Hot Time In The Old Town This Winter

When the conversation turns to fossil fuels, as it inevitably does, confusion is the order of the day. To compound the matter, there's always some know-it-all off in the corner talking about how long-term correlations between heating oil and natural gas, once so disparate, have started to increase.

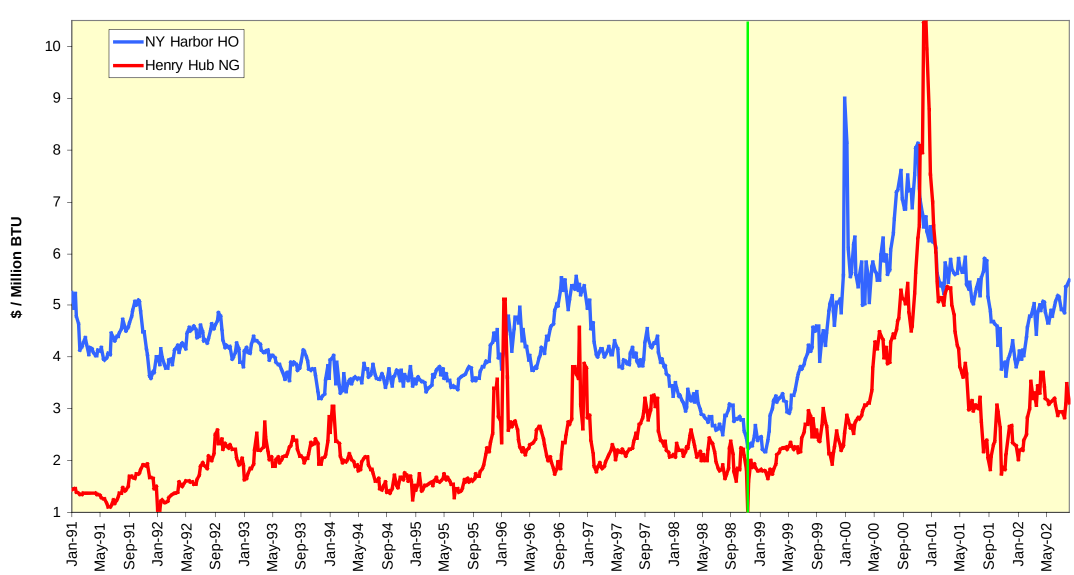
Isn't it bad enough that those who have sought diversification by global investing have had to endure a convergence between European stock markets and our domestic disaster area? Tell you what we should do: Let's pick a date, any date, and have all of our quote vendors broadcast a market opening in a direction opposite to ongoing European trade. Watch how those always-carping Old World sophisticates stop dead and their tracks and reverse their positions. Then, on cue, let's start broadcasting the real quotes along with a computer virus-like taunt, "Bonjour, Francois! How's your higher opening going?"

OK, so it's massively fraudulent and completely illegal: Good comedy is not cheap.

Home Heating

Now back to today's topic, the increased correlation between heating oil and natural gas, the forward curve of natural gas futures prices and implications for beleaguered energy firms. Good thing I like the word 'beleaguered;' I've been getting a lot of chances to use it lately.

Shedding Light On Heat



If we convert the price of heating oil in New York harbor from its customary cents per gallon to dollars per million British Thermal Units (BTU), the pricing basis for natural gas, we find that the two fuels have started to move more closely in tandem since heating oil prices hit their lows in January 1999. Natural gas prices are quoted at the pipeline center in Henry Hub, Louisiana, and are lower than heating oil prices to reflect their higher transportation costs.

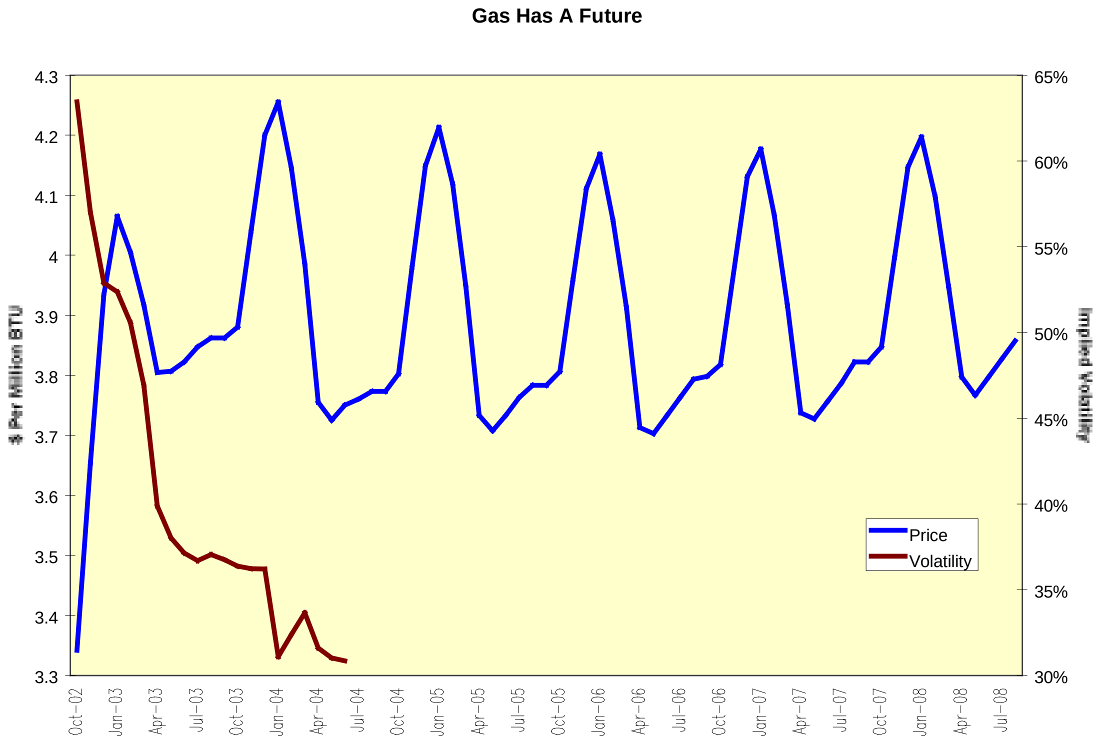
Both markets since had price spikes; heating oil in January 2000, and natural gas throughout most of that year. How much of that price spike in natural gas was due to the market machinations of our dearly departed friends at Enron and other soon-to-be defunct energy traders can be debated; what is clear is an increasing convergence between the markets.

