

StockInterview:

How are the lower natural gas prices impacting Coalbed Methane producers?

Eric Nuttall:

For many CBM or shallow gas producers, this means their current drilling program is likely uneconomic, suggesting deferrals in drilling programs until natural gas prices strengthen. It is this very supply response that we need to balance storage levels, so it should not come as a complete surprise.

StockInterview:

What, then, should investors do while storage levels are rebalancing?

Eric Nuttall:

I would view this period as an opportunity for medium to long-term minded individuals to start building positions in not just unconventional gas producers, but conventional ones as well. The long-term fundamentals are still extremely bullish for natural gas. Many quality names are down 20 to 40 percent year-to-date.

“The current surplus in gas storage will correct itself, and investors should position themselves ahead of natural gas stocks reacting to this inevitability.”

StockInterview:

How do you view the long-term fundamentals for gas?

Eric Nuttall:

North American natural gas production has been in decline for several years. Most incremental production is coming from smaller, more expensive-to-drill, thinner economic, higher decline pools and reservoirs. Over the past five years first-year decline rates on natural gas wells have doubled to 50 percent. The base decline rate has also doubled to approximately 25 to 30 percent. Pool size has also decreased materially over that time frame. The Western Canadian Sedimentary Basin and much of the US producing basins are mature. Consequently, higher and higher natural gas prices are required to create incentive for producers to drill increasingly marginal wells.

StockInterview:

And you expect a continuation of declining natural gas production? And that is that your premise for higher natural gas pricing?

“The long-term fundamentals are still extremely bullish for natural gas.”

Eric Nuttall:

Conventional gas production has been in decline for many years, and the growth areas have largely been unconventional, such as the Piceance Basin (tight gas), the Barnett Shale (shale gas), and the Jonah Field (tight, deep gas). Also, many of the growth assets, such as the Barnett Shale, are already a few years into development, and because the wells have such a steep decline rate in the first few years, it is only adding to the depleting base that we have to make up. It is unlikely that over the next three years, the increase in unconventional gas can offset the decline in conventional, because the depleting base is so much larger. The major natural gas basins in North America are mature. Decline rates are increasing. Pool size is decreasing. Rig count is increasing yet production is at best flat. Until LNG imports increase in a material way, which is not expected for at least four or five more years, I think the case for healthy natural gas prices is intact.

StockInterview:

Earlier, you noted drilling was more expensive.

Eric Nuttall:

Over the past year, onshore drillings costs are up over 15 percent while operating costs are up over 10 percent. A recent *Wall Street Journal* article commented on how rig rates for the Gulf of

Mexico, on very deep drilling platforms, are as high as \$520,000 per day, up from \$185,000 a few years ago. And the drilling platforms are still leaving the Gulf of Mexico! Although many are leaving the Gulf of Mexico to go to more prospective areas such as the West African Coast, the current rig situation is still somewhat tight in the Gulf. We have only begun to see signs of moderating rig rate pricing.

“There is zero doubt in my mind that natural gas is an excellent long-term investment.”

StockInterview:

How would bad weather, such as a hurricane, impact natural gas prices?

Eric Nuttall:

Short term, you would see both natural gas and related stocks surge. If a hurricane strikes the producing area of the Gulf, and we almost need one to – to correct the surplus supply situation. Initially, you’ll have an emotional upward response. Only after assessing the status of production platforms and sub-sea infrastructure would we know the longer-term impact.

StockInterview:

Should investors be watching the Weather Channel and ready to phone their stockbrokers?

Eric Nuttall:

Timing on any natural gas investment right now is tricky. You need to have a medium- to longer-term focus. We probably have another two months of volatility. There are two camps right now on natural gas. One camp is saying that due to bloated storage levels companies are going to increasingly lay down their drilling rigs, cut production guidance, and stress their balance sheets. Then in the fall, when companies set their 2007 budgets, they will be using low gas prices and presenting moderating production growth profiles to their investors.



Will a hurricane, or another weather disaster, bring ‘instant’ relief to slumping natural gas prices?

StockInterview:

What does the other camp say?

Eric Nuttall:

Another camp says that the current natural gas strip already discounts the present and forecasted storage levels. Also, stocks are cheap on a price-to-cash flow and price-to-net asset value ratios, and now is the time to load up on the stocks. I lean towards this viewpoint. But I am also admitting that until the fall, barring a severe hurricane, it is likely that the stocks are going to trade sideways, as opposed to in any clear direction.

