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Surge in Natural-Gas Price Stoked by New Global Trade

Further Gains Likely
Despite 93% Spike;
Bidding With Japan

By ANN DAVIS and RUSSELL GOLD
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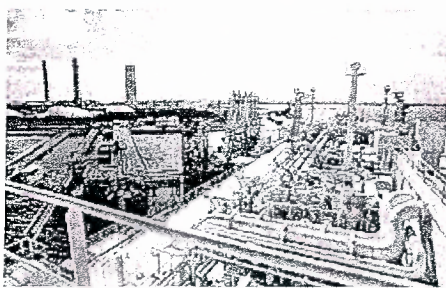
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Americans feeling the pain of record gasoline prices now face the likelihood of another fuel shock, from natural gas.

Prices in the U.S. have risen 93% since late August as power-hungry nations like South Korea and Japan compete in a global natural-gas market that scarcely existed a half-decade ago. Still, U.S. prices are as low as half the level of some overseas markets, suggesting they have much further to rise.



Tokyo Electric Power Co.'s Futtsu Thermal Power Station seen from aboard the LNG Pioneer, a liquefied-natural-gas carrying ship.

The global appetite for natural gas has profound implications for a U.S. economy already tipping toward recession and struggling against inflation pressures. The fuel heats half of U.S. homes, generates 20% of the country's electricity and is used to make everything from fertilizer to plastic bags. In March, rising natural-gas prices contributed to a higher than expected 1.1% increase in producer prices, according to the Labor Department.

U.S. natural-gas output has actually been rising in recent months, and not everyone agrees that prices are destined to surge. However, a significant number of financial players are now betting on an increase.

On Thursday a report by the Barclays Capital unit of Barclays PLC warned that, partly because of rising natural-gas prices, the U.S. could start to see spikes in electricity costs in as little as a year. "Power is at the cusp of its next boom cycle," analysts said. "When power markets tighten, prices do not notch up, they skyrocket."

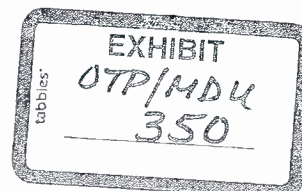
On Thursday, natural-gas prices on the New York Mercantile Exchange fell five cents per million British thermal units, or 0.5%, to settle at \$10.383, ending a three-day upward march. That's 33% shy of the record close of \$15.378 on Dec. 13, 2005, when a cold snap jolted the market.

What's new is the global price competition. Prior to 2003, gas was primarily a regional commodity, consumed near where it was produced and transported by pipelines. Often, it would be simply

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burned off as waste at oil wells, since transportation was so difficult.

That changed with development of cheaper methods for supercooling and transporting the fuel across the ocean in liquefied form, which requires 1/600th the space. The global trade took off.

Attracting Imports

Today, a tanker of liquefied natural gas, or LNG, pulling into port in Japan can command close to \$20 per million BTUs, roughly double the price of the U.S. benchmark. As a result, the U.S. is having trouble attracting the imports it needs to supplement homegrown production.

Last weekend, Cheniere Energy Inc. inaugurated a massive new LNG terminal on the Texas-Louisiana border capable of accommodating six tankers a week, making it the largest terminal in the U.S. However, observers expect few tankers to dock there until they can obtain higher prices for their cargo. Cheniere's stock is down 70% from its 52-week high; earlier this year, it put itself up for sale.

For the moment at least, the import slowdown means the U.S. has a glut of LNG import terminals like these. From California to New England, proposals for such facilities have faced staunch community opposition. This month New York Gov. David Paterson said the state wouldn't issue a permit for a proposed terminal in the Long Island Sound, arguing that it wasn't appropriate for the environmentally sensitive area.

Overall, U.S. imports of LNG have slid over the past nine months to a five-year low, and natural-gas inventories are running relatively low. Deutsche Bank commodities chief David Silbert says that if the U.S. is unable to attract LNG supply this summer, prices could spike up sharply within a few months if a hot summer were to reduce the ability to build a cushion of gas going into next winter.

As the odds increase that the U.S. will pass climate-change regulations that raise financial penalties for burning coal, cleaner-burning natural gas is gaining favor as the fuel to power electric plants.

Overall, gas demand from the U.S. power sector grew by 10% last year, according to the Energy Information Administration. By 2025, the U.S. could see domestic production lag demand by 15 billion to 20 billion cubic feet a day, Linda Cook, executive director of gas and power for Royal Dutch Shell PLC, told a recent energy conference.