We should never expect perfect convergence: Natural gas is a petrochemical feedstock as well as a fuel, and it is a major cost component for manufacturers such as DuPont, Dow Chemical in plastics and Mississippi Chemical and Terra Nitrogen in fertilizers. Heating oil comes from the same cut of the crude oil barrel as diesel fuel and its price cycle reflects such factors as agricultural demand for tractor fuel, railroad demand by the likes of Burlington

Northern Santa Fe and Union Pacific, and trucking demand by JB Hunt and others. Even the recently bankrupted Consolidated Freightways got in on the diesel fuel act.

The implications for natural gas prices of a closer correlation to heating oil will be compounded by whatever action or inaction we take against Iraq. If we don't invade and petroleum prices sink under the weight of a weaker economy, natural gas prices are likely to be dragged down for the ride, with positive implications for consumers and negative implications for producers such as Anadarko Petroleum, Apache or Pogo Producing. If we invade and things don't go as smoothly as they did in 1991, watch for natural gas prices to shoot higher. Let's see where we are now.

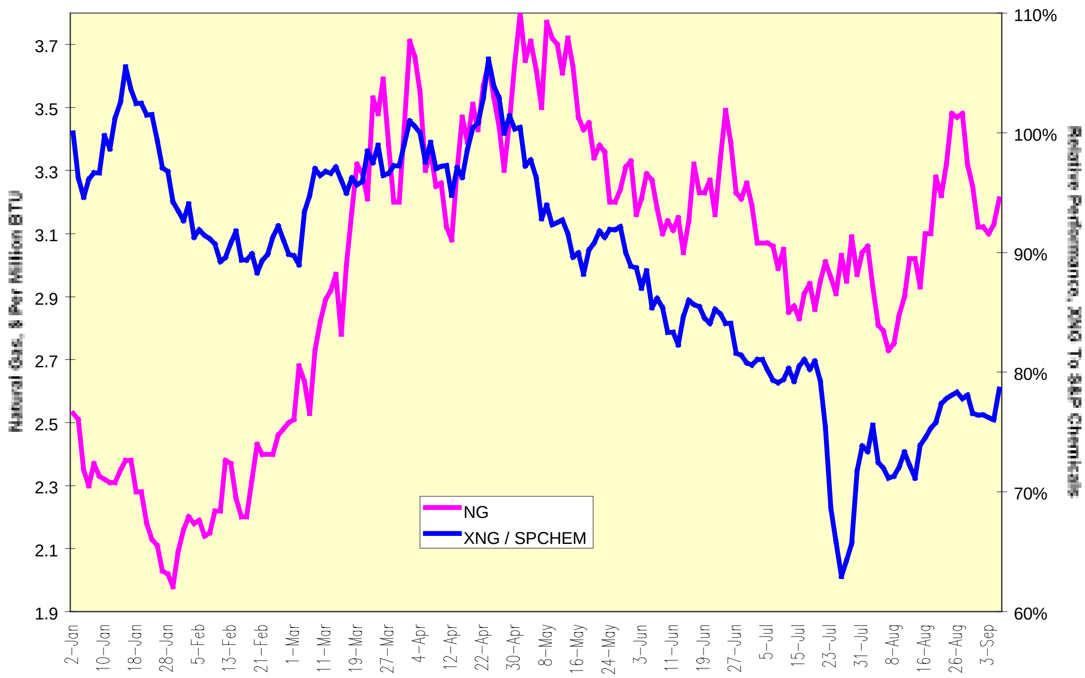
Forward Curves
Just like in stocks, September and October are the weakest months for natural gas prices; the summer peak load electrical generation season is over and the winter heating season has not begun. We should expect to see a pattern of higher prices in the winter, and this is visible in the curve of NYMEX futures as of September 5.



What is interesting here is how flat the futures price remains going forward into 2008. Since long-term natural gas swaps and other hedges are based on the present value of the futures price curve, and since these prices are still high by historic standards, natural gas producers should be falling all over themselves to lock in a floor price for gas based on these levels. In addition, the forward curve of option volatility is falling like a rock, and all else held equal, that lowers the costs of hedging gas in the distant months.

Buy The Buyers, Sell The Sellers
Whenever producers should be selling forward and aren't, do it for them. As an aside, all commodity producers are as bullish about their production as investment bankers are about theirs, and they consider long-term hedging to be a concession to the forces of evil.

Producers Remain Under Pressure



As the price of natural gas has remained high in 2002, the XNG has underperformed the S&P Chemicals index. This trade is likely to continue so long as the forward curve of natural gas hangs around at high levels. A trade of going short the producers of natural gas and long the consumers is suggested. A short-term spike in natural gas prices, such as may result from an attack on Iraq, would disrupt the trade, but you can limit your risk by using XNG index puts and call options on either DuPont or Dow Chemical. Of course, this trade can be executed through single stock futures as a matched pair trade once these instruments become available.