

Seeking Alpha α

Out of favor with investors as a result of today's low price, natural gas offers the best energy investment opportunity of the decade on the basis of accelerating demand, environmental advantages and a supply breakthrough that radically changes the outlook for cleaner energy, we believe. While the potential reward is a several fold gain, the main risk is timing, in our opinion. The immediate outlook depends on economic activity, political action, and weather, all of which no one can predict with much certainty. Because the current near-month futures price of about \$4 a million btu is down some 75% from the high of the past five years of about \$15, we think the downside risk is low. Strong upside, no cost to wait and minimal downside looks like a money-making combination for patient investors. Five of six buy recommendations are concentrated from 59% to 100% on the growth fuel. We like oil, too, as we see the current near-month price of about \$74 a barrel exceeding the \$145 high from the past five years in the next decade.

Opportunistic Price Outlook

The U.S. Energy Information Administration probably spends more money than any other group to forecast energy price. Yet the product of their effort falls within a wide band of uncertainty. Forecasting a price of \$5.24 for December 2011, the actual price might be as high as \$10.04 or as low as \$2.79 and still be within the confidence interval (see chart Henry Hub Natural Gas Price, below). The oil price forecast for December 2011 is \$84 a barrel within a confidence interval of \$41 to \$164 (see chart West Texas Intermediate (WTI) Crude Oil Price, below). Natural gas price is at a low extreme at a third the energy equivalent of oil (see chart Oil/Natural Gas Futures Ratio, below).

Accelerating Demand

At \$4 a million btu, natural gas is also cheaper than coal taking account of today's permissive environmental standards for coal burning. EIA expects U.S. natural gas consumption to be up 4% in 2010 over 2009. Helped by a hot summer requiring additional power generation for air-conditioning, the growth in natural gas for electric power may be 8 percent in the second half of 2010 compared to the same period in 2009.

Though the pace may subside depending on weather and other factors, the ultimate global demand for natural gas to replace coal in power generation is almost unlimited. Coal for power is about a third of global energy supply while all uses of natural gas account for another third. Environmentally it could be desirable to replace all coal burning, implying a doubling of natural gas demand. At the same time, electric power generation is usually the fastest growing source of energy demand. China, the world's largest energy economy and growing fast, gets 80% of its energy from coal.

Fuel of Choice for Power Generation

New coal plant construction in developed countries is virtually grinding to a halt. Though the U.S. has not passed restrictions on carbon dioxide emissions, it hasn't passed subsidies for "clean coal" either. A costly carbon dioxide control program is probably not justifiable anyway, but increasing restrictions on obvious pollutants like sulfur, mercury, toxic metals and the like are common sense, we think. A prudent utility executive has to consider that restrictions on coal-fired generation will get progressively tighter one way or another. Not knowing for sure that such regulations could render a new coal plant uneconomic, the reasonable course of action is not to take a chance on the long lead time, high capital cost investment. James Rogers, the chief executive of Duke Energy ([DUK](#)), a major coal and nuclear utility, declared to an audience in Tianjin, China on September 13, "Gas-fired power plants will be built in lieu of coal plants because of uncertainty in the regulation of coal, on sulfur oxides and nitrogen oxides as well as carbon." according to Bloomberg.

Clean Fuel Technological Breakthrough

It is an article of faith among optimistic Americans that technology will provide magical solutions to our problems. On that basis, political leaders and alternate energy promoters champion costly subsidies for uneconomic and impractical projects. To replace gasoline with ethanol, we would practically cover the whole country with corn fields! At least that might look better than wind towers. Would covering the whole country with solar panels be more appealing? In other words, those alternatives don't have scale and costs are prohibitive especially when government debt is exploding. Those who want more government in our economy might applaud the control that government retains with the ability to turn subsidies on or off at will.

The problem with natural gas, to be facetious, is that oil companies produce it. Environmental lobbyists, it seems, see the whole purpose of alternative energy to get rid of evil oil companies. Now in the irony of ironies, the energy cost breakthrough sought in nuclear, solar and wind has arrived in natural gas and has been developed primarily by oil and oil service companies!

Horizontal multistage fracturing didn't arrive over night, but it has changed the supply equation in a major way since the financial panic of 2008. To the surprise of energy analysts, natural gas production did not decline much when rigs drilling

for natural gas were cut by two-thirds in reaction to the financial disruption. The remaining one third were drilling highly productive horizontal wells with an increasing number of fracturing stages with better and better optimization. The technique has opened up hydrocarbon-rich shale formations that were always known, but couldn't be produced economically.

The advantages of natural gas for power generation have become increasingly obvious the past two decades with the combined cycle power plant that combines a jet engine with a conventional boiler to increase conversion efficiency. Since a jet engine can't use coal, the solid fuel became disadvantaged on efficiency in addition to cleanliness. The problem utility executives had with natural gas had been the fear that as soon as they committed to the better fuel its price would go up. That essentially happened to the natural gas merchant power generation pioneers in the past decade. Now with the supply breakthrough, the natural gas producing industry has the capacity to develop much more fuel at an economic price.

