



## Winter 2010 Edition

# Natural Gas TODAY



For Municipal Gas Systems



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## Risk Management



This is a continuation of the Risk Management series from the Winter 2009 edition of the Natural Gas Today. This edition will focus on the basics of options. All information in this series is courtesy of the NYMEX.

### OPTIONS BASICS

A simple long or short futures hedge works much like a fixed price transaction: it locks in a price level. The hedger thus obtains full protection against adverse price moves but incurs an opportunity cost if prices move favorably. At times, the hedger is more than willing to accept this trade-off. At other times, he is not.

There is another risk management tool - an options contract - which allows a hedger to achieve price protection while retaining the ability to participate in favorable price moves. His opportunity cost is limited to the premium paid for the option.

But that is just one of the main risk management and trading opportunities afforded by this highly flexible tool. The natural gas options contract which opened for trading October 2, 1992, complements the futures contract by allowing a company to develop a host of trading strategies, using either contract alone or in combination, to fit virtually any risk profile, time horizon, or cost consideration.

#### What is an Options Contract?

An options contract essentially works like an insurance policy. If a homeowner wants to protect himself against a risk, he pays an up-front premium. If the risk occurs, he is reimbursed. If the risk doesn't occur, he is out nothing but his premium.

When the homeowner buys an insurance policy, he doesn't assume any obligations. He pays his premium and receives the right to reimbursement if the specific risk occurs. The insurance company that writes the policy takes on an obligation, though. In exchange for the

premium, the company is obligated to reimburse the homeowner if the risk occurs and he files a claim.

The holder of an options contract has the right, but not the obligation, to exercise his option. The seller, or writer, of an options contract has an obligation to perform if called upon to do so.

There are two types of options: calls and puts. A call gives the holder of the options contract the right, but not the obligation, to buy the underlying futures contract. Conversely, a put option gives the holder the right but not the obligation to sell the underlying futures contract.

The price at which the underlying futures contract may be bought or sold is the exercise price, also called the strike price.

An options contract affords the right to buy or sell for only a limited period of time; each options contract has an expiration date.

On the opposite side, a seller, or writer of an options contract incurs an obligation to perform, should the option be exercised by the purchaser. Therefore, the writer of a call incurs an obligation to sell a futures contract and the writer of a put has an obligation to buy a futures contract.

Because trading on the Exchange is done with anonymous counterparties, when an option is exercised, the Exchange randomly assigns an options writer to fulfill the obligation.

#### Terminating An Options Position

An option is a wasting asset. It has an initial value that declines, or wastes away, as time passes. Depending upon the movement of an options price, the

Continued on page 4A.

### PHMSA Issues Distribution Integrity Management Programs Final Rule

By John Erickson, APGA Vice President of  
Operations  
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Public Gas News

On December 4, the Pipeline and Hazardous Materials Safety Administration (PHMSA) published the long awaited final rule on Distribution Integrity Management Programs (DIMP). APGA is pleased that in the final rule PHMSA has thoughtfully and appropriately addressed all the comments it received from the public, gas utilities, state regulators, APGA and others during the comment period. The rule will require utilities to focus their resources where resources will have the greatest potential to improve public safety. The rule is flexible so that utilities of all sizes can craft a workable integrity management program.

Utilities have until **August 2, 2011** to write a DIMP plan that meets the requirements spelled out in the rule, including:

- Knowledge of the infrastructure.
- Identify threats to pipeline integrity.
- Evaluate and rank risk.
- Identify and implement measures to address risks.
- Measure performance, monitor results, and evaluate effectiveness.
- Periodically evaluate and improve the DIMP plan, and
- Report results to PHMSA and state pipeline safety agencies.

Some of the provisions in the proposed rule that were dropped from the final include:

- Performance Through People (PTP) that was criticized in comments as duplicative of operator qualification and other existing rules.
- Plastic pipe failure reporting, which will continue to be voluntary through the Plastic Pipe Database Committee, although PHMSA has kept the reporting requirement for compression coupling failures.

