Coal Outlook Not Black

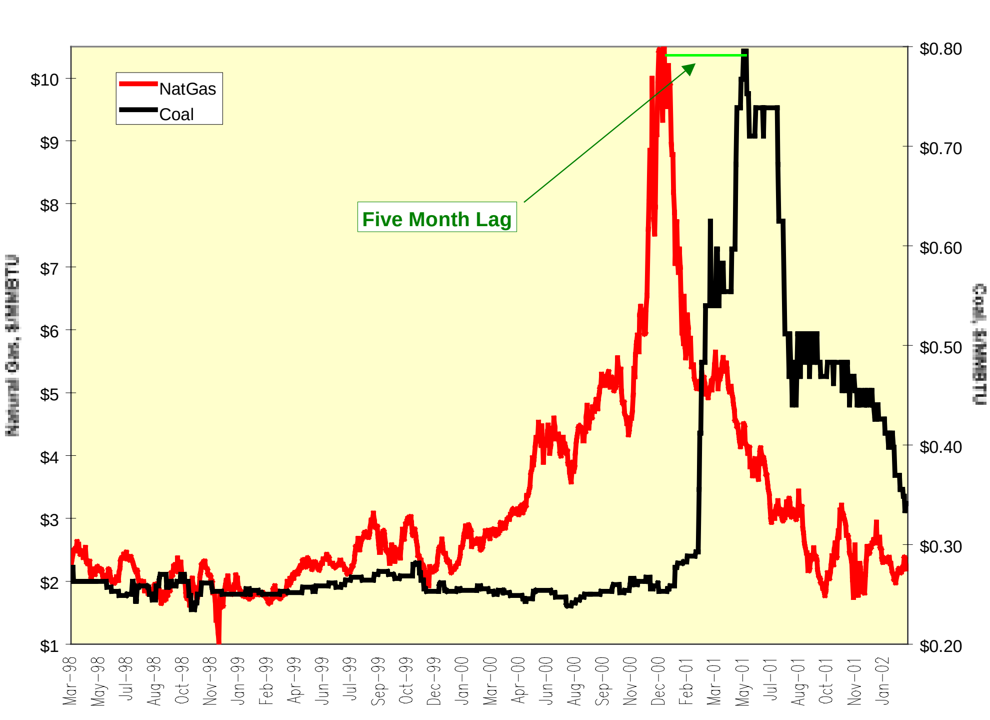
Coal has always been the Rodney Dangerfield of the energy world, the literal and figural black sheep of fossil fuels. It deserves some respect, however: It still accounts for 51% of the electricity generated in the United States; about 87% of the coal used in this country is purchased by electric utilities, most of the rest goes to produce coke for steel manufacture. However, it seldom is included in the various brave new world schemes that always define the energy debate.

It's environmentally unfriendly in all phases, from the strip mine to the railroad to final combustion. It's blamed for acid rain, global warming, greater total releases of radioactivity than nuclear power, and it is characterized by the worst labor relations this side of major league baseball.

But, as natural gas and residual fuel oil prices soared in 2000 and early 2001, cheap coal started to look good in comparison, and the shares of coal producers started to look even better. However, this was an ephemeral rally, as I noted in the predecessor site to RealMoneyPro at the end of March 2001:

> Whether the price break in natural gas occurs in 2001, 2002, or 2003 is immaterial. It will occur. Moreover, the high returns in coal will lead to expansion of mine and transport capacity, and no doubt to construction of large new coal-fired generating units. Once investment in coal begins, and once natural gas prices start to decline, the party in coal stocks will be over. Until then, let's all enjoy.

The price break in natural gas occurred in 2001 and has continued to-date. Let's update the picture for coal by comparing the wellhead price for natural gas at Henry Hub in Louisiana to the FOB price for low-sulfur, 8,800 BTU per pound, coal at Gillette, Wyoming, the beating heart of the Powder River basin. Both prices are converted to dollars per million BTU.



