

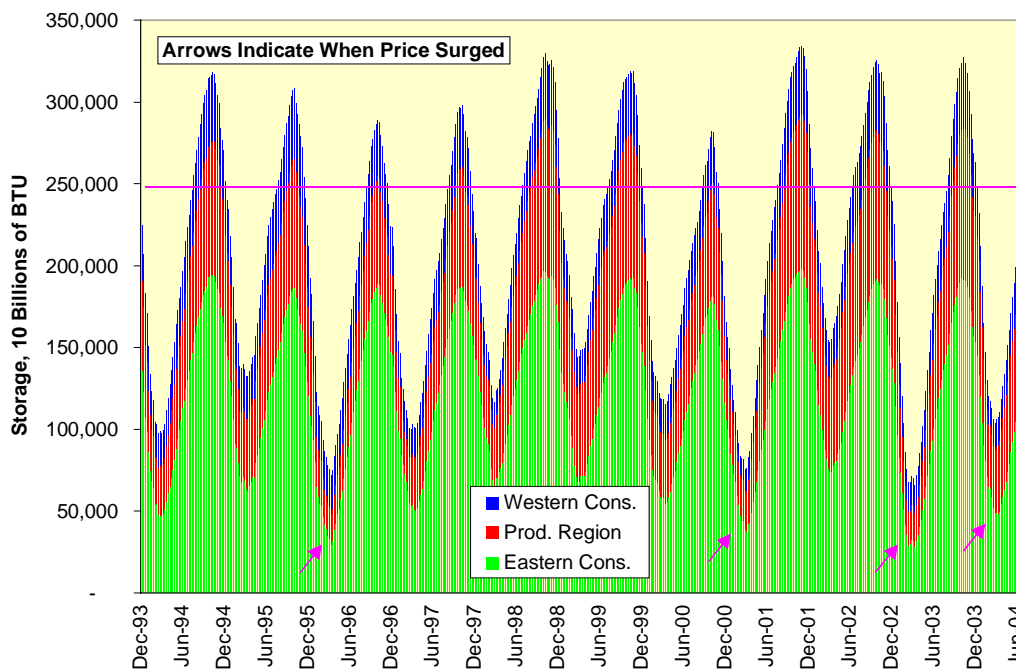
Natural Gas Is Behaving Itself For Now

Every parent knows the feeling: When the kids are uncharacteristically quiet, something is about to happen. Natural gas, which has earned a reputation over the years as being the most volatile of all the physical commodities, has been keeping a low profile of late while crude oil has been grabbing all the headlines.

The role of good luck cannot be overstated in this market: Much of the eastern half of the U.S. has experienced an unusually cool summer this year, which reduces the demand for natural gas-generated electricity. Natural gas that could have been used to power air conditioners has gone into storage instead, and that should give the natural gas market a little bit of a cushion going forward into the winter.

It is necessary to emphasize the "little bit" part, however. We can see this in two views of the Department of Energy's natural gas storage data. The first is absolute storage by the DOE's three regions, eastern and western consuming and Gulf Coast producing. The data are converted into 10 billion BTU chunks to match the size of the NYMEX futures contract. Arrows mark storage levels reached prior to four early-winter price spikes, and the horizontal line marks the current storage level of 242,500 NYMEX contract equivalents. Actual open interest on the NYMEX, by way of comparison, totals 378,485 contracts, with the front two contracts, September and October both over 50,000 contracts.