The APGA Security and Integrity Foundation (SIF) is nearing completion of an on-line DIMP Plan writing tool called "SHRIMP" (Simple, Handy, Risk-based Integrity Management Plan) that will soon be available free to small utilities (e.g. less than 1,000 customers) and at a nominal charge to larger utilities. Development of SHRIMP is funded through a cooperative agreement with PHMSA and the SHRIMP Advisory Board that includes federal and state pipeline safety regulators as well as industry professionals.

The complete text of the final rule and a summary prepared by APGA can be downloaded at [www.apgasif.org](http://www.apgasif.org). For further information please contact John Erickson, APGA Vice President, Operations 202-464-2742, ext 1002 or [jerickson@apga.org](mailto:jerickson@apga.org).

Prices. News. Resources. Training... [www.imga.org](http://www.imga.org)

Congressional leadership is working to finish legislative business in both chambers and begin the Christmas recess by December 24. The only must-pass bill remaining for the first half of the 111th Congress is the 2010 Defense Appropriations bill that funds military operations including the wars in both Iraq and Afghanistan. Senate leaders may elect to keep the Senate in session longer than the House of Representatives in an effort to pass healthcare reform legislation, although they do have the option to wait until January to finish work on that particular bill. The House passed their version of healthcare reform in November. One session of Congress runs two years. Lawmakers will most likely return for the second session around the time of the President's State of the Union address in late January 2010.

#### Stimulus

The American Recovery and Reinvestment Act (ARRA) was the first major piece of legislation Congress passed in 2009. Signed into law in February, the bill authorized approximately \$787 billion in tax credits and direct spending intended to stimulate economic activity and create jobs. The bill allocated approximately \$43 billion in tax credits and direct spending for energy-related projects.

A large portion of the spending on energy related projects went towards increasing energy efficiency, renewable energy and upgrades of the electrical transmission system. Many of the tax provisions focused on longer-term extensions of existing renewable energy tax credits for wind, solar, geo-thermal and others. Large portions of the direct spending also went to the Department of Energy's Weatherization and State Energy Programs. For up-to-date information on ARRA spending visit [www.recovery.gov](http://www.recovery.gov).

#### Climate Change

Throughout the spring of 2009, the House Energy & Commerce Committee worked to put together energy and climate change legislation entitled the American Clean Energy Security Act

## Congress Set to Finish 2009 Legislative Business

By Nate Hill, reprinted with permission from APGA's Public Gas News

(ACES). Committee Chairman Henry Waxman and Energy & Environment Subcommittee Chairman Ed Markey co-authored the ACES legislation (H.R. 2454).

On May 21, the committee voted 33-25 to pass the ACES legislation that seeks to reduce domestic greenhouse gas emissions levels in 2012, 20% below 2005 emission levels in 2020 and 83% below 2005 emission levels in 2050. The cap within the bill requires natural gas LDCs that emit more than 25,000 metric tons of CO<sub>2</sub> equivalent per year to hold and manage permits for their customers to comply with the U.S. Environmental Protection Agency (EPA).

Approximately 160 public gas systems would have to comply with the cap and trade program. The cap would not apply to natural gas LDC's until 2016. Also, nine percent of free allowances are set aside for natural gas LDCs. On June 26, 2009 the full House of Representatives voted 219 to 212 to pass H.R. 2454 (ACES) to be the first-ever chamber of Congress to pass a bill to regulate greenhouse gas emissions. The legislation is now before the U.S. Senate which plans to take up the bill in the spring.

