Coal's Good Day At Black Rock

This is the year when the first Baby Boomers have become eligible for Social Security; hold your applause. This generation remembers not only the duck-and-cover routine for foiling Russian ICBMs, it remembers various points of propaganda about how we should eat two eggs a day, drink plenty of whole milk and be proud of living in various ages. Yes, we were in the Oil Age, the Atomic Age, the Steel Age and the Coal Age, amongst others.

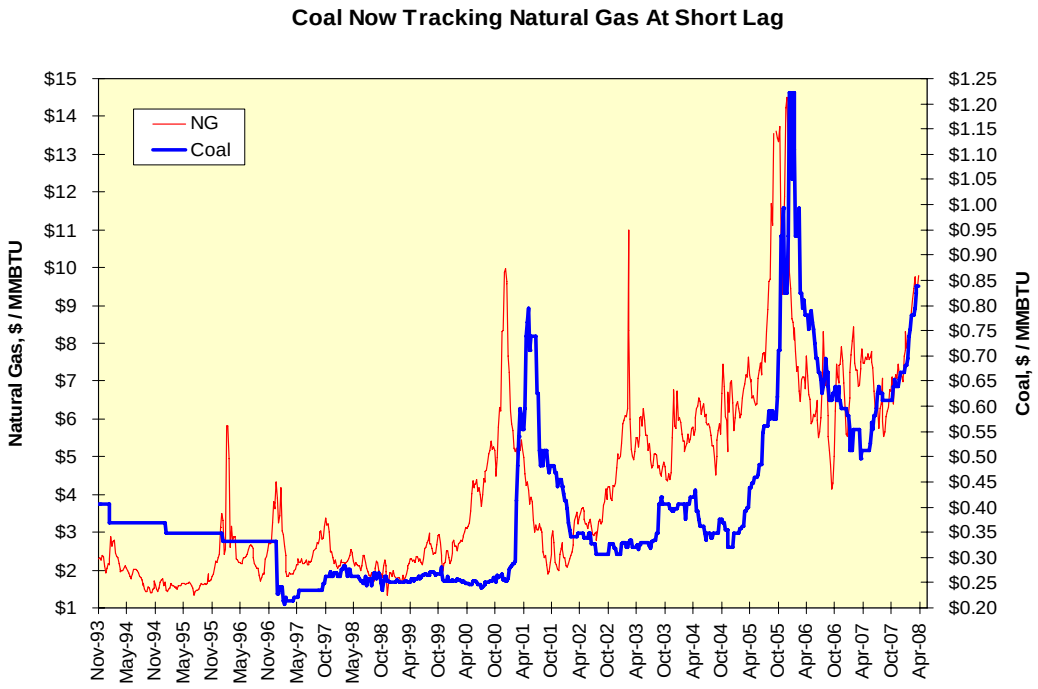
What were we taught about coal? Well, there was that whole Industrial Revolution thing, replete with steam engines, belching locomotives, Spinning Jennies and other wonders made possible by burning coal. Less emphasis was placed on soot, sulfur dioxide, particulate and mercury emissions, underground mine cave-ins, strip mining and the worst labor relations this side of Major League Baseball. Carbon dioxide emissions were not even on anyone's radar screen.

Once the first energy crisis of the 1970s hit, we were told America was the Saudi Arabia of coal; this presumes, of course, we should want to be the Saudi Arabia of anything. But even with coal always providing half or more of the fuel for electricity generation and with coke, a coal derivative, being required for steel production, coal mining never was a glamorous or particularly profitable business. And let's just say we never have internalized coal's massive environmental costs.

Substitution At Last

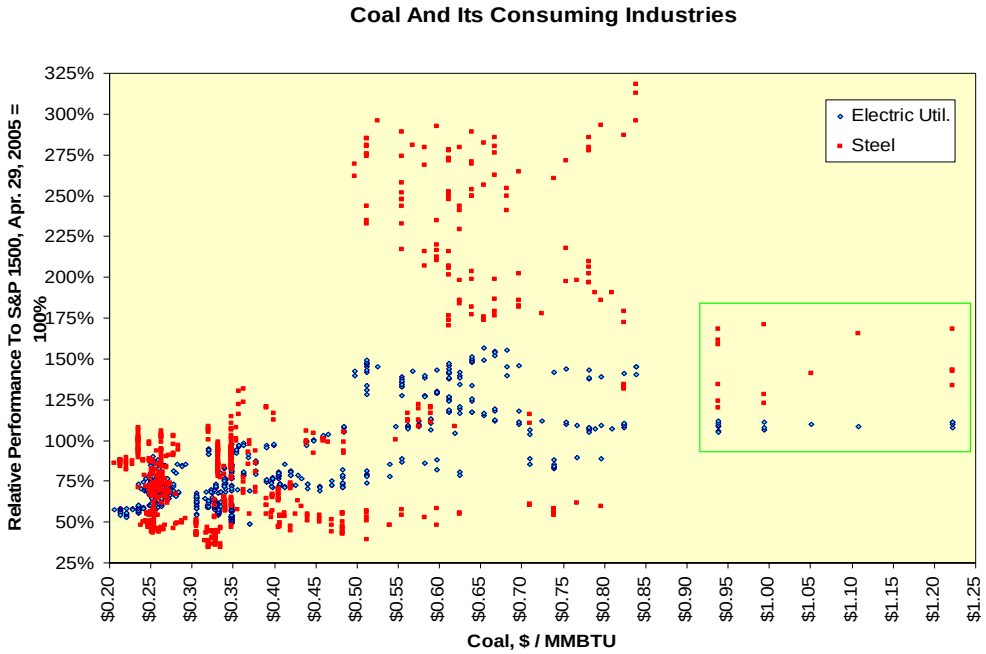
None of the fossil fuels, which include petroleum and natural gas along with coal, are very good substitutes for each other for reasons discussed in January 2006, but their rise in price is changing that. That has been the case between natural gas and petroleum products, and now it is the case between coal and natural gas. As the commodity becomes more valuable, the price to the producer captures a greater share of over all value relative to the transportation chain's share. The coal business over the years has been a railway business and has provided the baseload for carriers such as Union Pacific, CSX, Norfolk Southern and Burlington Northern Santa Fe.

