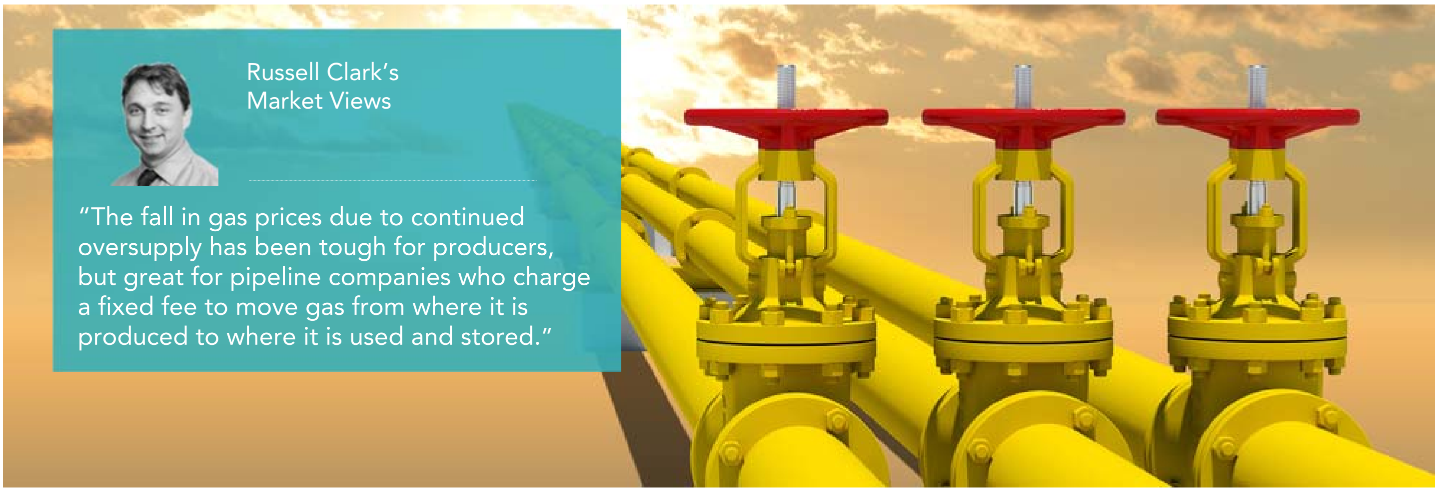
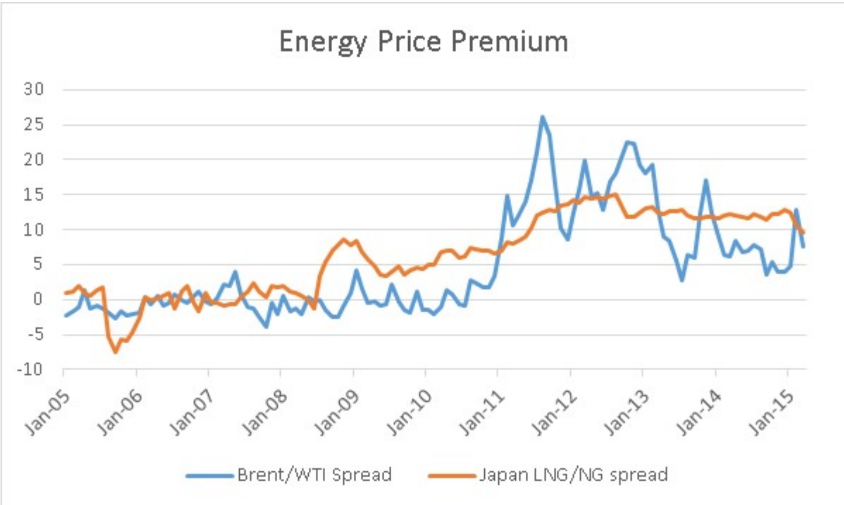
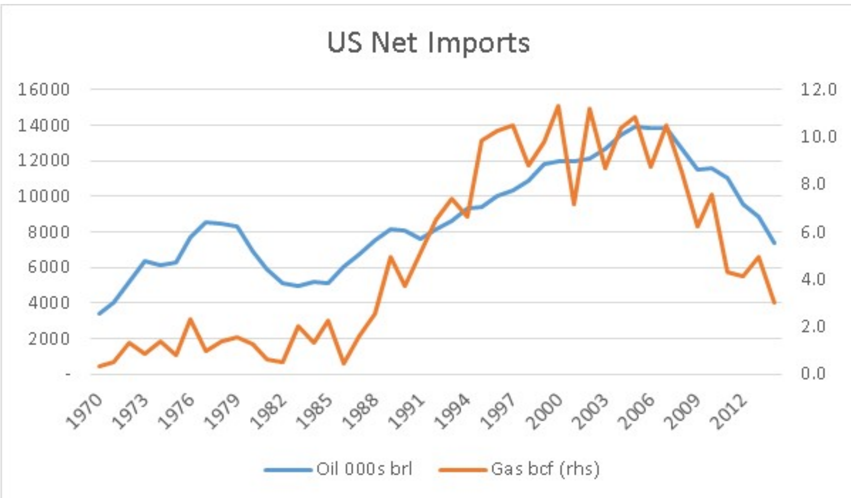
PIPE DREAMS



