

## ENERGY PRICE UPDATE

### CRUDE OIL NEARING \$80 MARK

Crude oil prices are continuing their upward trend, pushing \$78.00 per barrel yet we have not even experienced any supply disruption. Here are some facts:

- US Crude oil inventories are well above the 5-year average level for this time of year.
- Distillate (diesel and furnace oil) inventories are above the 5-year average level.
- Gasoline inventories were down slightly, but saved by imports which averaged 1.1 million barrels per day.
- Refinery utilization in the US was down by 2.6% to just 90.5%, yet inventories did not suffer.

So why the sharp rise in price? It's no surprise that world politics have been the main indicator playing havoc with energy exchanges but one must ask what else might go wrong. To sum up recent events we would note the following:

- N. Korean nuclear missile tests continue to provoke the international community, including Japan, who is currently investigating its war enactment rights.
- Iran continues to work towards uranium enrichment for supposed technological reasons, yet international concerns over weapons development is in the forefront.
- Israel and Lebanon are at the brink of war.
- Nigerian oil pipelines are being destroyed which reduced the country's output of crude by 20% (Nigeria export 2.5 million barrels per day and supply 10% of US crude imports). Refiners prefer this crude because of its low sulphur content and very high gasoline yield.

What else could go wrong? Plenty.

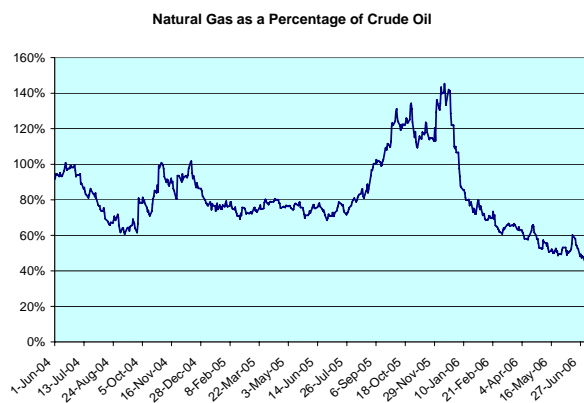
The problems thus far have been mostly tied to speculation by NYMEX traders. There have not as yet been any fundamental issues causing a crude oil supply disruption that should lead to higher prices. Furthermore, we have not yet had any hurricane devastation and it only stands to reason that many storms will be rising in the Gulf of Mexico before winter. The water temperatures in the Gulf are warmer than normal which will provide the necessary fuel for severe storms and we can only hope they don't hit the oil port regions of the Gulf that were devastated last year.

If the geopolitical tensions continue to escalate we expect the fundamentals that give direction to energy prices to be disregarded. Should the UN impose economic sanctions against Iran, they could retaliate by closing the Strait of Hormus blocking 30% of the flow of world crude supply. Assuming a worst case scenario we look for a short term ceiling for crude at \$90/bbl especially if the \$80/bbl level is breached and holds in the next week. This will force up the prices of diesel and gasoline to record levels at the start of the hurricane season with diesel racks approaching the \$0.80/L level. Then if hurricanes hit and supply is disrupted, further escalations in price are inevitable.

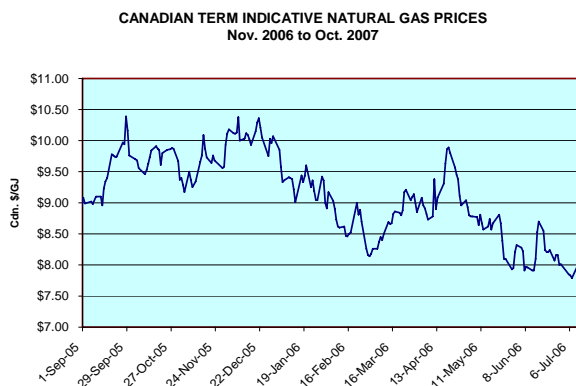
Our recommendations: One would think it a logical time to consider a futures position, however these are illogical times. Currently the back month futures contracts are higher than the front months. In addition, the oil companies are not offering futures until the official launch of ULSD (ultra low sulphur diesel) in mid October because they don't know where the ULSD price will be at this point in time. If you are a bulk consumer, continue to follow our guidance on when to order fuel to take advantage of the gyrations of the NYMEX. Continue to monitor your fuel surcharges charges and look to us for support in upward movements.

## NATURAL GAS – CRUDE OIL DISCONNECT PROVIDES FALSE SENSE OF SECURITY

Historically, even though natural gas is not derived from crude oil, it has always traded at an average of 90% of the value of crude on the New York Mercantile Exchange (NYMEX). Last year, following the Katrina and Rita hurricane devastation, natural gas futures rose well above crude oil futures, but only briefly, and only because the entire natural gas infrastructure in the southern United States was disrupted. Due to the huge surplus in natural gas supplies, futures prices for natural gas are down to less than 45% of the value of crude and, it keeps falling. See the chart below:



Falling with the gas futures prices are the day to day spot gas prices out of Alberta, now down to about \$5.75/GJ Canadian. These low spot rates are making the available term prices for the next gas year (Nov. 06 to Oct.07) look over-priced yet in our view, they are a bargain. The following chart shows where the term price for the next gas year has been trading over the past 9 months:



While it is true that day to day spot prices for gas are about \$2.50/GJ lower (30%) than one-year term prices, we do not believe term rates can dip much further, not unless crude comes off significantly in value. The low natural gas spot prices are a short-term

treat, caused only by very low demand (a cool start to summer) and huge inventory surpluses. The fact remains, hot summer weather is now arriving and much of the natural gas supplies are going to be needed to fuel electricity generating plants.

The hurricane season is upon us and it is only a matter of time until storms appear in the Gulf of Mexico. Whenever rigs are threatened, traders on the NYMEX drive up futures prices out of fear. In addition, there is gas production from the Gulf that still has not returned to operation following Katrina. That coupled with some worldwide pressure for a number of source-drilling platforms (very large producing natural gas platforms used in the Gulf), are being enticed to move elsewhere and that could eventually impact total Gulf production as well as the price. Finally, the disconnect between gas and crude will most likely begin to repair itself and when that happens, watch out. A large correction in price will be in order.

Our view is that now is the time to look at some fixed pricing arrangements for 2006/07 as waiting further presents a fair degree of risk.

## LOW SUMMER ELECTRICITY RATES SHOULD SOON COME TO AN END

The open access markets in Ontario and Alberta have been blessed with much lower than expected summer electricity rates. Some of the reasons are as follows:

- Hydro reservoirs are in healthy shape.
- Hydro-electric and nuclear reactors are running at good capacities, thus reducing the requirements for higher-priced fossil fuel electricity generation.
- Natural gas spot prices have been quite low due to huge inventory surpluses.
- Summer temperatures have been modest at best, thus demands have not reached peaking levels necessary for electricity price surges.

We believe this situation will soon come to an end. The hot and humid weather conditions now seem to have arrived and all it will take is a change in direction of spot natural gas prices and some peaking electricity demands. Furthermore, any type of electricity generation disruption or maintenance shutdowns will necessitate higher priced fossil fuel generation.

We know from history that hot weather in September leads to very high electricity prices as the lower cost

generators must come down for maintenance after being run for extended periods at full capacity. If natural gas prices are back to normal levels by that point, look for some very high electricity prices. Our advice is to take advantage of term prices for the balance of 2006, they are in a range that are worth considering.

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