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HEARD ON THE STREET

Natural-Gas Prices Are Likely To Be High Amid Tight Supplies

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The race is on.

Last week marked the official start of the annual six-month push to fill up the natural-gas storage tanks so utilities in the nation's northern reaches don't run out of gas, leaving their customers to shiver in their beds next winter.

With gas inventories at their lowest levels in a decade, the effort takes on increased urgency this year. That could lead to a pitched battle between utilities, which have to fill their storage tanks no matter what the cost, and chemical and fertilizer producers, among others, who use gas to make their products.

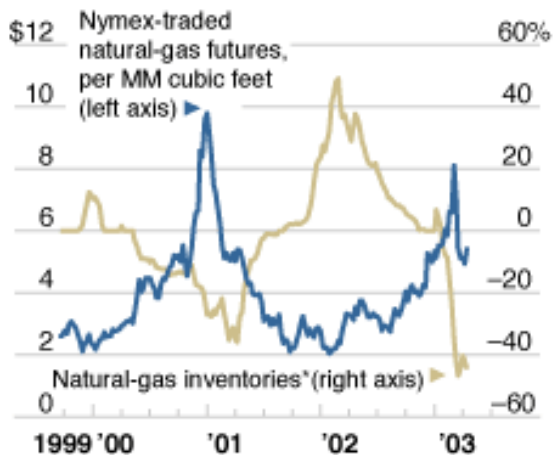
The net result likely will be high gas prices. "Every day we move toward the winter, you lose that day in terms of refilling inventory," says Dan Pickering, director of research at Simmons & Co., a Houston-based investment bank specializing in energy. "It feels like there's a showdown coming sometime over the summer, and the only question is what's the price that's going to be the result of that showdown."

HOT COMMODITY

- [Natural-Gas Prices Are Likely to Remain High This Summer²](#)
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- [Market Terrain:³ Trends now and during the 1991 war](#)

SUPPLY AND DEMAND

Natural-gas inventories are way below normal, and prices are relatively high. Some analysts say demand could keep prices higher than expected, which could boost some energy companies' stocks.



*Deviation from 1994–2001 median levels

Sources: Simmons & Co. International; Department of Energy's Energy Information Administration

The big winners will be natural-gas producers. Many of these companies are rolling in cash because of high energy prices, but their shares have yet to reflect their good fortune. The Dow Jones Energy Index is down slightly for the year, lagging behind the broader-market Standard & Poor's 500-stock index, which is up 4%.

Both natural-gas and oil prices started moving higher late last year largely because of tight supply. But the supply issues for oil -- the strike in Venezuela, turmoil in Nigeria and, most important, the war with Iraq -- have largely ebbed, and oil prices have fallen, though not as far as many analysts expected.

For natural gas, the story is different. Gas is largely a domestic commodity, with the only significant imports coming from Canada. So what producers pull out of the ground in North America is largely what there is. Last year, production fell 5%, even though demand has stayed strong, driven by cold weather and a growing preference by utilities to use gas to generate electricity, because it burns cleaner than most other fuels.

"We continue to be unable to turn production around," says Robert Morris, an analyst at Banc of America Securities, who expects production will drop an additional 2% this year. A big boost in drilling could ease that decline a bit, but new wells take time to start producing and gas is getting harder to get out of the ground in North America. In 2001, when the number of new wells soared, gas production rose only 1%.

That's worrisome given that inventories stand at 684 billion cubic feet, down from 1,575 billion cubic feet at this time last year and the five-year average of 1,257 billion cubic feet, according to the federal Energy Information Administration. With the start of replenishment season last week, inventories rose 61 billion cubic feet. (A couple of warm weeks in March led to some replenishment, but that was wiped out by cold temperatures in early April.)

"It boils down to three simple factors: supply, demand and inventories," Mr. Pickering says, adding that the only way to balance out the market is for prices to rise so demand falls.

The question is what that price will be. Many analysts believe natural-gas prices will average between \$3.50 and \$4 per million cubic feet for the rest of the year. That's higher than the prices of the past few years, when gas averaged about \$3 per million cubic feet. But it's below where gas has been trading, meaning the price that analysts expect isn't high enough to cut demand enough to fill the storage tanks. So natural-gas prices are likely to stay high.

Natural gas settled Tuesday at \$5.24 per million cubic feet, up two cents on the New York Mercantile Exchange

Despite the favorable pricing developments for natural-gas producers, shares of most of these companies have remained relatively flat this year. That's largely because energy companies rarely get credit for high oil and gas prices: Investors assume the prices will fall back to past levels. Energy stocks are now trading as if gas were \$3.50 per million cubic feet.

On the oil side, investors have been convinced that oil prices would follow the path they did during the first Gulf War, collapsing after the attack began. This time they have fallen, but not as far as they did in the early '90s.

Natural-gas investors don't have to go that far back for an ugly scenario. In the spring of 2001, inventories also sank to low levels and prices went up. But a confluence of events -- warm weather, increased drilling, then declining demand, thanks to a slowing economy -- sent prices tumbling. Those aren't likely to happen, or happen all at once, this time around.

"It was everything that you could imagine that would be negative," John Segner, who manages Invesco Energy fund, says of spring 2001. In fact, many of the biggest drillers at the time, such as **El Paso Corp.**, now are more focused on repairing their balance sheets than drilling for gas.

Also, some big gas consumers such as fertilizer makers, have seen the prices for their products rise 50% this year, meaning they can pay more for gas, keeping demand strong.

Given the decline in supply and steady rise in demand, some analysts see gas prices staying high for the next several years, which could convince investors that prices above \$4 per million cubic feet are sustainable.

"If you have a sustainable \$4 to \$5 gas price and \$23 to \$27 [a barrel] oil price, that's when both sectors need to take a quantum step up in valuation," says Kenneth Beer, an energy analyst at Johnson Rice & Co., a New Orleans-based investment bank that specializes in energy.

If gas prices do stay high and investors start to believe they are sustainable, a wide swath of energy companies, ranging from behemoths such as **BP PLC** to the big exploration and production companies such as **Apache Corp.** and **Anadarko Petroleum Corp.**, would benefit.

But the biggest winners would be companies that get the bulk of their earnings from gas rather than oil. **EOG Resources Inc.**, for example, gets more than 70% of its production from North American natural gas, and Banc of America's Mr. Morris expects the company to increase its North American gas production by 3% this year. EOG shares are down slightly for the year.

Similar companies include **Burlington Resources Inc.**, up about 7% for the year, and **XTO Energy Inc.**, which is up slightly for the year. The biggest risk to strong natural-gas prices is the economy. A big slowdown would cut demand, meaning the price needed to fill the tanks for winter would be lower. But since energy stocks already are valued as if natural-gas prices were lower than they are now, at least the downside would be limited.

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