Conditions for a Liquid Gas Market: North American experience

In North America over 60% of gas contracts are for one year or less. According to Peter Krenkel, president of NGX[1], this reflects the high level of market participation and short-term variability in trading conditions.

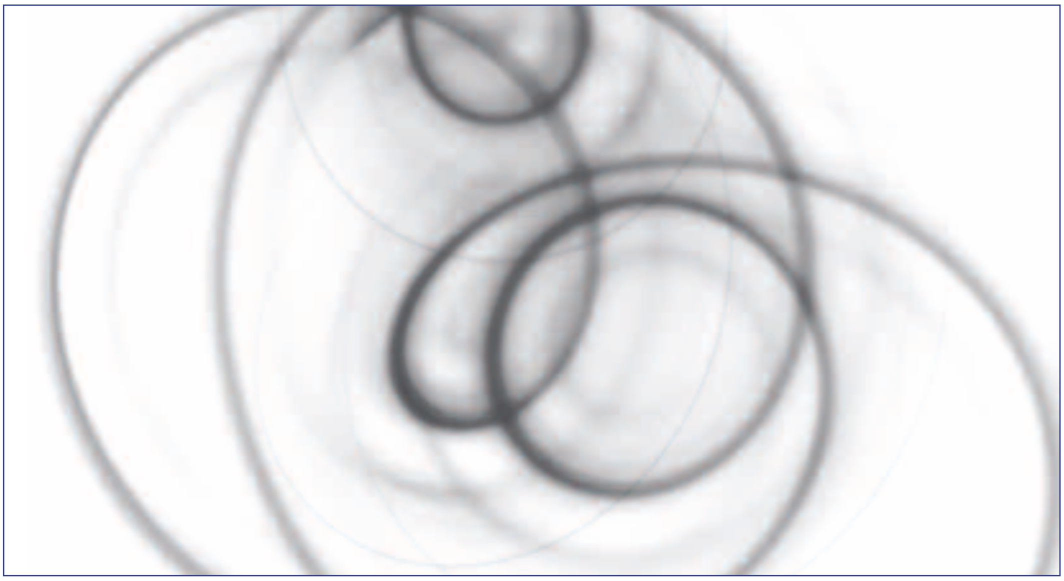
Liquidity criteria

For a liquid gas market to exist, numerous conditions need to be established. Multiple participants must exist so that there are significant volumes of gas trading daily. In addition, there need to be multiple instruments in existence that will provide a reliable delivery mechanism for the physical gas. Having access to storage and transportation, helps ensure reliable delivery. Just like other markets, the natural gas market has to abide by numerous government regulations; however, fewer regulations will promote a more active market.

NGX needs to provide accurate and reliable price indices that reflect a true market price. This accuracy allows for the development of derivative markets such as swaps and options. Encouraging the development of these markets lends support to both the exchange and the OTC markets.

In addition, NGX must support active paper and OTC markets to lure in speculators who could have some concerns about trading in new markets, such as lack of volume traded.
If however, even all these conditions exist, it must be remembered that an exchange itself cannot create a liquid market. It can only provide the mechanism to help markets expand and reduce impediments that may have previously slowed the exchange of money and gas.

[1]NGX is Canada's leading energy exchange and North America's largest physical clearing and settlement facility. NGX is a subsidiary of TSX Group.



Variable market conditions

In North America over 60% of gas contracts are for one year or less. The reason is the highly variable nature of conditions in the natural gas market. Factors that move the price of gas up and down are more likely to occur in the short term. These variables include supply and demand, production and exploration levels, storage injections and withdrawals, weather patterns, pricing and availability of competing energy sources. Utilities, producers, marketers and pipelines rely on this information to make decisions as to when to purchase and when to sell gas. These short term variables are more accurate and easier to understand than longer term variables.

With all of these variables impacting on the market, it is easier to predict the demand curve for less than one year.

Because of this predictability, companies have more of an appetite for the risk in the short term. Clients also prefer shorter contracts because of the price that is involved in entering a long term deal. Companies must provide collateral for the entire length of the contract; therefore a longer contract will result in a higher cost of collateral with all the variables factored in, a shorter deal is less expensive for a company to undertake.

Finally traders hesitate from going into long term contracts because of the lack of liquidity. If more companies are buying and selling shorter term contracts, then there will be more liquidity in that time frame. By definition, a liquid market attracts participants because it is easier in a liquid market (compared to a non-liquid one) to buy and sell into and out of positions.