StockInterview:

One equities strategist, whom we interviewed, suggested some time in August we might start to see the natural gas stocks moving higher.

Eric Nuttall:

There is the potential that we might endure another month or two of flat trading in small cap natural gas stocks. By the end of August, it is likely that we will have had both a supply and demand response – worries of massive laying down of rigs, forced well shut-in's, and overleveraged balance sheets should have subsided. Investors will begin to focus on the natural gas strip rather than spot prices, which currently are around \$9.00 for the upcoming winter and \$8.00 for next summer.

“Timing on any natural gas investment right now is tricky..”

StockInterview:

And until then?

Eric Nuttall:

Until that time comes, I think it likely, as a group, the large caps will outperform. They are more weighted towards oil, and have recently been catching a bid on the heel of a huge \$22 billion all-cash takeover by Anadarko of Western Gas and Kerr-McGee. Importantly for unconventional gas investors, Anadarko paid around \$2.00 for 3P (Possible) Mcf, which is very healthy (Western Gas was predominantly tight gas in Wyoming and coalbed methane in the Powder River Basin). It speaks to Anadarko's view of strong long-term natural gas fundamentals. These all-cash transactions likely set the bottom in the large caps.

StockInterview:

How do you feel about the smaller, lesser known gas companies?

Eric Nuttall:

Nearly all small-cap natural gas producers have taken it in the teeth this year. The price decreases in their stocks have been absolutely brutal. There are now companies whose stocks are

down 40 percent year-to-date. They are still strongly growing production on an adjusted share basis. Yet, they are trading as low as 2.5 times 2007 cash flow. Many stocks have gotten incredibly cheap. Although the market might still be a bit sloppy for a few months, I think there are some great bargains to be had for the patient investor.

StockInterview:

How do you sum up the natural gas equities market, right now?

“Nearly all small-cap natural gas producers have taken it in the teeth this year.”

Eric Nuttall:

Currently, there are many very cheap natural gas weighted companies. Companies with active drilling programs, who are adequately financed and sitting on highly prospective acreage, are trading under three times 2007 cash flow. If the stock prices don't improve for the juniors, I would expect many seniors and trusts will jump at the opportunity to acquire existing production below what current finding and development costs would require through exploration or development drilling.

StockInterview:

Let's review some of the more speculative companies we talked about this past spring, such as Crew Energy, Rockyview Energy and Canadian Spirit. How do you feel about them now?

Eric Nuttall:

Crew (TSX: CR) is a very well run natural gas focused company. They are set to grow production per share over 40% this year and next, have a very active drilling program for the second half of the year. Canadian Spirit Resources (TSX: SPI) has been chopped in half from its peak, yet nothing but the price of natural gas has changed. We're still quite bullish on Canadian Spirit. Their play is in early stages, and production and economic risks are still there, but if they can repeat their previous rates, I think they could have a very large and economic project. Rockyview (TSX: RVE) recently cut their drilling capex by 67% taking a bit of momentum out of the story short-term. With a recovery in natural gas, the stock should rebound along with the rest of the group.



Rockyview Energy



StockInterview.com

StockInterview:

What unconventional companies are you following?

Eric Nuttall:

We are keenly following the drilling progress of EnCana (NYSE: ECA; Toronto: ECA) in the Columbia River Basin in Washington State. For an investor looking for a lower risk, relatively lower rate of return, EnCana is a great way for an investor to gain exposure to natural gas. They have around 95 percent of their 2007 natural gas hedged at slightly over \$7 per mcf, so are protected from today's brutalized spot price. Another is Calfrac (TSX: CFW), which is down 45 percent from its peak, and is now 10X 2007 earnings estimates. They are heavily exposed to CBM, and with a recovery in natural gas prices, the stock should recovery nicely.

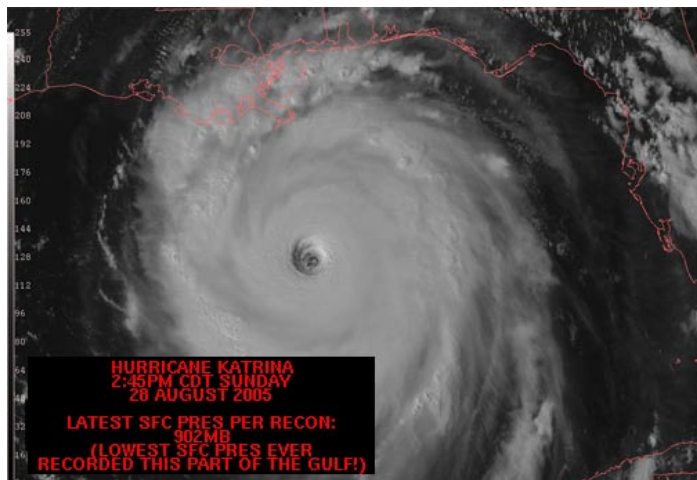
“Although the market might still be a bit sloppy for a few months, I think there are some great bargains to be had for the patient investor.”