This graph could be used to teach the principle of economic substitution. Coal prices rose with a five-month lag to capture the rent of higher natural gas prices, and then fell with a similar lag. The lag is accounted for by delays in rail car nominations, boiler switchovers, and other contractual and logistical issues. In addition, the BTU price of coal generally ranges between 10% and 15% of the natural gas price; given the much higher life cycle costs of coal use, this is all generators can afford to pay.

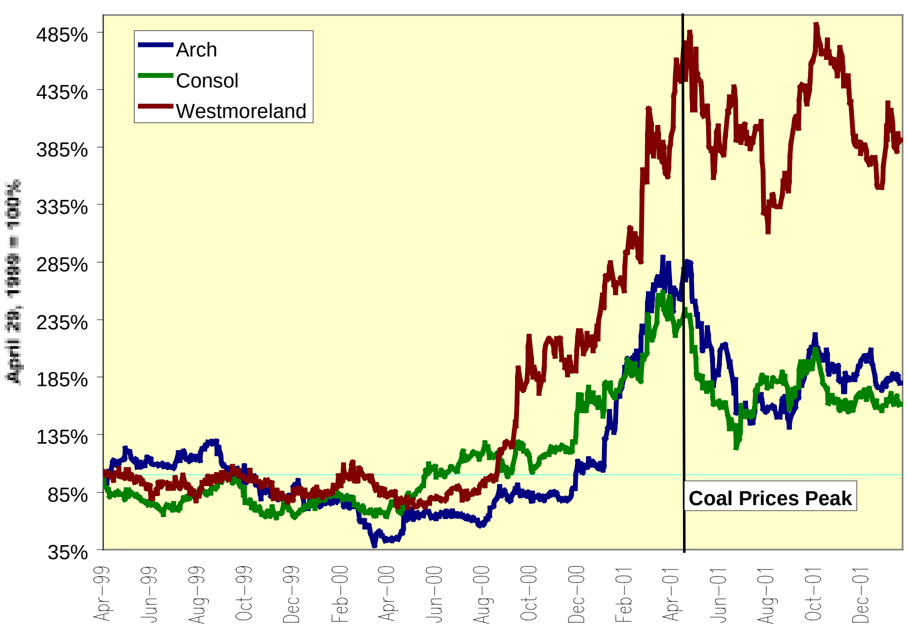
No Future In Coal Futures

The New York Mercantile Exchange (NYMEX) launched futures on coal in 2001. The contract is on barges of 12,000 BTU per pound coal delivered to docks on the Big Sandy River, which forms the border between Kentucky and West Virginia, or on the Ohio River near Huntington, West Virginia. Given that the largest coal reserves in the U.S. are in the Powder River basin, and that the U.S. coal export market is based on rail cars delivered to Hampton Roads, Virginia, this choice of contract basis may strike you as odd. Predictably, the contract has drawn very little commercial or speculative interest; its open interest is just over 500 contracts with a daily volume between 20 and 30 contracts. The NYMEX had been looking toward spread trading opportunities between coal, natural gas, and petroleum products; their electricity futures contracts are de facto dead.

Coal Stocks

The shares of coal miners may be a better way of playing coal prices than these virtually defunct coal futures. Markets are supposed to discount future developments, and the shares of miners such as Arch Coal, Westmoreland Coal, and Consol Energy appear to do this well. In the petroleum industry, the oilfield service firms such as Schlumberger or Baker Hughes often rise in advance of oil price increases. In coal, most of the price changes flow directly to and from the miner's bottom line.

Relative Performance Of Coal Miners To S&P Barra Value Index



What is interesting about this chart is how the coal miners have maintained a significant portion of their gains relative to the S&P Barra Value index even as both natural gas and coal prices have retreated. This suggests that coal is being viewed not only as a fuel but as an insurance policy against any future resurgence in either natural gas or residual fuel oil prices.

Does this security premium in coal mean that some of the next price cycle higher has been discounted already? Yes, but these shares also have been willing to forgive the significant price drop that already has occurred. This puts a natural floor under the group. Once again, we can look at the stocks of resource producers as a call option on the resource itself. They'll allow you to capture the upside in a leveraged manner while absorbing much of the downside of the resource's price. That's not such a bad deal. In fact, it deserves a little respect.