

Coal: A Good Day At Black Rock

The phrase "There's always a bull market somewhere" ranks below "I told you so" in the endearment department. After all, the speaker inevitably enjoys the benefit of hindsight. But in our wonderful gales-of-creative-destruction environment, the industries that looked dead and uninteresting until recently are enjoying a renaissance of uncertain duration; we don't need to recount what has happened to last year's highfliers.

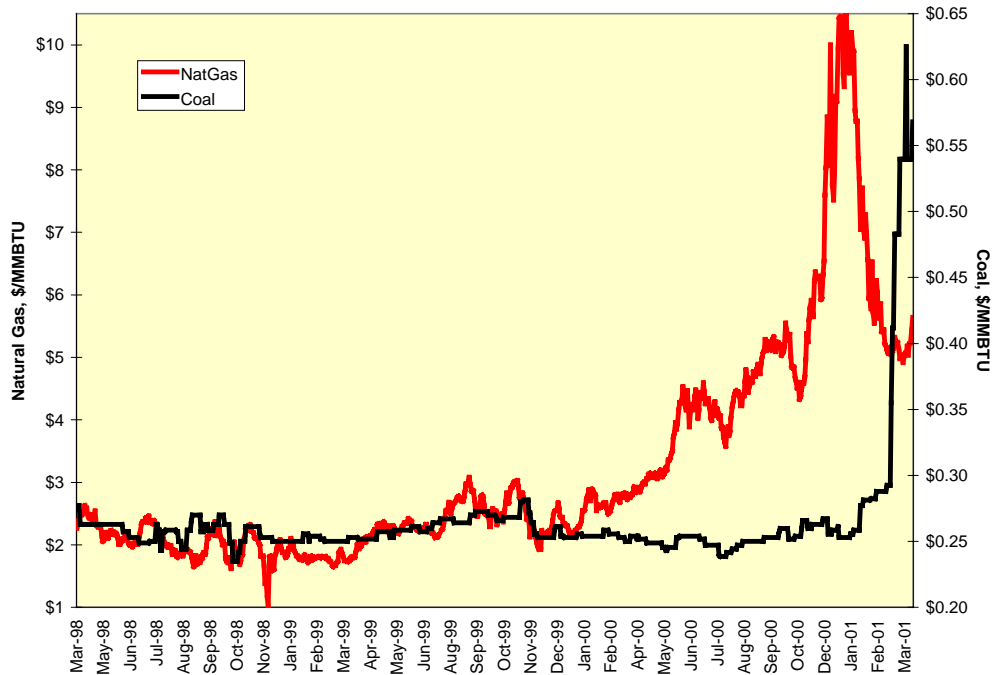
Coal, the fuel of the first industrial revolution, still plays a critical role in the Information Age. According the Department of Energy's Electric Power Monthly report, coal still accounts for 51% of the electricity generation in this country. More than 87% the coal consumed in the U.S. goes into electricity generation. No other fuel has coal's life-cycle environmental problems; at the mine, in transport, and in combustion it affects the quality of air, land, water, and the health and safety of all those involved. Still, as we observe the 22nd anniversary of Three Mile Island and the 15th anniversary of Chernobyl, we can be reasonably certain of coal retaining its advantages over nuclear power, imported fuel oil, scarce hydropower, and suddenly expensive natural gas.

Substitution In Action

Economic logic dictates that coal prices should rise to capture the rent of higher natural gas prices, and for once this logic works, albeit with a lag for contract negotiations and engineering considerations. Coal's high transportation and environmental costs account for the order of magnitude difference in price between the two fuel sources. For the sake of completeness, we should note that heavy fuel oil and natural gas prices, substitutes in many industrial applications, have oscillated around each other for years; at present, natural gas is more expensive.