#### NGA Section 5 and Supply

Beginning in May, the Senate Energy & Natural Resources Committee began putting together an energy bill including a renewable electricity standard and controversial provisions to open additional federally-restricted areas in the Gulf of Mexico for oil and gas exploration and production. APGA pushed to include language in the bill that would amend Section 5 of the Natural Gas Act. However, on June 16, the committee voted 11-12 to reject an amendment offered by Senator Maria Cantwell. The amendment would have modified Natural Gas Act Section 5 to provide the Federal Energy Regulatory Commission (FERC) with the authority to grant refunds to consumers that are paying unjust and unreasonable pipeline rates.

S. 1462 entitled the American Clean Energy Leadership Act (ACELA) passed committee on July 17. Senator Cantwell has indicated that she remains committed to pushing NGA Section 5 legislation on the Senate floor when the full Senate takes up the energy bill.

#### Market Transparency

The House Financial Services and Agriculture Committees began working in the fall on regulations to overhaul the U.S. financial markets including the use of over-the-counter (OTC) derivative products that some public gas systems use to hedge gas supply for their consumers. While APGA has been a supporter of additional market transparency since 2005, many proposals in Congress to regulate OTC markets would increase costs on public gas systems by mandating their hedging or prepay transactions to be cleared or exchange-traded. The mandated clearing of all OTC transactions would require public gas systems to post margin and to meet potential margin calls. In the case of a standard exchange (NYMEX) traded natural gas contract, the initial margin collateral posted at inception is approximately \$5,000 per contract (10,000 MMBtu).

APGA was asked twice this year by Congress to testify on this issue. First, Dave Schryver of APGA's staff testified in September before the House Agriculture Committee. Second, Jeff Billings with the Municipal Gas Authority of Georgia testified before the Senate Agriculture Committee in November. APGA expressed to lawmakers that a municipality's OTC transactions should be exempted from regulation for two main reasons: first, public gas systems' transactions do not pose systemic risk to the U.S. financial system; and second, public gas systems often don't have the resources to post the collateral associated with clearing a transaction which could significantly impact efforts to hedge and keep prices stable for consumers.

On December 11, the full House of

Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 by a vote of 223-202. The bill exempts end-users such as public gas systems from the bill's mandated clearing requirements. During the debate, APGA sent a letter to House leadership opposing three amendments that would have negatively impacted public gas systems and each amendment was defeated.

The bill now moves to the Senate where its path remains uncertain. The Senate Banking and Agriculture Committees are working together to draft their own legislation to address Wall Street reform. Their goal is to pass a bill in spring 2010. APGA plans to continue to push Senators to maintain the exemption for public gas systems' OTC transactions.

#### LIHEAP

On December 8, 2009 Congress passed the remaining government funding appropriations bills by packaging the remaining bills together in a "mini-bus" and passing them in block. The "mini-bus" includes the fully authorized \$5.1 billion in funding for the Low Income Home Energy Assistance Program (LIHEAP). APGA has sent letters in March and May this year pushing Congress to fully fund LIHEAP to the authorized \$5.1 billion. APGA also joined hundreds of other groups and participated in LIHEAP day on Capitol Hill last February, which we plan to do again this coming February 2010.

### This Winter Could Become the Worst in 25 Years

From AccuWeather.com

Nearly the entire eastern half of the United States is enduring bitterly cold temperatures not experienced since 1985. Even Florida, which has been hovering around freezing levels overnight recently, is also feeling the almost-nationwide chill.

"It'll be like the great winters of the '60s and '70s," said AccuWeather.com Chief Meteorologist and Expert Long Range Forecaster Joe Bastardi.

The last time such a large swath of severely low temperatures struck the nation was in January 1985. That historic arctic outbreak had below-zero temperatures Fahrenheit stretching from Chicago eastward to New York City, and all the way south to Macon, Ga.

While Bastardi says the upcoming days will bring cold not seen since 1985 or 1982, he believes this winter is shaping up much like that of 1977-78. That winter, nearly all of the United States east of the Rockies had a cold October followed by a warm November, with the cold returning in December.

What is most interesting in this case is what followed, where the months from January through March can all be classified as very cold, relative to normal.