Gas Storage: Injection And Withdrawal Cycle

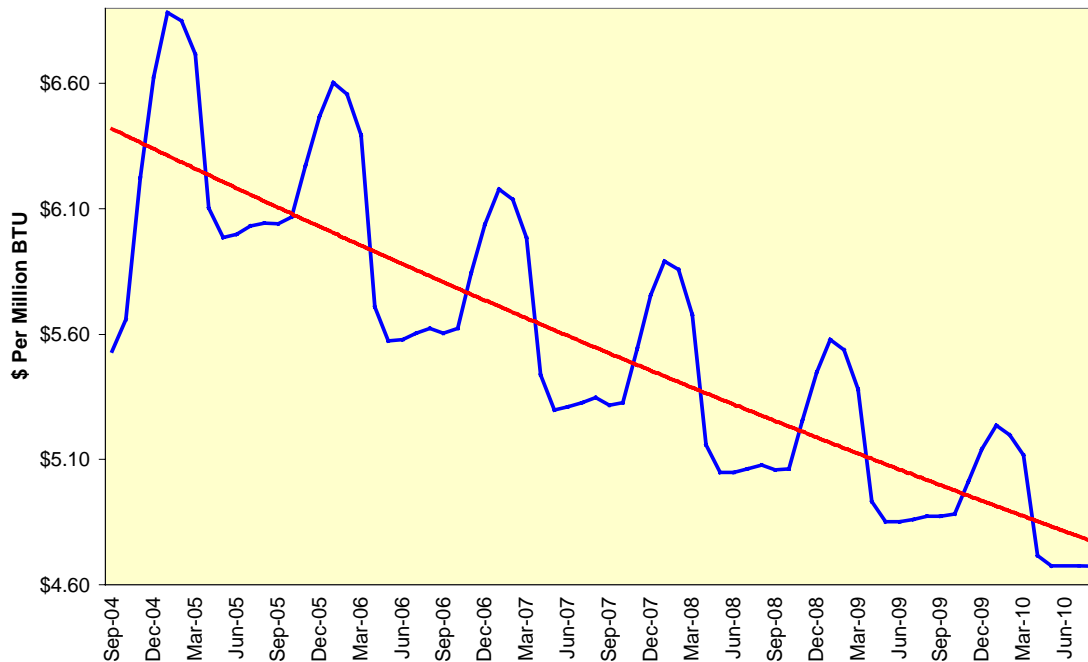


A second view of present storage levels can be achieved by comparing the data to year-ago levels. The picture is of concern: Despite the favorable summer weather, storage levels in the eastern and western consuming regions are only 8.3% and 4.5% over year-ago levels, respectively. Storage levels in the producing region are 23.9% over year-ago levels, but this could be of literal and figurative small comfort should a weather-related demand spike occur this winter given the limited capacity of the pipeline system to move extraordinary quantities of natural gas. Natural gas storage has to be located near the consumer to be of use during tight markets.

A Linear Forward Curve

The natural gas futures market has some of this risk priced into contracts for this winter; the December 2004 - March 2005 futures all are priced at more than \$6.60 per million BTU, as compared to just over \$5.50 for the September contract.

Forward Curve Of Natural Gas Futures

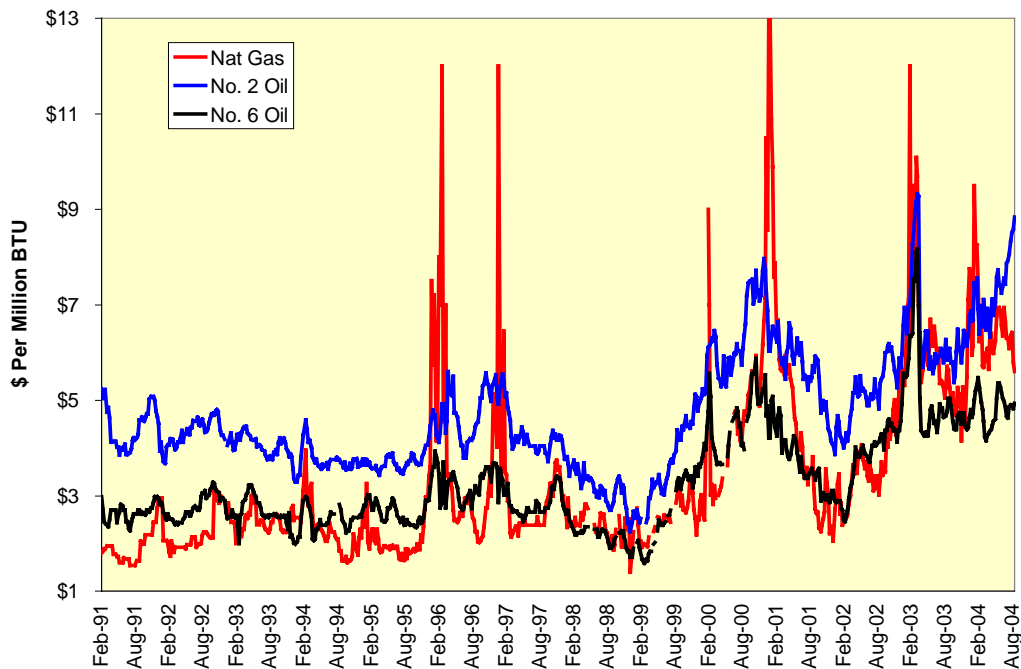


What happens after this winter is quite remarkable. Each successive year out to 2010 is priced lower than the ones before. Long-term buyers are unwilling to pay much more than \$4.50 per million BTU, a level first reached in May 2000 and exceeded frequently since, for delivery six years from now. Conversely, producers are willing to sell long-dated strips of natural gas futures at levels less than current prices. Both of these behaviors reflect a sentiment that current prices are unsustainably high, a sentiment often conducive to producing price spikes. Unless there is strong agreement within the industry that liquefied natural gas (LNG) from Trinidad, Algeria, Indonesia and elsewhere is going to start pouring into the U.S. pipeline system in an uninterrupted stream, the forward curve for natural gas indicates a market in denial.

Burner Tip Comparisons

For years, energy industry economists hurled themselves headfirst into the brick wall of burner tip parity, the concept that competing fuels would have to be priced equally in the final market. Let's just say reliable sightings of Elvis have been more frequent. The engineering costs and capital investments required for dual-fuel use and switching capabilities on a large scale are formidable, and they ignore one of the permanent advantages petroleum fuels have over natural gas, that they are liquids capable of flowing under their own pressure. If we compare prices of natural gas against No. 2 home heating oil and No. 6 heavy fuel oil in New York against natural gas, we see how infrequently burner tip parity has occurred.