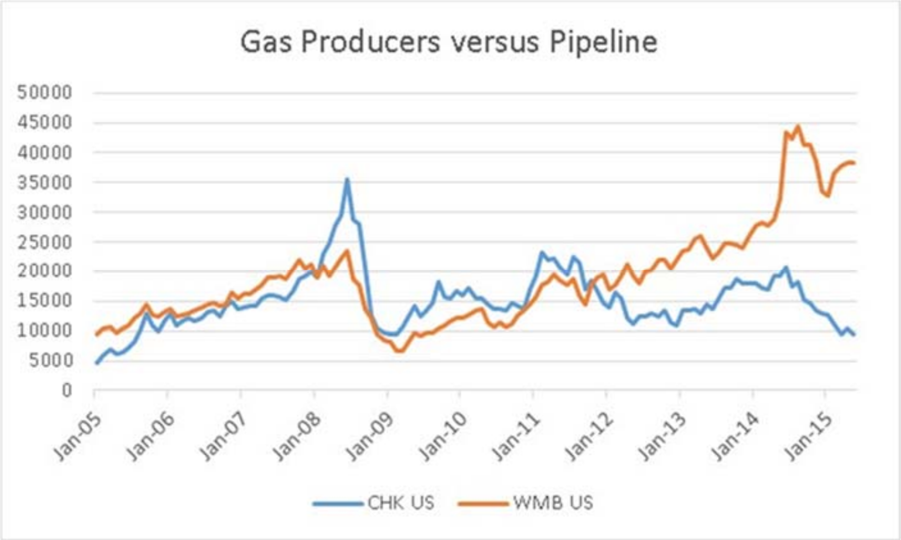
US oil and gas production has been revolutionised by the development of fracking techniques. Gas and oil production has risen by half, to make the US the world's largest producer of energy. The big increase in supply has led to a collapse in prices. The increase in supply has been larger and faster than the market was able to digest. This has caused US energy prices to be substantially below world prices.