Futures traders have been waiting for several years for a coal contract to be launched by the New York Mercantile Exchange (NYMEX). The contract, if and when traded, will be 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. The largest coal reserves in the U.S. are in the Powder River basin of Wyoming. This coal, which has a much lower heat content of 8,800 BTU per pound, is delivered by rail. The NYMEX is looking toward spread trading opportunities between coal, natural gas, and petroleum products; their electricity futures contracts are de facto dead. Until these coal futures begin trading, investors will have to play coal prices through coal mining stocks, which isn't a very bad idea at all, as we shall see below.

Coal Catches Up

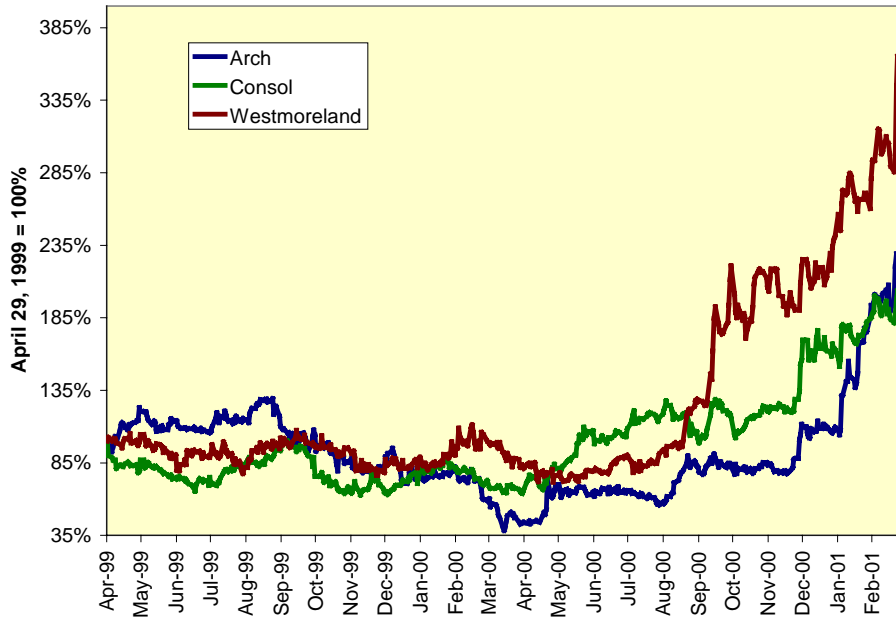


We could look at the soaring coal and moan about yet another skyrocketing energy cost, but this would be an inappropriate response. Is replacing \$5.65 / MMBTU natural gas \$0.568 / MMBTU coal a bad idea? One of California's problems has been reliance on natural gas peaking plants for electricity generation; these higher-cost plants can be replaced by coal-fired baseload capacity. Of course, California might have to accept the environmental horror of building coal-fired units somewhere within the confines of the Golden State, but that's another story altogether.

Profits: The Real Coal Miner's Daughter

Markets are supposed to discount future developments, not react hysterically to after-hours earnings announcements. The shares of various coal stocks have done this beautifully. Issues such as Arch Coal, Westmoreland Coal, and Consol Energy began moving higher in the spring of 2000, just after the start of the natural gas price rise, but well before anyone realized just how high gas prices would get. The rise has continued even after natural gas retreated from its December 2000 highs. We can interpret this as coal prices having further to rise to capture the rent of higher natural gas prices. Unlike the petroleum industry, where oilfield services firms are often the largest beneficiaries of higher prices, most of a coal price increase flows directly to the miner's bottom line. The results over the past year have been spectacular: A 245% return for Consol, a 280% return for Westmoreland, and a 319% jump for Arch. Does anybody recall any of these stocks being touted during the Internet boom?

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



What could go wrong with buying the miners? Let's turn our attention back to natural gas: The history of all physical commodities, as noted so often in this series, is for long-term declines in real prices punctuated by price spikes. The spike in natural gas prices, which could see a second leg this year as we enter the summer cooling season, is attracting new investment in supply, from LNG terminals on both coasts, to an upsurge in drilling, to the importation of ammonia and methanol to avoid high U.S. prices. Energy prices have negative correlation between the short and long terms; higher prices today will lead to lower prices tomorrow, and vice versa.

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.