"If it stays this cold for this long, will the groundhog even want to come out on Feb. 2?" wonders Senior Vice President and Chief Meteorologist Elliot Abrams.

This winter has already been rough for many areas of the country, with several blizzards dumping high accumulations of snow upon the Plains, mid-Atlantic and New England.

The cold air currently streaming across the Upper Midwest into the East and South will only compound the winter problems of the nation, especially since these depths have not been experienced across such a wide area simultaneously in decades.

Over the past 20-plus years, when

Continued on Next Page.

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## Oil and Gas in Illinois

From the Illinois Department of Natural Resources  
Office of Mines and Minerals  
Division of Oil and Gas

### History

The development of oil and natural gas in Illinois began more than 140 years ago. In 1853, holes drilled near Champaign produced "swamp gas" or gas contained in glacial sediments. The first significant production of oil came in the early 1860's from areas just north of Casey in Clark County and near Litchfield in Montgomery County. In 1905, 181,000 barrels of oil were produced in Illinois. By 1912, Illinois ranked third amongst oil producing states with an annual production of 33 million barrels. By 1913, production started to decline and by 1936, production was down to 4.5 million barrels a year. Technological advances enabled operators to drill deeper wells and by 1937, the decline in Illinois production reversed with the discovery and development of the deeper-producing areas of Illinois near Clay City, Patoka, Centralia, Olney, Beecher City and Salem. Illinois regained a ranking of fourth in the nation by 1940 with annual oil production of 146.8 million barrels. Since 1940, overall production began to decline as the discoveries of the deeper part of the basin were developed and the resource was depleted.

In the late 1940's and early 1950's

secondary recovery techniques, primarily water flood operations, began in previously developed oil fields. Annual oil production rose from 50 million barrels in 1953 to over 80 million barrels in 1955. The secondary recovery techniques used during this time stabilized the state's annual oil production at around 80 million barrels a year until approximately 1963, when production began to decline. This trend has continued since that time except for a brief increase in production in the mid-1980's as a result of significantly increased oil prices. However, as the price declined, production in Illinois dropped from approximately 30 million barrels in 1985 to less than 13 million barrels in 2000. Illinois production currently averages 10-12 million bbls per year.

### Industry Overview

Since the onset of commercial oil production in the early 1900's, over 150,000 wells have been drilled. Although the majority have been plugged over the years, 32,000 oil and gas production wells and 9,500 Class II Injection wells remain active. Approximately 500-700 oil wells are drilled every year in Illinois. The wells are operated by more than 1,200 oil producers.

ditions in the last decade. However, that year the cold was not as widespread as what is happening now.

With the entire eastern half of the country in the throes of this arctic snap, this is shaping up to be the coldest winter in many people's memories.

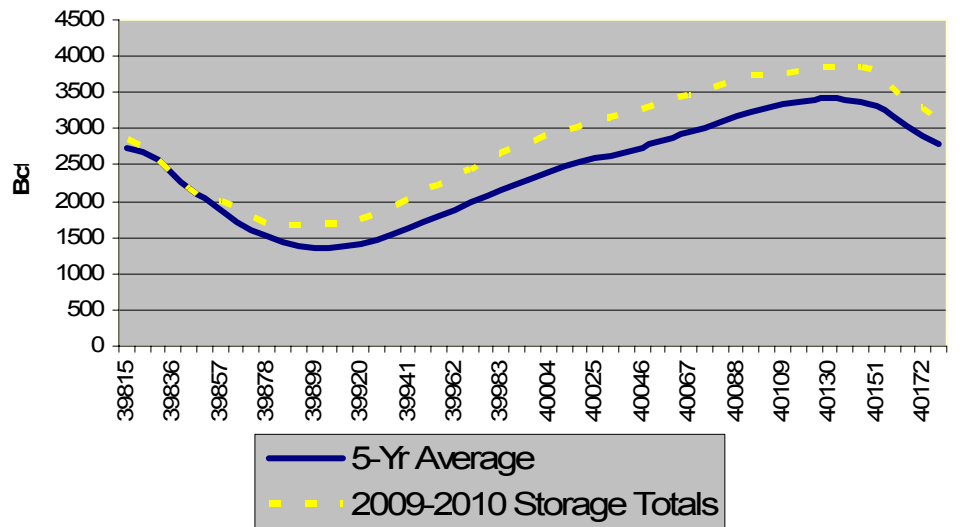
### Winter Continued

below-normal cold periods have arrived in the winter they tend to have been limited to one region, according to Bastardi.

