

## Leading Indicators Of Future Price Often Overlooked, Consultant Says

By Paul Wells

A Calgary-based energy marketing consultant says many companies in the natural gas sector have a poor understanding of leading indicators of future price and as a result are not adequately prepared for pending market spikes or a downward spiral in price such as that witnessed earlier this year.

**Dave Maffitt**, president of **Phoenix Energy Marketing Consultants Inc.**, told a seminar Oct. 14 that strategies for growth in up cycles and survival in down cycles require the understanding and utilization of select leading indicators that provide sufficient lead time to change direction, especially when it comes to making investment decisions or considering hedging strategies.

Unfortunately, he adds, many in the sector ignore the importance of understanding future price signals.

"Industry can do a better job at using the leading indicators for planning our businesses prudently and be a little more proactive," Maffitt told a breakfast seminar sponsored by **Awesome Journey Inc.**, a company that specializes in executive leadership coaching.

Maffitt told the industry gathering that during the 20 years he's acted as a consultant he's come to note that very few executives in the oil and gas industry are good strategic thinkers across all facets of their business, especially when it comes to marketing and price.

"Some of you are very good from an exploration point of view; many are very good from a finance strategy point of view or a production strategy point of view. But what we're missing is a good knowledge of marketing and pricing," he said.

Although industry officials are obviously aware that price is an integral variable in the revenue equation, he said most executives he deals with tend to view pricing as being "uncontrollable," a notion he dismisses.

"I think that's a cop-out," Maffitt said. "I think it's easier for them to use that because everybody else is using it rather than develop the intelligence around what pricing is doing to make sure they are making good decisions long-term for their company."

Phoenix Energy Consulting recently conducted a mini-survey of intermediate oil and gas companies in an effort to determine how each developed their growth strategies and the results were not encouraging, Maffitt said.

"The conclusion I come to and the theory I'm developing is that most intermediate oil and gas companies don't currently (plan) their growth strategies with enough independent, filtered marketing intelligence. They're relying on their lender, their investment banker, the newspaper ... they're not doing enough of their own independent research," Maffitt said.

"I think they need to start looking at it more aggressively and independently and develop a good understanding of these price cycles."

To make his point, Maffitt highlighted some leading indicators that are currently in play that will lead to improved natural gas prices in the coming months.

Although demand is an obvious indicator, Maffitt said that simply using projections from the likes of the United States **Energy Information Agency** (EIA) may not be sufficient to get a true read on what may occur in future months.

For instance, he pointed to a recent **Bernstein Research** study that correlated U.S. industrial gas demand to the **Institute of Supply Management's** forward manufacturing order book. That study concluded that there's about a five-month lag between an increase in orders and a resulting increase in demand from the manufacturing sector.

"This is one of the leading indicators that I'm suggesting we need to start looking at because what it would give us, if the correlation holds, is about a five-month heads up on when gas demand will recover," Maffitt said.

"As orders for new durable and non-durable goods that use energy to manufacture them go up, then we can see where the demand for natural gas as an input to the manufacturing of those products goes up."

Bernstein Research also correlated the percentage change in industrial demand to the percentage of change in natural gas prices and concluded there is about a three month lag, information that could be useful in determining if prices will lean to the bearish or the bullish side.

"What they found is that year over year, if prices increased say by 150%, you could easily expect a 20% drop in industrial demand – 18 bcf per day suddenly becomes 15 bcf per day," he said.

"This is another indicator and correlation that's very useful."

Projections from the EIA can also be very useful, but perhaps not in the way many industry leaders might expect as Maffitt said a study on the accuracy of that agency's projections show it's very rarely on the mark.

"A lot of folks have started to analyze how accurate the EIA is and they found that the EIA has historically been lower in terms of their forecasts of gas prices and gas demand – especially power demand. On the other side, they often frequently over forecast production," he said.

"We believe from one study from the **Pennsylvania State University** that there is some inherent bias in the (EIA) model."

The Penn State study, which was published in 2007, concluded the following: "(EIA) price predictions are substantially below actual prices. As a result, projections of residential, commercial, and industrial gas consumption are considerably above observed levels. Projected natural gas use by electricity providers, however, is considerably below actual consumption. On the supply-side, natural gas production and liquefied natural gas (LNG) imports have fallen far short of the levels predicted by EIA."

According Penn State researchers, EIA gas prices are historically low and the average percentage of error increases over time. For instance, in the first year the university found that EIA projections were 16% lower than actual process, rising to 30% error in the second year and 42% in year three.

"Just on average in absolute terms we're talking the difference between \$1 and \$2 (over a three year EIA projection) in their price forecast," Maffitt said, adding that the EIA is currently calling for natural gas prices to average in the \$4.40 to \$4.50 (U.S.) per mcf range next year.

"So, if we apply (Penn State's findings), the average (2010) price will be about \$5.50 or more," he said.

Other leading indicators that Maffitt said should be explored and understood by companies in-house include supply, which he says could currently be overstated because of lack of long-term data regarding U.S. shale gas production, potential LNG imports to North America and the status of short natural gas contracts held by hedge funds and speculators.