Natural Gas Should Make Winter Mild

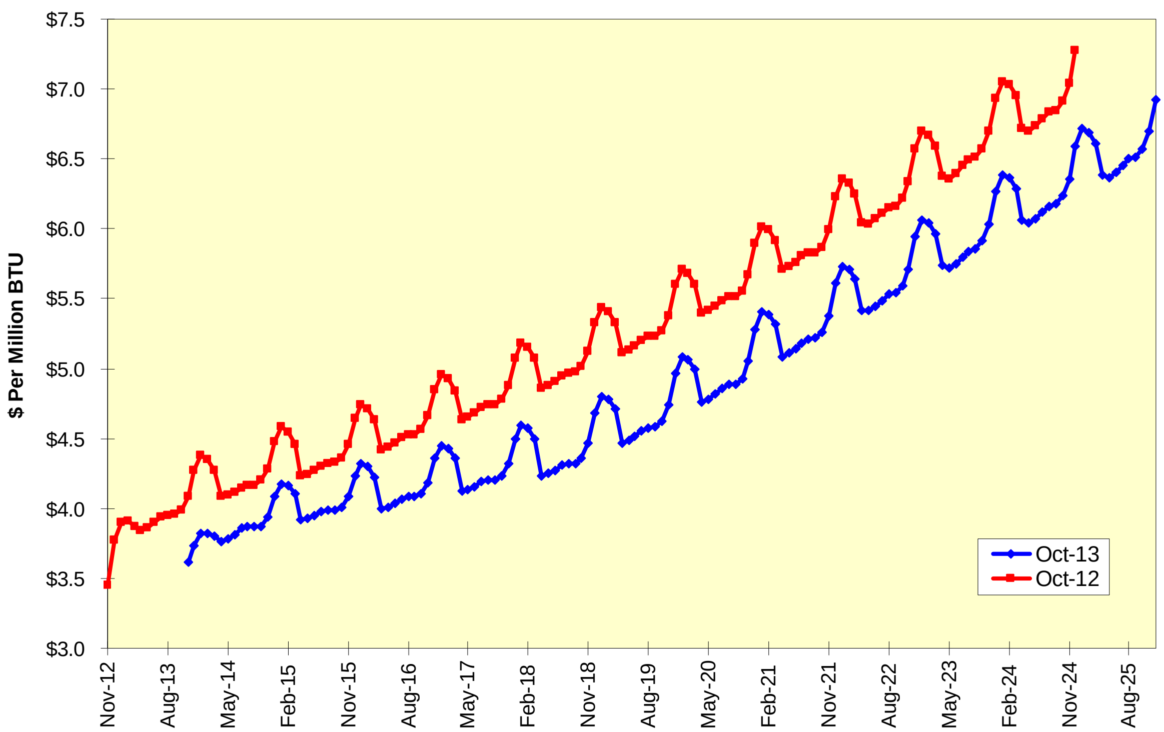
I have observed in other times and places the only issue in American history more regionally divisive than natural gas pricing was slavery. That narrative went from the drafting of the Constitution through the descent into the Civil War and its abolition by the Thirteenth Amendment, and then into another century of Jim Crow laws, the civil rights movement and an ongoing controversy over the 1965 Voting Rights Act.

Natural gas-related struggles were not quite so violent, but went through various phases of wellhead prices controls and phased decontrol. The original Carter-era national energy plan was based on perceived scarcity of natural gas; at one point during the late 1970s, years of price controls had left the U.S. with nine years of proven reserves, those reserves producible at current prices and technology. To say we have swung to an opposite point today would be an understatement: A technology revolution has created abundant supplies. Firms in the petrochemical and fertilizer businesses such as Dow Chemical (DOW) and CF Industries (CF) have prospered while coal producers such as Arch Coal (ACI) and Peabody Energy (BTU) have struggled to maintain market share against both cheap gas and the campaign to reduce carbon emissions. Ah, dynamic capitalism and creative destruction!

Winter Heating

For those of us whose direct exposure to natural gas is limited largely to residential space- and water-heating along with cooking appliances, the outlook going into this heating season is good. Six-month strip prices are just below year-ago levels, and the forward curve of natural gas futures has shifted lower with little change in its slope. Even though storage in the Department of Energy's Eastern Consuming region is 6.9% below year-ago levels, unless we have a much colder than expected winter that strains delivery capacity, prices are unlikely to advance significantly.

Year-Over-Year Change In The Natural Gas Forward Curve



I might add that the carry structure of this forward curve depicted above will continue to make long-only investments in natural gas such as the U.S. Natural Gas Fund (UNG) a dreadful investment. That instrument has lost -16.20% over the past year while spot natural gas prices themselves have advanced 6.25%. P.T. Barnum was more correct than he knew.

Hooray For The Middlemen

Just as no one ever builds a statue of the speculator in the town square, no one writes epic poetry about logistics and distribution systems. Investors do, however, reward the members of the S&P Gas Utilities index with above-market returns, so they can keep the songs upon the flute and lyre to themselves. This index has outperformed the broad market by more than 5% since natural gas strip prices bottomed in April 2012. Members of this index include ONEOK (OKE), New Jersey Resources (NJR) and Laclede Group (LG).

Their ability to outperform the broad market reflects how the value in natural gas is dominated by the delivery system; gathering, processing, storing and delivering it can exceed the wellhead price. If wellhead prices fall, you the buyer are unlikely to see your delivered price decline anywhere near as much, but if the wellhead price rises, you will see it reflected forthwith.

Finally, I should note that more than thirty years ago I noted how gas buyers should want to see decontrol even if it meant higher prices in the short term as it would induce greater supplies over the long term. Applause was, um, sparse. The conclusion, however, proved correct.