Ferguson: Energy Matters

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The Bears Dominate Energy Markets

The price of natural gas traded on the NYMEX stood at $8.20/MMBtu on August 1. Yesterday, the near-month contract closed at $4.98/MMBtu, below $5 for the first time in two years.

What's going on?

The most obvious cause of falling gas prices is the large amount of gas in storage. When the heating season begins every year around the first of November, 3,000 billion cubic feet in storage is considered adequate. This year, storage is already above that level, and more will be added in the next seven weeks.

The September 14 storage report showed a very large increase for the prior week - more than 100 bcf. This surprisingly high number knocked nearly 50 cents off the price of gas yesterday. But storage levels have been well above their historical average all year.

Last year's hurricanes reduced supplies and raised prices. As I noted after the hurricanes, consumption decreased even more than supply, resulting in extra gas for storage. Last spring I suggested that gas prices could drop into the $5 range as a result of the storage surplus.

I am surprised to see the price drop but wonder why it took so long.

My guess is that the high price of crude oil has been supporting the price of gas all summer, despite the gas storage surplus. From its high of $77 per barrel on August 8, crude oil has fallen to about $63/bbl today, a level not seen since last March. The prices of oil and gas are not independent of each other - when the price of oil swoons, gas gets dizzy, too.

But that begs the question of why the price of oil was so high this summer and why it has fallen 18 percent in a little over a month.

The standard reasons for recent high oil prices given by the pundits are the turmoil in the Middle East, rapid economic growth in India and China, and, more recently, the threat of more hurricanes in the Gulf of Mexico. For all I know, the pundits were right.

Today, however, we know that Lebanon can get blown up without disturbing our oil supplies, and the war in Iraq has become more or less permanent with no diminution in oil exports from the region. Economic growth in China this year has been somewhat less than expected, prompting the International Energy Agency recently to reduce its estimate of global oil consumption for the year.

So far, no hurricanes have disturbed the Gulf of Mexico this season. On September 5, Chevron announced a major new oil discovery in the Gulf in water over a mile deep from a well drilled to a total depth of more than 28,000 feet, a new world record.

The market has run out of reasons to keep oil prices high. The Wall Street bears that bet prices would drop are making lots of money these days.

Consumers should enjoy the low prices while they can. Despite Chevron's discovery, no one expects ultra-deep oil to be very plentiful, and it surely will be expensive. It will be years before we know whether such resources will add significantly to global supplies. In the meantime, we remain extremely dependent on Saudi Arabian oil. I don't expect to see really low oil prices in the near future unless the economy goes to pot. (Which it may - the U.S. trade deficit hit another new record high last month due in no small part to the mega-dollars we spend for oil.)

On the gas side, North American production is still falling. If gas prices remain in the $5 range for long, production is expected to fall even faster, since some marginal supplies cost that much to produce.

Liquefied natural gas imports over the last 12 months are running less than in 2005 as well. The surplus in storage is a blip caused by weather over the last year that will get burned off before long unless this coming winter is especially warm.

So if you are a fan of the Street Bears, now is the time to cheer for your team. But as you know, the momentum of this game can turn in a single play. My analysis of the fundamentals makes me think that the Bulls will be just fine in the later periods.

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