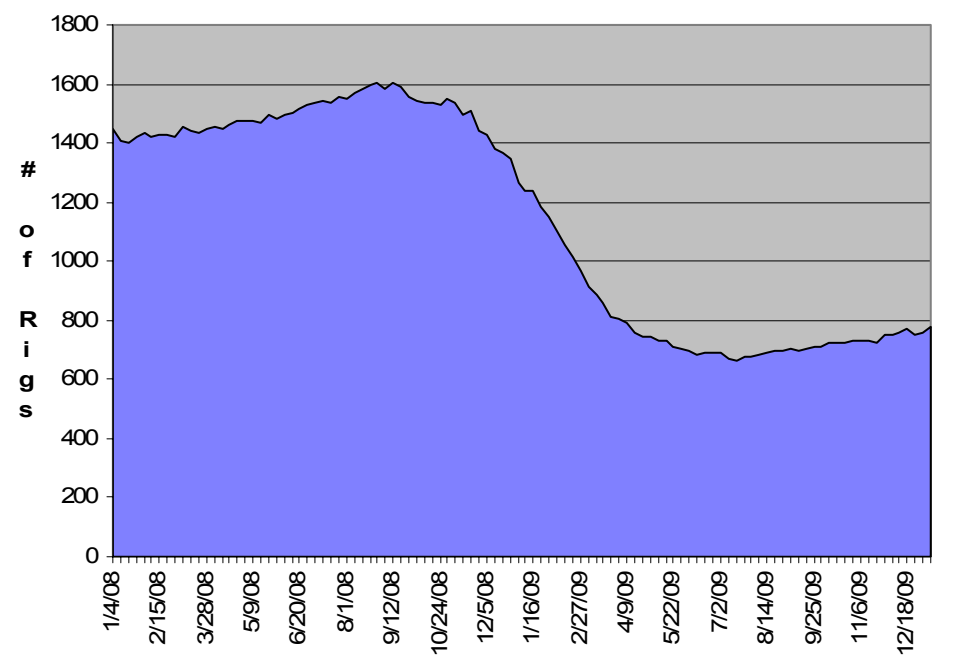
Temperatures have not been this low since the winter of 2002-03, which is known as the benchmark for frigid con-

# Snapshots

Natural Gas Storage



Natural Gas Rig Count

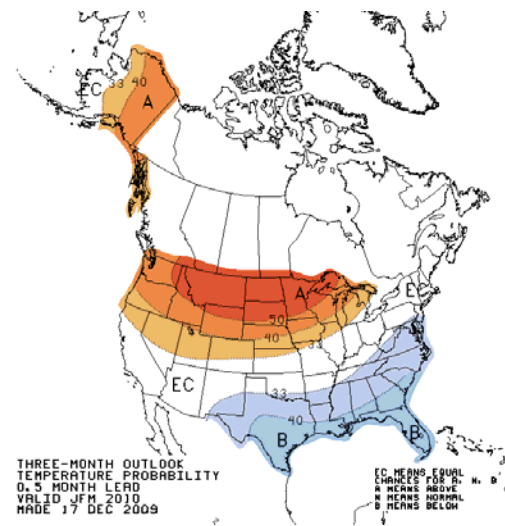


## Did You Know?

There are five main groups of natural gas users.

