Natural Gas Utilities In Sweet Spot

If you are supposed to make lemonade when life hands you a lemon, what should you do when life hands you a surplus of natural gas? The answer seems to be clear and mercifully unequivocal: Tilt your investment portfolio toward natural gas utilities.

The total return over the past twelve months of the 14-member S&P 1500 natural gas utilities index has been 35.6%, a sizeable premium to the 31.6% total return for the Supercomposite itself. The gains have been led by Oneok, AGL Resources, National Fuel Gas and my local gas utility, Nicor.

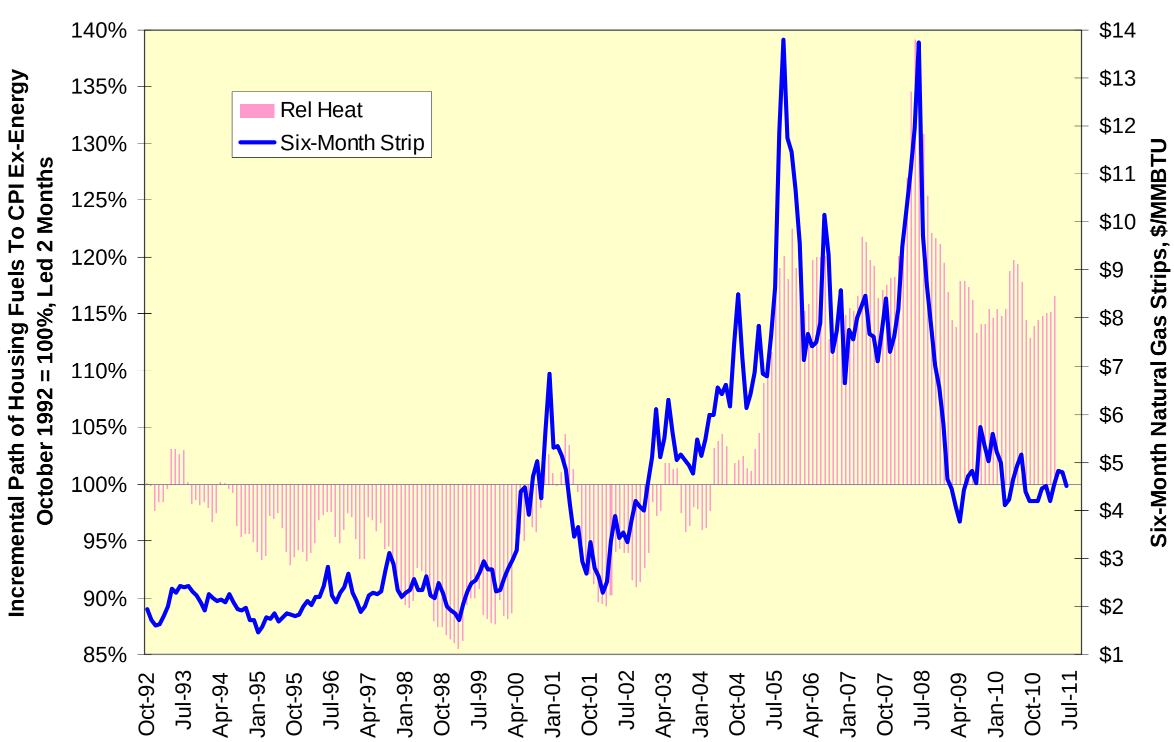
What might be driving this performance? The answer seems to be the ability of the distribution chain to maintain its margins as the price of natural gas remains under pressure. The price pressure on natural gas is both relative and absolute; twelve-month strip prices are 8.2% year-ago levels and an astonishing 66.2% below their levels of three years ago. Please remember this is for a twelve-month strip of futures and thus averages out those periodic plunges lower in the front-month contract when supplies are high.

On a relative basis, natural gas remains at a substantial discount to competing petroleum fuels. The city-gate price in Chicago is a mere 27.5% of the BTU-equivalent of 1% sulfur residual fuel oil. While we should not expect the two fuels to be at burner-tip parity for reason discussed in January, the mere presence of the gap removes the final downward burst of price pressure between the pipeline and the final customer.

Relative Price Indices

In addition to the relative stock market performance and the price discount to competing fuels, we can see another piece of evidence pointing to high margins for the gas utilities, the relative performance of the Housing Fuels consumer price sub-index to the CPI Ex-Energy (Would the government keep publishing these statistics if they knew they made my life easier?). Natural gas prices have been under substantial pressure for the better part of three years, and yet the home-heating CPI has been stronger than the CPI Ex-Energy. This is prima facie evidence once natural gas prices began their climb in 2004, the distribution chain could raise its prices and then retain the economic rent once prices fell.

Home Heating Costs Still Outpacing CPI Ex-Energy



The notion prices can be sticky on the way down is not particularly new, but it does lend credence to the notion we are far less rational as economic actors than the textbooks proclaim. You get used to a price or a level and that becomes the psychological anchor against which you normalize things. Think of how high gold prices looked when they crossed north of the $400/500/600/700/800/900/1000/1100/1200/1300/1400/1500 level; if they were to retreat below any level $1,400 or less, it would look like a major downturn as we have grown accustomed otherwise.

The gas utilities realized once we became accustomed to paying the higher prices for natural gas, we were theirs, figuratively speaking. How can you join this predation upon your fellow citizens? Learn how to pronounce "Oneok," and then buy it and its confreres, as they say in Oklahoma.