

GAS PROCESSING MARGINS: WHO'S WINNING AND WHO'S LOSING?

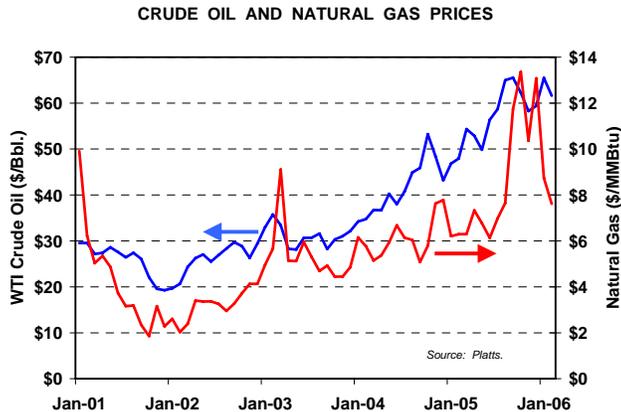
The increase in crude oil and natural gas prices over the last several years has been a significant economic benefit to oil and gas producers. These high commodity prices, however, have overshadowed a related shift in gas processing margins. John Emory, Senior Consultant at Dallas-based energy consulting firm Baker & O'Brien, Inc., notes an interesting, but perhaps overlooked trend, "Processing margins, while continuing to be volatile, have increased over the last two years. With the evolution of the midstream industry towards publicly traded master limited partnerships (MLPs), producers have been the primary beneficiaries of the improved processing margin."



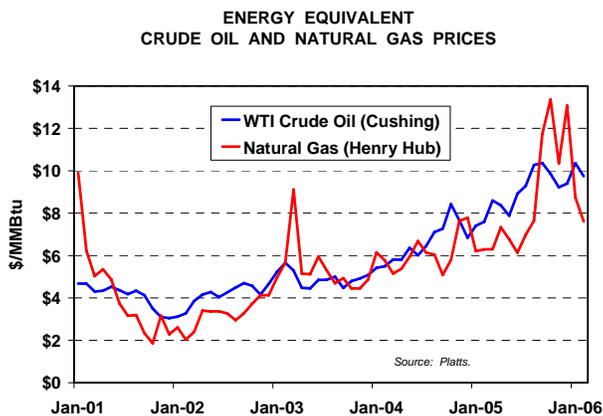
John W. Emory

OIL AND GAS PRICES

Commodity prices for crude oil and natural gas have increased dramatically over the last several years. As shown below, crude oil prices have more than doubled from the average price in 2002, while natural gas has almost tripled in price.



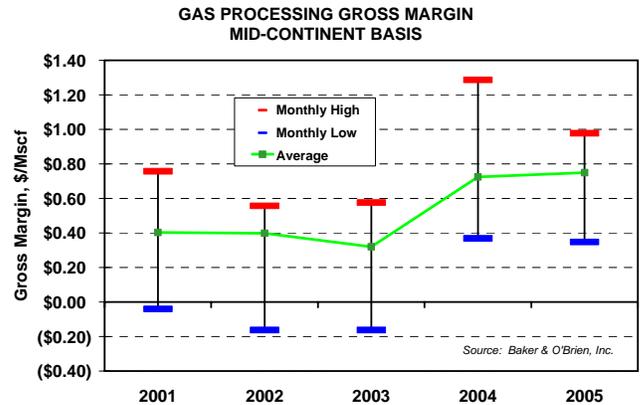
The prices for crude oil and natural gas are shown on an energy equivalent basis in the graph below. Over the last two years, the difference between the energy equivalent value of crude oil and natural gas has increased. Crude oil has been more valuable than natural gas since mid-2004, with the exception of a spike in gas prices due to the Gulf of Mexico hurricanes in late 2005. This crude oil/natural gas price spread impacts gas processing margins more so than absolute gas or crude prices.



GAS PROCESSING MARGINS

The gas processing margin (also referred to in the industry as the fractionation, or "frac," spread) is the difference in value of the natural gas liquids (ethane, propane, butane, and natural gasolines) that are extracted from raw natural gas compared to the value of natural gas on an energy equivalent basis. Natural gas liquid (NGL) prices tend to track crude oil prices. Therefore, when the value of crude oil increases faster than natural gas, gas processing margins will tend to increase.

As a result of changing oil and gas prices, gas processing margins can vary significantly from month-to-month and on a yearly average basis. Shown below is the monthly high, low, and average gross processing margin (not including fuel, operating costs, or transportation and fractionation) for a typical mid-continent processing plant.



MIDSTREAM GAS PROCESSING

Processing of raw natural gas traditionally has been undertaken by major producers in order to provide gas suitable for pipeline transportation and sale to utilities and end users. As a result of the deregulation of the natural gas pipeline industry since the late 1980s and early 1990s, the role of gathering and processing natural gas has evolved into an independent, contract based business (commonly referred to as the "midstream" industry).

Gas processing contracts between producers and processors typically vary between "keep-whole" (KW), percent of proceeds (POP), or fee-based, with the key difference being who is taking the inherent risk of the frac spread. In KW contracts, the processor takes the risk as the producers are literally kept whole on the value of the natural gas produced, including the NGLs. With POP contracts, the processor and producers share the value of both natural gas and NGLs and, therefore, the frac spread risk is effectively shared. Fee-based processing puts the risk of processing on the producer as the processor is indifferent to changes in commodity prices.

Publicly traded MLPs have become the dominate business entity in the midstream business since the late 1990s. Because of their unique capital structure, the MLPs prefer steady and predictable cash flow and earnings and, therefore, have continually shifted their processing contract portfolios away from KW and towards POP and fee-based type contracts. While providing the MLPs with more predictable earnings, these new and/or renegotiated processing contracts have transferred the risk (and potential reward) of processing margins to the producers.

With generally increasing processing margins over the last two years and the midstream MLP trend toward less risky processing contracts, the producers are benefiting from the processing uplift. This processing benefit is in addition to the significantly higher base commodity prices experienced over the last several years. Mr. Emory comments, "If higher margins persist, it will be interesting to see if the larger and more diversified midstream MLPs try and recapture some of the processing margin through their contracting strategies."