- ≈ **Residential users:** use natural gas in their homes to fuel furnaces and appliances such as stoves, water heaters and clothes dryers.
- ≈ **Commercial users:** use natural gas in businesses such as restaurants, hotels, and hospitals.
- ≈ **Industrial users:** use natural gas for heating processes and as fuel for the generation of steam.
- ≈ **Electric utilities:** use natural gas to generate electricity.
- ≈ **Natural gas pipeline companies:** use natural gas as a fuel to run compressor units.

## Seasonal Temperature Outlook January - February - March



## You're paying how much for natural gas???

Not receiving quality risk management service and timely information from your natural gas supplier?

As a leader in the municipal arena of natural gas \$ risk management, IMGA has assisted municipal gas systems in the Central and Midwest United States by providing innovative risk management strategies that stabilize and lower natural gas prices.

IMGA can handle all of your natural gas price risk management needs with or without physically supplying your natural gas.

Unhappy with your natural gas risk management strategies?

Tired of trying to guess the natural gas futures market yourself?

Carol Mitchell, Mayor of the Village of Tamms IL states, "The biggest benefit of the IMGA is that we are all allowed to hold on to our individuality. Each purchase is set up for our specific town, not all towns in general. The Agency knows our specific situation and works to meet our needs. I don't have to worry. I know that we'll be taken care of."

Contact us today to learn how to get your natural gas prices under control with a personalized risk management strategy.

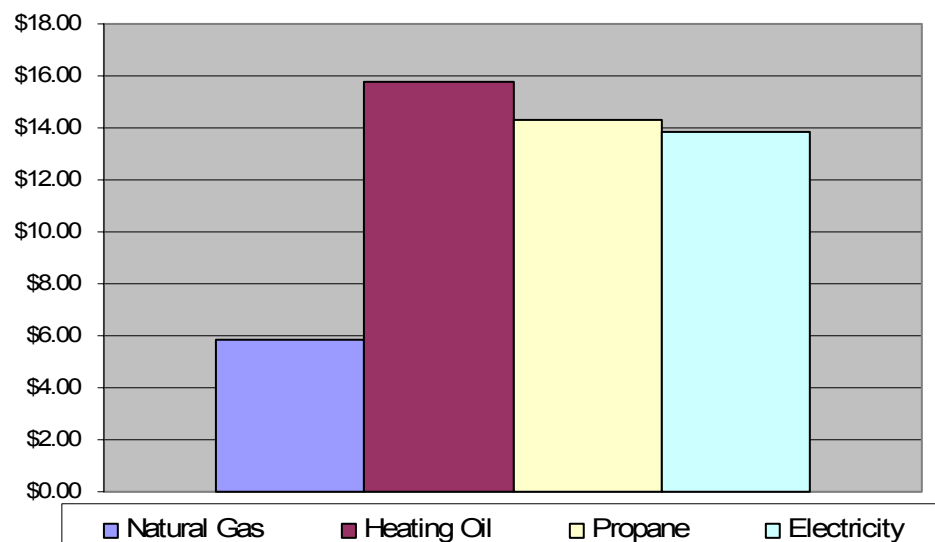
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More unhappy with your natural gas prices?

Price Per MMBtu As Of January 4, 2010



**Risk Management Continued**

buyer will choose one of three alternatives for terminating an options position: He can exercise the options contract, liquidate it by selling it back on the Exchange, or let it expire. While liquidation is the most common choice, a small percentage of buyers choose to exercise, particularly if their strategy calls for acquiring a long or short futures position at the strike price. The ability to trade in and out of positions is the great advantage of standardized options contracts.

If the futures price does not move far enough for an exercise or an offsetting position to be worthwhile, or moves in the opposite direction, buyers can simply let their options contract expire worthless.