The increased global trade in natural gas was driven partly by huge investments since 2003 in facilities to liquefy gas for export -- chilling it to negative-260 degrees Fahrenheit -- as big Western oil companies saw a business opportunity and ramped up spending on LNG infrastructure. This created economies of scale and further drove down the price of producing and shipping LNG long distances.

This triggered a revolution in gas markets. Previously, countries like Nigeria, which has ample natural gas, had no easy way to sell it due to a lack of pipelines to markets needing the fuel. Same was true for Qatar, also home to enormous gas reserves.

Early thinking assumed the globalized market would cause prices to fall because countries tight on supplies could more easily import. Former Federal Reserve Chairman Alan Greenspan, in 2003, predicted LNG would create a "price-pressure safety valve" to stabilize prices in the U.S.

Sellers With Clout

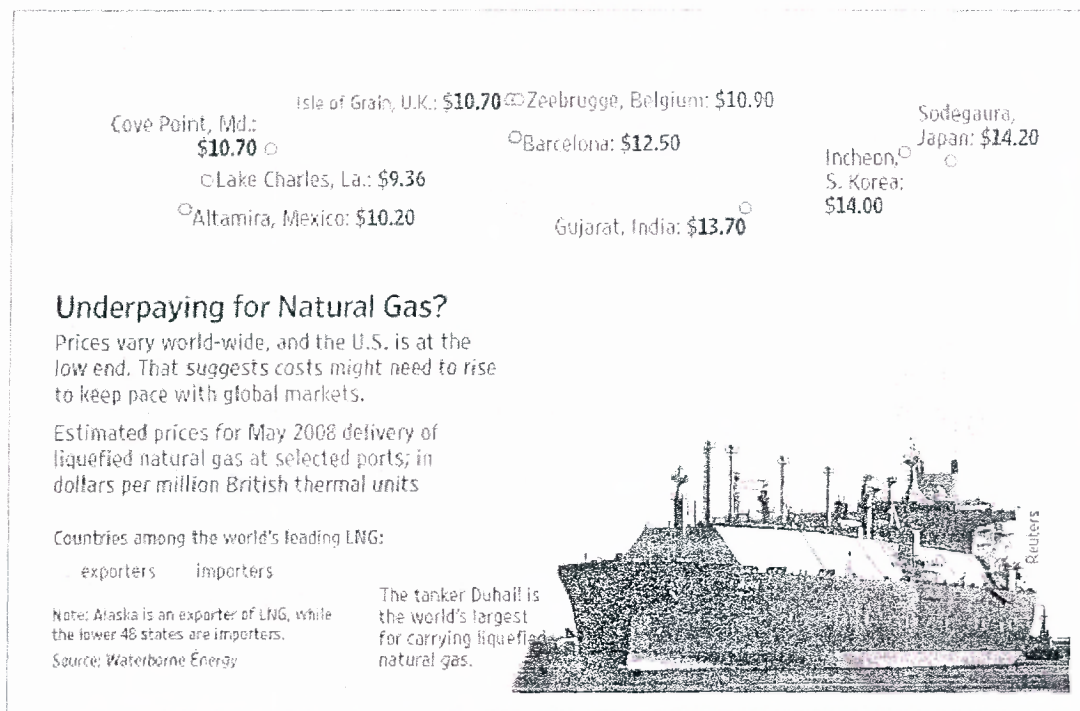
But the market is evolving differently. One key change involves the way LNG sales contracts are written. Until

recently, buyers were in the driver's seat: They were able to strike long-term deals and lock in their costs for many years. A seller like Indonesia, for instance, might have agreed to ship LNG to Japan for 10 years at relatively rigid prices.

Today, however, sellers have the clout. They are demanding that contracts be loosened to let them divert their output to markets where prices are higher. (In return they generally agree to share the profits with the customer.)

Free-for-All

This free-for-all has let suppliers shop their product to the highest bidder, adding to price volatility.



One example: When an earthquake last summer forced a massive Japanese nuclear plant to close, utilities there ramped up natural-gas use. Prices soared in Japan, which in turn drove up prices in far-off European countries, including the United Kingdom.