If we map the price of low-sulfur coal from Wyoming's Powder River Basin (8,800 BTU per ton) against the price of natural gas at Henry Hub, we see an interesting history. Price spikes in natural gas in 2000-2001, 2003 and 2004 were not reflected in coal prices until about five to seven months later. The most recent price jump in natural gas is being matched almost in real time by coal prices. The coal miners have become much better at capturing the value of their product.



Coal Consumers

If the biggest buyers of coal are the electric utility and steel industries, have their performances relative to the broad market been affected by the rise in coal prices? If this was the case and we mapped the relative performance of the S&P Supercomposite subindices for electric utilities and steel against Powder River coal, we would see a profit profile akin to a short call option. Instead, the impact on the steel industry is overwhelmed by the strong global market for steel, and the electric utility industry's relative performance to the broad market has been flat. Utilities, even in this more deregulated era, are quite adept at passing higher costs along to their customers.

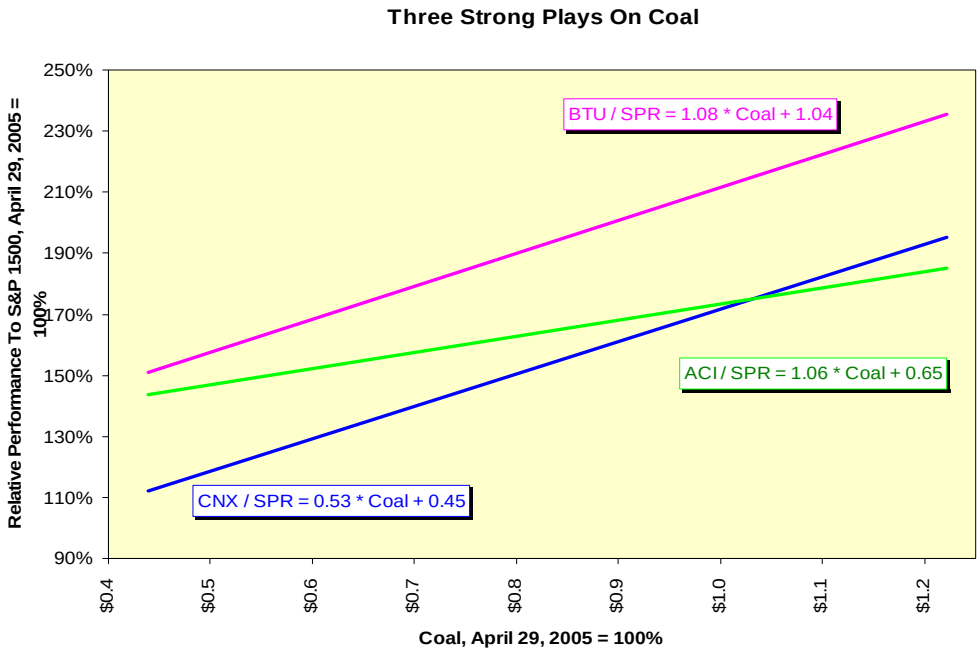


About the worst that can be said is both industry's became broad market performers during the late 2005-early 2006 surge in coal prices; that episode is contained within the green rectangle on the chart above.

The Producers

Are coal miners a good proxy for coal prices themselves? The answer is mixed. In the case of Massey Energy, the answer is, "No," and the data sample for Patriot Coal is too short to make a judgment. But three coal miners do reflect coal prices well.

If we map the relative performance of Peabody Coal, Consol Energy and Arch Coal against Powder River coal, we see near-linear relationships between Peabody and Arch Coal as a function of coal (only the trendlines are displayed in the interests of clarity). Consol's relationship is strong, but is far less linear.



Going forward, the world seems unlikely to break its reliance on coal for electricity production any more than we will break our reliance on petroleum for transportation fuel. This is true in the U.S. and even truer in both China and in India, both of which are major users of coal from domestic sources. Both Australia and the Philippines supply coal throughout the Asian market, which should continue to benefit mining giants like BHP Billiton.

Will we move to internalize the environmental costs of coal via a carbon tax or cap-and-trade scheme? The cynic in me says, "No," and that is independent of any judgment on the entire global warming debate. The simple fact of the matter is European schemes have been ineffective in reducing carbon emissions, and any global scheme has to include China and India to be anything other than pointless.

The net outcome, then, should be for both higher and more volatile coal prices in the domestic market as coal moves into alignment with crude oil and natural gas and for continued strong performance by the coal mining companies.