**The Pricing of Options**

In return for right without obligations, options buyers pay options sellers a premium. The four major factors affecting the premium, or price, are:

- Futures price relative to options strike price
- Time remaining before options expiration
- Volatility of underlying futures price
- Interest rates

As in the futures market, options trading takes place both in an open outcry auction market on the floor of the Exchange and electronically via NY-MEX ACCESS. While the value of futures is tied to the underlying cash commodity through the delivery process, the value of an options contract is related to the underlying futures contract through the ability to exercise the option.

**Strike Price vs. Futures Price**

The most important influence on an options price is the relationship between the underlying futures price and the options strike price.

Depending upon futures prices relative to a given strike price, an option is said to be at-the-money, in-the-money, or out-of-the-money. An option is at-the-money when the strike price equals or is closest to the price of the underlying futures contract.

An option is considered in-the-money when the price of the futures contract is above a call's strike price, or when the futures price is below a put's strike price.

A call is out-of-the-money when the futures price is less than the option's strike price. For example, if the December natural gas futures price is \$2.50 per million British thermal units and the December \$2.65 call grants the holder of the options contract the right to buy a December futures contract at \$2.65, it is clearly-out-of-the-money.

Conversely, a put is out-of-the-money when the underlying futures price is higher than the put's strike price.

An options premium will usually equal or exceed whatever intrinsic value the options contract has, if any. Intrinsic value is the amount by which options are in-the-money. It is never a negative number.

Natural gas strike prices are listed in increments of \$.05 per million British thermal units (MMBtu). In the first three months of a contract, there are 60 strike prices in five-cent increments, with 40 strike prices above and 20 below the at-the-money price, which is the price nearest to the previous day's close of natural gas futures and 10 strike prices in increments of \$.25 per MMBtu above the highest and below the lowest existing strike price for a total of at least 81 strike prices. In the fourth month and beyond of a contract, there are 40 strike prices in five-cent increments, 20 above the at-the-money price and 20 below and an additional 10 strike prices listed in \$.25 increments above the highest \$.05 and below the lowest \$.05 surrounding the at-the-money price for a total of at least 61 strike prices. Strike price boundaries are adjusted according to the futures price movements.

**Volatility**

Volatility is an important factor in the pricing of options. As prices fluctuate more widely and frequently, the premiums for options on futures increase, since the probability of options attaining intrinsic value or moving deeper into the money increases. Accordingly, writers demand higher premium payments. However, if market volatility declines, premiums for puts and calls decline correspondingly.

Assume that natural gas futures prices are at \$2.25 and, during the past year, have ranged between \$2.10 and \$2.40. Unless there is good reason to expect that the futures contract will break out of its past trading range, a \$2.50 call would be expected to be relatively inexpensive. But if prices have ranged between \$1.75 and \$2.75 over the past year, that same call would be expected to cost more.

An options seller will want more money because the probability that the \$2.50 call will move into the money is higher. An options buyer will be willing to pay more since, if prices have been trading in a wider range, his price risk is most likely higher.

Historical volatility is calculated from the past movement of natural gas prices over a specified time period. Technically, historical volatility is the standard deviation of the log of the changes in the futures price, expressed in percentage terms, annualized. Or, to put it another way, 50% volatility, for example, means that there is a 68.3% chance (one standard deviation) that a year from now, prices will be 50% higher or lower.

Historical volatility is useful because it provides a basis for forecasting future volatility, which is what options traders really want to know.

Implied volatility is also important to options traders. Implied volatility is embedded in the price of an option and represents the market's forecast of future volatility. Since the past is not necessarily a good forecaster of the future, at any point in time, implied volatility may be higher or lower than historical volatility.

Volatility has a large impact on an options price. The premium for a \$2.20 strike at-the-money options contract with 75 days to expiration is \$.21 at 50% volatility, and drops to only \$.11 at 25% volatility.

Volatility is the key component to options pricing. It is, in fact, the only unknown in the options pricing model. Given an options market price and knowing the other variables in the pricing model - the futures price, the strike price, the time to expiration and interest rate - the remaining factor - the derived volatility - is implied by the option's price. When the implied volatility appears low compared to history and, more importantly, to a forecast of future volatility, options traders will tend to buy options. Conversely, when implied volatility appears high, traders will tend to sell options.