This kind of situation can trigger domino

effects world-wide. Late last year, the global scramble for scarce LNG worsened as a drought hit Spain, cutting its ability to use hydroelectric power. Spain normally leans on neighboring Algeria and Egypt for LNG imports - but in February those countries were busy shipping to Japan where prices were twice as high as Spain.

Turning to Trinidad

Spain turned to Trinidad for imports. But that has meant less gas for the closer -- but lower-priced -- U.S. market, which in the past has taken most of Trinidad's output. Trinidad's shipments to the U.S. through the first two months of the year are down 31% from the year-earlier period, according to government data.

Not everyone agrees U.S. natural-gas prices are certain to rise. Domestic producers such as Chesapeake Energy Corp. have made significant strides tapping into new sources of natural gas, sending U.S. gas production up 7% in January from a year earlier, to 68 billion cubic feet a day.

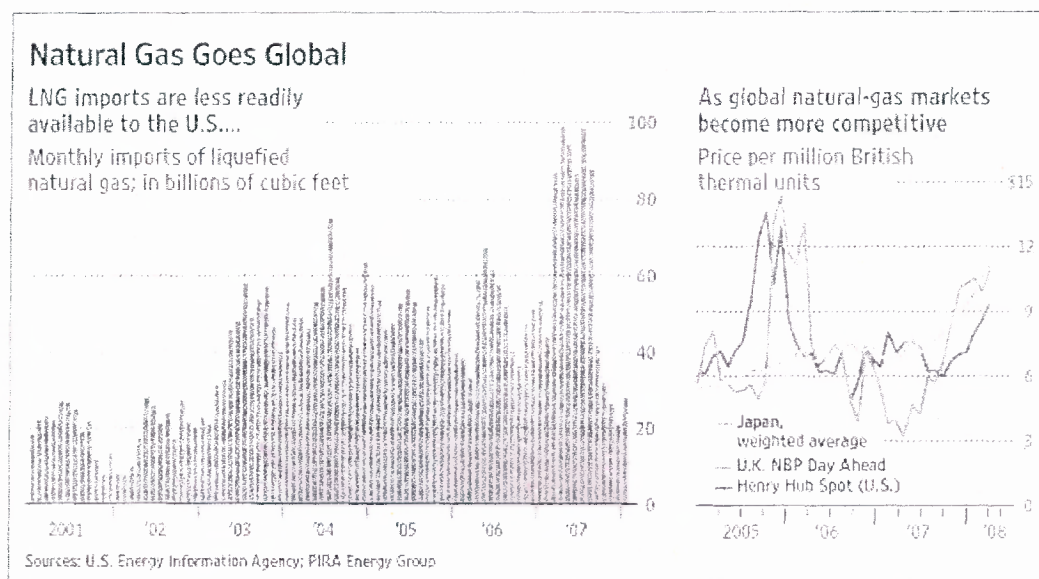
Chesapeake Chief Executive Aubrey K. McClendon sees production continuing to grow, holding U.S. gas prices between \$7 to \$10 per million BTUs and avoiding the need to increase imports. And Michael Stoppard, a senior director of energy consultant CERA, predicts world LNG supply will grow by 30% in the next two years,

making more chilled gas available for the U.S.

Nevertheless, more financial players are lining up against the bears, saying low prices won't last. They point out that, even as U.S. production increased in 2007, prices still rose 19%.

Meantime, as Asian buyers grab more LNG from the Atlantic basin, U.S. prices, though at 27-month highs, still look cheap. Energy hedge funds in Houston and New York have placed a flood of bullish bets on U.S. gas prices for delivery several years from now, say some of the traders and their Wall Street brokers.

One argument underpinning that bet: U.S. gas is far cheaper than it has historically been relative to crude oil. Until 2004, the price for a barrel of oil was roughly the same as the price of 6,000 cubic feet of gas, the equivalent amount of energy. Now oil is almost double the price of gas on that basis, Lehman Brothers analysts point out.



In a twist, the effort to build alternative-energy projects like solar arrays and wind farms also boosts construction of gas-fired plants. Because wind is unpredictable, it's often necessary to build back-up generators, and gas-fired plants have an advantage in that they can be started up relatively quickly, says Doug Kimmelman, senior partner with Energy Capital Partners, a private-equity firm focused on the power sector.

In addition, regulatory approval and construction times are shorter for gas plants than coal or nuclear. For reasons like these, new gas-fired power plants continue to be built or planned.

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