StockInterview:

And some of the others we talked about, such as Ember, Real Resources and Pacific Asia China Energy. Do you have any updates?

Eric Nuttall:

Ember Resources (TSX: EBR) has gotten absolutely crushed. They have an active drilling program for the second half of the year. To fund it, they will likely need to seek further equity financing. This has created an overhang on the stock. Until they are able to execute some form of a financing, the stock might stay weak in the short-term. Real Resources (TSX: RER) has been executing well on their drilling program. Once a pipeline is completed in the next month, production should jump 37 percent to 16,500 Boe/d. The company sits on 450,000 net undeveloped acres, prospective for a variety of targets including Devonian Nisku, 190 Bakken light oil locations, and up to 1.1Tcf of recoverable CBM as assigned by Sproule. When trading at 3.5X 2007 cashflow, the stock presents a good opportunity. Pacific China Asia Energy (TSX: PCE) recently released data on three core holes revealing pretty good gas contents and seam thicknesses, as expected. The question still remains whether wells will produce at an economic rate, which you only know by drilling test wells. I think that's scheduled for later this year or early next. They sit on what appears to be a very prospective land spread, and simply need the time to drill, and attempt to achieve economic rates across their acreage.



Another Hurricane Katrina would help in working down abundant natural gas storage levels. Courtesy of the NOAA

StockInterview:

What do you see for the near-term?

Eric Nuttall:

Many people have been hoping that warm weather or hurricanes would assist in working off the excess supply, but Mother Nature hasn't been terribly helpful so far this summer. It appears that we will exit the natural gas injection season at least 10% over last year. Barring any incredible heat waves or significant hurricanes, natural gas prices are likely to remain sub-\$6.50 until the fall. Unless we have a serious hot spell or a significant hurricane, it is likely that natural gas stocks will be very volatile without clear direction over the summer into the fall. I would think not until the fall, probably September - October, when people begin to focus not on natural gas spot prices, but on the strip pricing for the winter, which is still over C\$10. Until that time comes, I wouldn't see any clear direction in the stocks. The market is now providing opportunities to buy companies with high quality management for below-average multiples, commonly measured on a price-to-cash flow metric.

“Conventional gas production has been in decline for many years, and the growth areas have largely been unconventional...”

StockInterview:

Have you given up on the CBM sector or is it coming back?

Eric Nuttall:

There is zero doubt in my mind that natural gas is an excellent long-term investment. We've peaked in our ability to increase production meaningfully, just as we have with light oil. I think for there to be an increase in long-term natural gas supply, you have to provide incentive to producers to go drill wells that increasingly have lower economic rates of return. And to do that, you need higher natural gas prices. One of the few remaining growth prospects in Canada for natural gas production is coalbed methane. At current gas prices, the economics are very challenging. So to get a supply response from coalbed methane producers, you again need higher gas prices. The current surplus in gas storage will correct itself, and investors should position themselves ahead of natural gas stocks reacting to this inevitability.

Previous interviews with Eric Nuttall:

["Why Are Coalbed Methane Stocks Red Hot?"](#)

["What Should Investors Look For \(Or Stay Away From\) In A CBM Play?"](#)

Visit our Coalbed Methane Data Center:

<http://www.stockinterview.com/coalbed-methane.html>



Sprott Asset Management research analyst Eric Nuttall believes the worst may be behind us on coalbed methane stocks.

| Websites and Trading Symbols of companies mentioned in this report: | | |
|---|--|-----------|
| Calfrac | www.calfrac.com | TSX: CFW |
| Canadian Spirit | www.csri.ca | TSX: SPI |
| Crew Energy | www.crewenergy.com | TSX: CR |
| Ember Resources | www.emberresources.com | TSX: EBR |
| EnCana | www.encana.com | NYSE: ECA |
| Pacific Asia China Energy | www.pace-energy.com | TSX: PCE |
| Real Resources | www.realres.com | TSX: RER |
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