The 35% volatility assumption used in the hedge example in this brochure may, on any given day of options trading, be too high, too low, or just right when compared with actual implied volatility. Thirty-five percent was chosen simply as an example, but is certainly not outside the realm of possibility.

**Time Value**

Another component of an option's premium is its time value. The time premium is the amount buyers are willing to pay for the options above their intrinsic value on the chance that, at some time prior to expiration, they will move into the money. Premiums on out-of-the-money options are fully based on time since their intrinsic value is zero, as are at-the-money options. As options become deeply in- or out-of-the-money, the time premium shrinks substantially.

The time premium for in-the-money options is the amount that exceeds the options' intrinsic value and reflects the possibility that the options may move deeper into-the-money. The time value of an option necessarily shrinks as the expiration date approaches. The reason is that there is less and less time for a major change in market behavior, and a decreasing likelihood that the options will increase in value.

**Interest Rates**

Interest rates have a bearing on options prices because they represent the profit or cost that could result from an

alternate use of the funds used for the premium. Interest rates of 90-day U.S. Treasury bills are often used as a guide. In practice, though, isolating the effect of interest rates on options premiums is difficult, if not impossible. A change in interest rates influences the net present value calculation of a premium, the cost of buying and storing a commodity, and even the commodity's price. Most of the interest rate effect will already be incorporated in the futures price through the cost of carrying the physical commodity.

**Options Value at Expiration**

Options prices are linked to futures prices through the exercise feature. If, at the call option's expiration, futures are trading at \$2.70, a \$2.20 call, if exercised, is worth \$.50, the difference between the futures price and the strike price. The reason is that the holder of a \$2.20 call can exercise his option, receive a long futures position at \$2.20, immediately turn around and sell the futures contract for \$2.70, and make \$.50. If the trader notices that the market value of a \$2.20 call has declined to \$.30, he may still wish to purchase additional \$2.20 calls. Adding the \$.30 to the \$2.20 call brings the intrinsic value of the trader's position up to \$2.50. When he exercises his option and obtains a futures contract, he is then able to sell that futures contract for the prevailing \$2.70 and realize a risk-free \$.20 profit - the difference between the futures price and his options investment (exclusive of transaction costs); market forces ensure that an opportunity like this cannot last long.

Options cannot have a negative value, so if the risk does not occur, that is, if futures prices do not exceed the strike price, the options will be worth zero. No one will exercise the right to buy futures at \$2.20 via options when they can buy the futures directly in the futures market at \$1.70.

For a put option, the risk is the possibility that the futures price will be below the strike price. When this occurs, the options will be worth precisely the difference between the strike price and the futures price. Since a put gives its holder the right to sell futures, if futures are at \$1.70, the holder of a \$2.20 put could exercise the put into a short futures position at \$2.20 and immediately buy it back for \$1.70, making \$.50 (exclusive of transaction costs). At expiration, the put will be worth \$.50.

If the risk does not occur, that is if futures prices are not below the strike price, the options will be worth zero. No one would exercise the right to sell futures at \$2.20 when they can sell them in the futures market for \$2.70.

## Stay Informed With The IMGA Evening Report

The IMGA Evening Report is an excellent way to stay up to date on NY-MEX prices, weather, gas storage, and industry news. Each issue includes the days closing market prices for natural gas futures and crude oil, as well as a short commentary on market movement and industry related news.

The IMGA Evening Report is distributed electronically daily and is com-

plimentary to all of our members. If you are not an IMGA member, but would like to receive the IMGA Evening Report, please contact Charlene Howard at [choward@imga.org](mailto:choward@imga.org) or 217-438-4642. The IMGA Evening Report fee for non-members is \$150 per year, or become a member today for a one time fee of \$250.

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