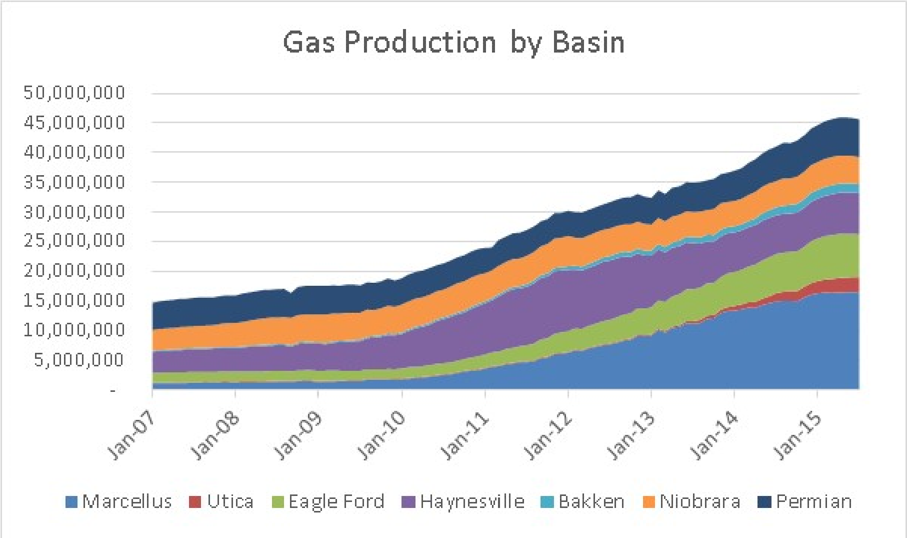
The cheaper prices in the US has had a very predictable result. More and more US production has replaced imports from elsewhere.



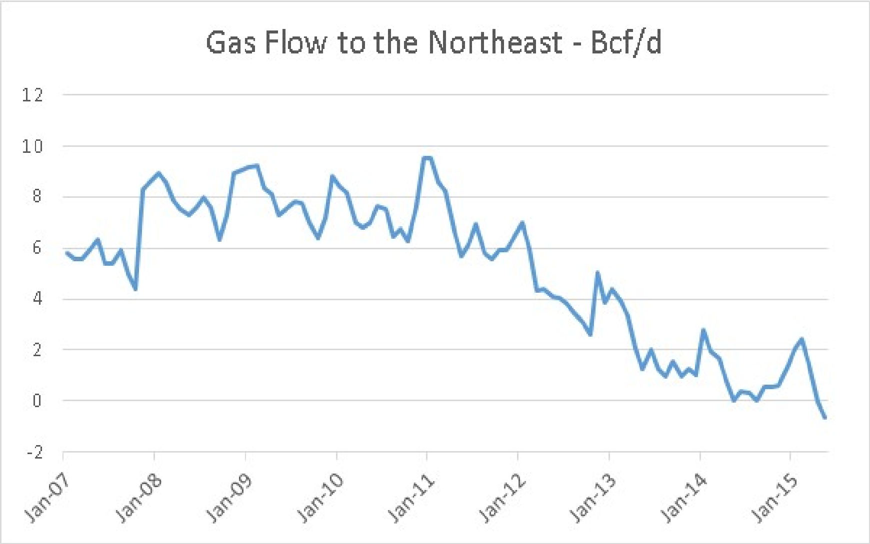
The effect on oil prices has been less dramatic than for gas. Gas tends to be much more difficult to store, and has a much smaller international market into which excess supply can be placed. The fall in gas prices due to continued oversupply has been tough for producers, but great for pipeline companies who charge a fixed fee to move gas from where it is produced to where it is used and stored. The relative market capitalisation of William Brothers, a large pipeline company, and Chesapeake, a large gas producer, bear this out.



US gas production has centred on six basins. While growth from some basins has noticeable slowed, growth from Marcellus and Utica basins have more than compensated.

