Natural gas prices headed up, not down

THE SOURCE

Dean Orrico, president and chief investment officer, Middlefield Capital Corp.

THE IDEA

Buy natural gas stocks, trusts or exchange traded funds because prices are headed up, not down.

"The consensus view on natural gas is that there's more supply than we're ever going to need," Mr. Orrico said in an interview. This view holds that new drilling in shale formations in Canada and the U.S., combined with rising liquefied natural gas imports, will add to supply and inventory and keep prices "at the low end for as far as the eye can see," he adds.

"We disagree wholeheartedly."

Currently, natural gas from shale represents 13 per cent of total U.S. supply, he notes. The remaining 87 per cent comes from more conventional sources, which are in significant decline.

Roughly half of the 13 per cent from shale comes from the Barnett shale formation in Texas, which was developed about 40 years ago.

"Its production peaked a year ago and is now declining," Mr. Orrico says. So only about half of the shale gas supply is actually growing because it is from newer shale deposits such as the Marcellus and Haynesville deposits in the United States. "It's not growing enough to offset the declines everywhere else," he adds.

"That's why we believe gas prices are going to go substantially higher" – from $5 (U.S.) a million British thermal unit (BTU) to

Dean Orrico, president of Middlefield Capital Corp.

an average of $7 over the next 12 months. "We think you'll start to see that rise this year."

Longer term, say five to seven years, the price could climb to an annual average of about $10, although "the reality is you get a lot of volatility on either side of that."

So how can investors participate? "First and foremost, buy some of the stocks" and income trusts, Mr. Orrico says, because they "give you pure exposure to gas, which is how we play it."

Among his favourites are ARC Energy Trust, Bonavista Energy Trust, Nuvista Energy Ltd., Peyto Energy Trust and Progress Energy Resources Corp.

EnCana Corp., the country's largest gas producer, would also benefit from rising gas prices, Mr. Orrico says. "The only issue is that it has a great portion of its production hedged this year." That means it has locked in prices for a portion of its production this year that are lower than Mr. Orrico's gas price forecast.

Another way to play a rise in natural gas prices is through ETFs, such as the Claymore Natural Gas Commodity ETF in Canada or, better yet, the United States Natural Gas Fund (UNG), which trades on the New York Stock Exchange and is much more liquid, Mr. Orrico says. Natural gas ETFs participate in the commodity through futures contracts.

THE BIG RISK

Weather is usually the biggest factor, he notes, in that a cool summer can dampen demand. Now, however, an even greater risk now is the global economy.

"If we have a significant double dip [recession], that could have an impact on demand because industry would use less natural gas," Mr. Orrico says, but he thinks the fundamentals on the supply side are so powerful they would be able to offset part of a decrease in economic activity.

THE PAYOFF

"We think returns will be significant," Mr. Orrico says. "We think those stocks will move a lot higher on the back of $7 and $8 gas prices over the next six months."

Middlefield Capital and Mr. Orrico have many years of experience in the oil and gas market.

As well, Middlefield works closely with the esteemed analyst Henry Groppe, founder of consultants Groppe, Long & Littell of Houston. Mr. Groppe has 55 years of experience in the industry and an enviable track record of forecasting oil and gas prices.

Says Mr. Orrico: "We're not aware of anyone who has the track record that they do in calling oil and gas prices."

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