Income and Growth Stocks

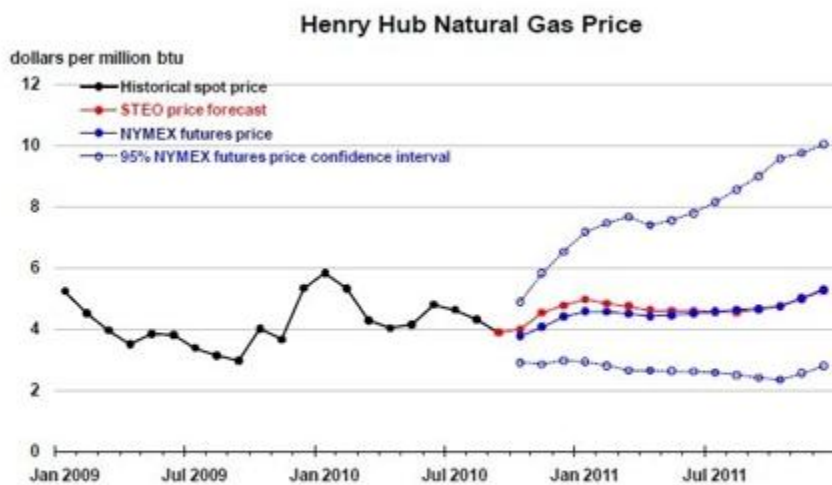
While the price of gas will likely not rise to make power generation uneconomic, it still has attractive potential to increase. Bloomberg reports that Mr. Rogers, the Duke chief and large future natural gas customer, conditions his conclusion on a price range of \$4 to \$7. Since we are at the bottom of that range now, the trend from here may be up. Next twelve months futures prices are about \$4.50, roughly where they have been for the past year. Futures for the next six years may have stopped declining at \$5.50. Our long-term price expectation is \$8 though we make year-ahead projections at the futures price, currently \$4.50.

Our long-term prospect anticipates that conditions will improve with moderate economic growth. Expectations now are generally low as they usually are after a steep economic downturn. Natural gas price confidence is also at a seasonal low point after peak summer demand and before peak winter demand. Stock market confidence is low before November mid-term elections. Seasonal tax selling may be in swing.

Despite all the economic and political gloom, most income and small cap oil and gas stocks are in an uptrend with current price above the 200-day average. Income stocks look good because distributions have continued to be attractive and our projected yields have remained strong using a \$4.50 one year price for gas. Nor is there much competition from traditional savings and money market interest. Existing volumes from long-life producers is nearly always the most economic source of energy.

Our growth stock buys look good helped by strong current cash flow from oil. More important, natural gas drilling using the latest technology has unlocked large new potential. Yet, because new production declines rapidly, new investment is in continuing demand to grow or maintain supply.

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Note: Confidence interval derived from options market information for the 5 trading days ending September 2, 2010
Intervals not calculated for months with sparse trading in "near-the-money" options contracts



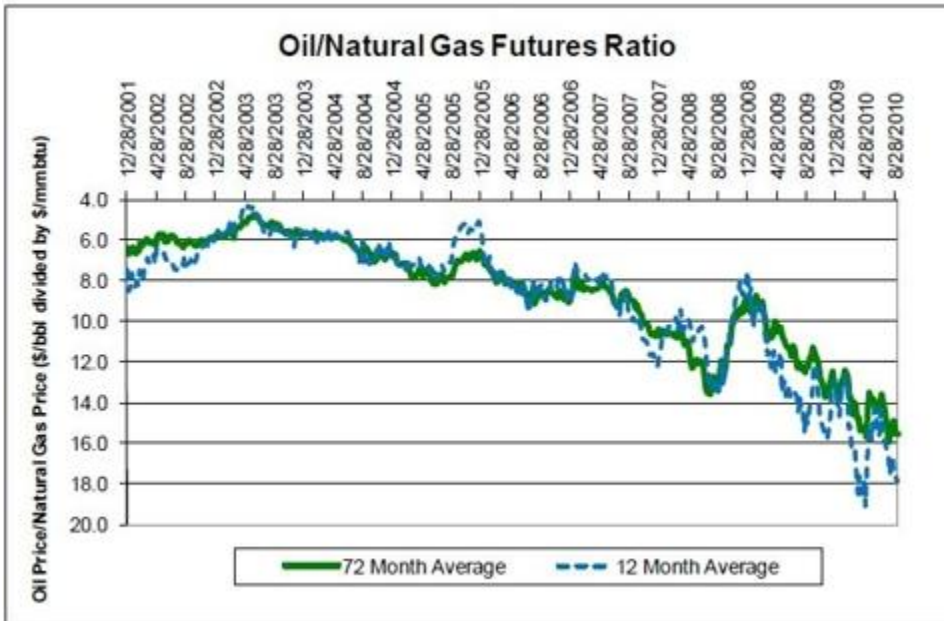
Source: Short-Term Energy Outlook, September 2010; Reuters News Service; and CME Group

West Texas Intermediate (WTI) Crude Oil Price



Source: Short-Term Energy Outlook, September 2010; Reuters News Service; and CME Group

Oil/Natural Gas Futures Ratio



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