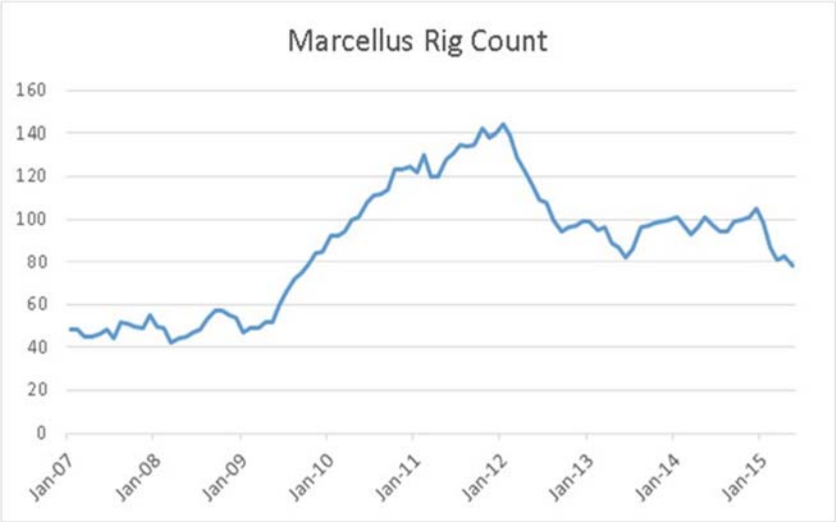


The Marcellus and Utica basins are located in the north east of the United States. This area is both densely populated and experiences very cold winters. Until recently gas from the rest of the United States flowed to this region, but is now self-sufficient.

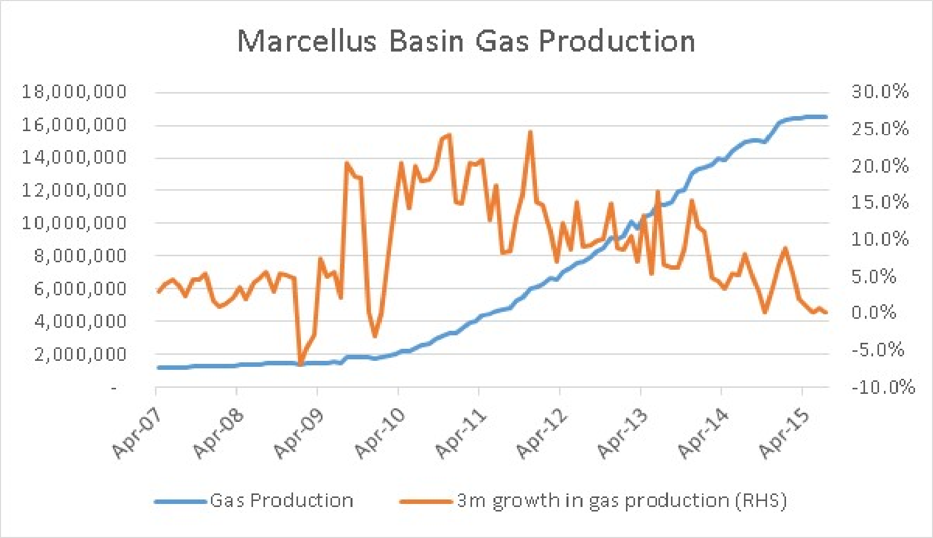


US regulators and pipeline companies have become accustomed to the idea that US gas production will grow despite low prices. A presentation from the Federal Energy Regulatory Commission (https://www.ferc.gov/market-oversight/reports-analyses/st-mkt-ovr/2014-som.pdf) on page 8, shows the assumed growth of shale production and pipeline investment in the Marcellus Basin. The presentation assumes Marcellus production will grow from the current rate of 20 bcf/d by 50% to nearly 30 bcf/d over the next 5 years.

This has led to some pipeline companies reversing the flow of their pipelines in anticipation of exporting production form the Marcellus basin. Cheniere Energy expects to be buying 6 bcf/d of US gas for the export market by 2020. This represents 7% of current total US production, or most of the assumed increase in Marcellus production. The problem is that recent efforts by OPEC and particularly by Saudi Arabia to win back market share in the oil market seems to be having an effect on the gas market as well. Marcellus rig count is falling as shown in the chart below.



US Gas Production is increasingly coming from the Marcellus, which is located in the Northeastern USA. This field, as shown in the FERC report linked to above, is expected to continue grow production until 2020. However recent data from EIA shows that 3 month growth in gas production is forecast to be zero. (Note the EIA data included forecasts for both current month and next month production.)



Pipeline companies have been investing heavily in this region with a view to transporting the expected increased production in this region. The response of energy producers outside of the US may make exporting energy a pipe dream. Given the striking outperformance of natural gas pipeline companies relative to natural gas producers, it looks to me there is now only downside risk to pipeline companies, who are investing at an unsustainable rate.

INFORMATION

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