Competing Fuel Prices In New York



At present, natural gas in New York is near \$5.60 per million BTU, while heating oil is more than \$8.80 per million BTU. More important, the two prices are headed in opposite directions at the moment, with heating oil rising and natural gas falling. Fuel oil, which burns less cleanly than heating oil, trades just under \$5.00 in the New York market.

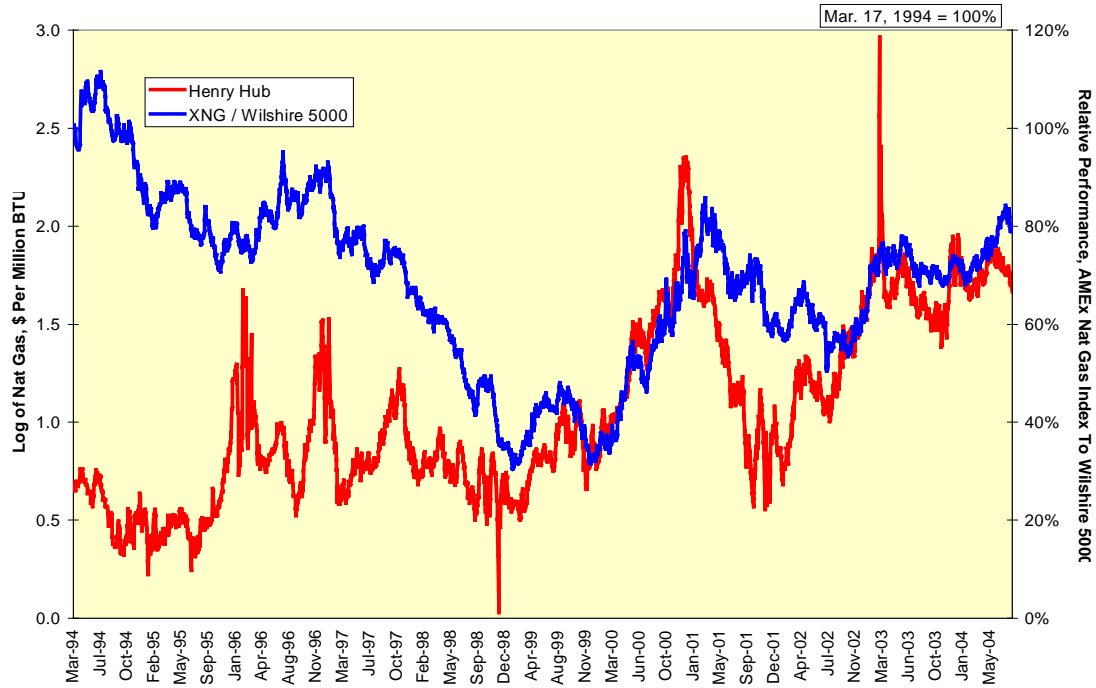
The price gap between heating oil and natural gas may look like a yawning arbitrage opportunity, but as the financial regulators tell you, when it looks too good to be true it probably is. Virtually all heating oil users, residences included, have on-site storage facilities, while almost no natural gas users do. Most industrial natural gas contracts are sold on an interruptible basis. In option terms, industrial buyers are short a call option at a price to be determined to non-interruptible residential users. This short call, which is capable of closing a business, makes natural gas worth less to the industrial customer.

Even so, if petroleum prices stay high, natural gas prices will - and that is a "will," not a "may" - rise to capture the economic rent. Only if crude oil prices fall and fall significantly enough to offset their major embedded short call option, political risk, will natural gas prices stay at present levels or fall themselves in the near future. Longer term it is still quite rational to be optimistic about lower natural gas supplies from conventional sources in garden spots like western Siberia, Turkmenistan, Iran and Qatar (yes, those are the big reserve holders of conventional natural gas for those of you interested in an adventurous working vacation to see any of them). And while unconventional crude oil sources such as oil shale will be investment black holes forever, unconventional natural gas sources such as seabed methane hydrates hold promise of being economic.

Taking Stock Of The Situation

One of the great surprises for many investors in commodity-linked equities is just how poorly the stocks track the commodity. Natural gas is no exception. If we take the performance of the AMEX Natural Gas Index (XNG) relative to the Wilshire 5000 over the past decade, we see the XNG had only 80% of the gain of the Wilshire 5000 at a time when wellhead natural gas prices increased by 170%. That may not be the perfect definition of a waste of time, but it is reasonably close thereto.

Gas Stocks Don't Light A Fire



If anyone, anywhere can show me promotional literature for an energy stock fund that mentions this relationship, my eternal gratitude will be offered in return. No such offer is extended, either here or in the proverbial prospectus, for literature that mentions natural gas' strong fundamentals as a reason to buy. I suspect these are safe bets, just like worrying when the kids are quiet.