**Market Overview**

Oil, Oil, Oil – As evidenced by gas prices that we are paying at the pump, oil prices have dropped considerably during the 4th quarter of 2015, and early 2016, so much so that EIA experts are now predicting that a further drop in prices may happen during early 2016 (this is called an overcorrection!). These same experts are predicting a turnaround during the second half of 2016 with calls for a large upward move in oil, supported by some equalization of the global oil supply demand curve and with expectations that year end oil prices will be 30-50% higher than current prices. All of our clients have heard us talk about oil and the effects that it has on all other energy commodities, and at the current moment, oil appears, by a larger than normal margin, to be the main driver of energy prices, where as other fundamental and technical indicators (that would point to an immediate and sharp rise in energy prices) have gone ignored.

While we have experienced spot price moves to the downside, futures prices during the quarter have been flat to slightly higher, indicating that there is a growing belief that the low point is behind us, and that higher prices lie ahead. The data supports that even those who have been on index, are paying more than those who signed fixed price contracts.

Working gas in storage was 3,297 Bcf as of Friday, January 15, 2016, according to EIA estimates. This represents a net decline of 178 Bcf from the previous week. Stocks were 629 Bcf higher than last year at this time and 473 Bcf above the five-year average of 2,824 Bcf. At 3,297 Bcf, total working gas is above the five-year historical range.

Additionally, with a very late start to the winter heating demand season, storage data continues to support lower prices. Working natural gas in storage was 3,297 Bcf as of Friday, January 15, 2016, according to EIA estimates. These stocks were 629 Bcf higher than last year at this time and 473 Bcf above the five-year average of 2,824 Bcf. Due to the massive winter storms across most of the U.S., there are some large forecasted draws for natural gas over the next few weeks and we do expect to see storage numbers closer to the 1 year and 5 year averages by end of winter.

Speaking of winter, we continue to get word that winter 2016 will be a long one, with temperatures below normal for most of the country. Expectations for cold weather extend in March and even April for most of the country. If this comes true, we may jump directly from heating season into the cooling season of summer. This weather forecast is very bullish for the short term energy prices, and presents a large upside risk for anyone with contracts coming due during 2016.

As previously stated, while we do not necessarily see massive appreciation in prices for the short term, we do feel that many risk factors point to much more upside risk than downside opportunity in energy prices. Such factors include stabilized (or bouncing) of oil prices, the start of an outflow of natural gas outside of the U.S., the continued shutdown of coal fired electricity generation facilities, weather, and a 12 month consecutive drop in exploration rigs. All these factors are providing some pretty solid arguments that the true bottom is behind us, as we stated in our final energy report from 2015.

The chart below shows the natural gas settlements for the last 3 years. We continue to believe that charts really help our clients to put our thoughts and viewpoints into an easier to understand perspective.

**Market Fundamentals**  
 *Storage Update*

Current storage data above the 1 year (23.6%) and 5 year average (16.7%) numbers is bearish for both numbers, brought about by a very warm start to winter 2015/2016. Forecasted storage numbers for the rest of the winter season call for significant reductions in the storage number with some reports calling for end of winter storage to be lower than the 1 year average. This is something that we will be watching very closely over the remainder of winter. For those that have contracts ending during 2016, you can expect some urgent calls from Team Seven if this potential becomes close to a reality.

*Natural Gas Production*

The U.S. rotary rig count from Baker Hughes was down 13 at 637 for the week of January 22, 2016. It is 996 rigs (61.0%) lower than last year. Rig count remains at the lowest level since the week of August 13, 1999 when there were 627 active rigs.

Rigs directed only toward natural gas were down 8 at 127. The number of rigs drilling for gas is 189, lower than last year's level of 316.

As alarming as this drop off in well counts might initially appear, new techniques in drilling have so far been able to sustain the demand needs that exist today. Modern well design and techniques for extraction now allow for much greater production per well compared to even a few years ago.

With the increase in per well production, the downside is that the lifetime of a well is reduced from decade’s long life down to a period of 1-3 years. With the announcements of so many capital and exploratory projects being stopped, we feel that the supply side of the supply/demand curve is stretched. There has now been 54 consecutive weeks where the rig count has dropped. Lack of weather related or economy related demand needs have allowed for this rig count drops to happen with very little impact to energy markets. Further erosion in rig counts or what now projects to be a large winter heating demand could change things significantly and in a hurry.

As more and more wells are taken out of service, and with little prospects of new wells being put into service, the clock is ticking on how long these two diverging paths can last before a large scale adjustment needs to be made.

More than likely, it will be a combination of lower wells in service and erosion in output from current wells that cause this ‘perfect storm’ to happen. When this adjustment happens, it will come with a jump in prices that will need to be substantial enough to motivate the producers to starts re-investing funds into again growing the number of wells in service. There is not a lot of talk about this yet and we at seven may be slightly ahead of the curve, but we now believe that this will happen sometime during 2016.

*Electricity Futures Pricing*

We continue to see large scale increases in capacity and transmission (adders) for electricity going up. As such, “all in” electricity rates are being largely increased due to these factors outside of just your base energy component which as stated above, which actually is sitting at a yearly low level. It is for this reason why electricity “all in” prices do not show this type of drop. Reality is that the energy portion of the “all in” number is lower, but the adders have jumped so significantly that it skews the “all in” numbers to be higher. This jump in adders is permanent and likely to only increase going forward.

With EPA’s Clean Air Acts enacted during 2015, overall electricity generation will continue to wean off of coal fired power, over to more environmentally friendly, yet more expensive power. With this Green Energy not able to fully support the future mandated levels set by the EPA, we believe that there will be a growing trend for demand and capacity adders to go up over the next few years, thus driving electricity prices higher beyond just the base energy price.

**Recommendations**

It is likely that we will see much higher prices by the end of the year. This move will not come without some brief periods of downward movement as well, especially as the energy markets continue to work towards higher and higher low points on the run up. We do expect some rather large volatility in prices to start to return during 2016, as is normal when we bounce of such large drops lower in the spot market.

It is our belief that clients need to be ready to act during one of the low points.

If you have a contract coming due in 2016, we do suggest that you work with your consultant to set some aggressive, yet realistic targets for next generation contract prices so that we can start to monitor the market, waiting for these price points to happen with our expectations that acting now will be a smarter decision that waiting.