

SE Business
HD **Power Investing; There's a lot of money to be made—and lost—in the energy markets. Here's what you need to know.**

BY By Liam Denning
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LP For investors, the energy business used to be a pretty simple play: Buy a stock and stick with it.

Until a couple of years ago, soaring oil and natural-**gas** prices made any energy bet pay off. Not only did oil and **gas** stocks rise, but so did alternative-energy shares: With fossil fuels getting pricier, solar and wind power looked much more competitive.

TD Then came the crash of 2008, and all that went out the window. These days, the energy sector is about as complicated as it gets, with a range of issues buffeting stock prices and making it tough to know where to put your money—and when to do it. Not only is the economy playing havoc with demand and energy policy world-wide, but individual industries are facing complex challenges with very uncertain outcomes.

Oil and **gas** producers, for instance, are grappling with the aftershocks of the BP PLC oil spill, at the same time they're facing a massive glut of natural **gas** that's driving down the price of the fuel. And alternative-energy companies in the U.S. are stuck in limbo. They were pinning their hopes on ambitious climate legislation to make fossil fuels more expensive—but the bill stalled and likely won't be back on the table anytime soon. Overseas, governments are slashing the subsidies that alternative suppliers desperately need.

Still, there's money to be made in the energy business—if you know where to look. Below, we offer a few signposts to look for over the next year or so to help tap potential winners.

Oil and **Gas** Producers

When it comes to oil and natural **gas**, it's hard to ignore the elephant in the room: Many companies in this sector have been thrown for a loop by the spill in the Gulf of Mexico, and the effects of the disaster are likely to linger. Stephen Richardson, an analyst at Morgan Stanley, sees increased costs for oil and **gas** producers as regulations tighten, which could hurt profit margins and even force some smaller companies to exit high-risk offshore projects.

What should investors watch for? Federal officials have hinted at an early end to the deepwater-drilling moratorium, due to run until Nov. 30. If that comes to pass—something that's by no means certain—it could be a hopeful sign for drillers.

Beyond this, investors will have to wait for the results of continuing investigations into the disaster and how to prevent future ones. The House Energy and Commerce Committee, for example, is due to issue its report in December.

Another near-term factor to watch out for is further merger activity, which could potentially drive up stock prices. There has been a spate of deals involving larger companies buying smaller **gas** producers. Last December, Exxon Mobil Corp. agreed to buy XTO Energy Inc. for \$31 billion, the oil major's biggest deal in a decade.

Still, there's an even bigger issue facing the industry than the Gulf spill: oversupply.

Oil and **gas** producers have adopted and refined advanced drilling techniques enabling them to tap unconventional resources such as shale **gas**, trapped in dense rock thousands of feet underground. U.S. natural-**gas** reserves and production, after years of decline, are now back to levels last seen in the early 1970s. Meanwhile, U.S. **gas** consumption peaked in 2000 and fell 2% in 2009, as the recession damped demand.

Extra supply has caused **gas** prices to tumble almost 30% in the past three years, hurting producers' profits and stock prices, with companies like Chesapeake Energy seeing big drops. Even though oil prices have more than doubled since February 2009, that has only partially offset the producers' losses. "The overriding question for exploration and production stocks is the future of the U.S. **gas** market and when oversupply ends," says Mr. Richardson.

Low prices would usually spur producers to stop drilling and help rebalance the market, but that isn't happening for a variety of reasons, including lease conditions and the sector's natural bias toward growth. Jonathan Wolff at Credit Suisse calculates that for every dollar of cash flow producers make in 2010, they will reinvest \$1.52 on average.

One way investors can gauge the industry is to track the number of U.S. drilling rigs in operation, particularly "horizontal" rigs, which target shale **gas**. (The easiest way to find this tally is on the [website](#) of oil-field-services company Baker Hughes Inc.; look for the "Rig Count" box on the site's [main page](#).) If this number levels off or drops, it would indicate efforts to bring on new supplies were easing, helping to address the oversupply issue.

If all this suggests avoiding the sector, Jonathan Waghorn, co-head of Investec's Global Energy Fund, posits a contrarian view. "**Gas** is hated" by investors, he says, which could present a buying opportunity for those willing to ride out near-term weakness.

Mr. Waghorn argues that producers with the highest costs need a **gas** price of about \$4 per million British thermal units to keep running. Today, the average **gas** price in the futures market for 2011 is about \$4.70 per million BTUs.

But developing new shale resources, which will be needed in the future, requires a much higher price—\$6 or more per million BTUs—to deliver a suitable return on producers' investment. If developers don't think they can get that price, they won't go ahead with new **gas** projects—which will limit new supply, tighten the market and cause the **gas** price to rise.

For Mr. Waghorn, this suggests the risk of further big declines in **gas** prices is limited, with big potential for them to rise significantly over time, as higher prices will be needed to justify investment in new fields.

But he sees potential for oil prices to fall substantially if the global economy sputters over the next 12 months and demand falters. So, investors should look for signs that demand for **gas** is recovering and that inventories of the fuel, currently very high, are declining. These data, and more, are published weekly at the Department of Energy's website, www.energy.gov.

There's one more long-term factor to consider. If Washington passes comprehensive climate-change legislation, including effective limits on carbon emissions, this could help redress the imbalance of natural-**gas** supply and demand. **Gas** emits about half as much carbon as coal when burned, so putting a cost on carbon would make **gas** more competitive versus coal. **Gas** demand would likely rise.

Utilities

Gas and government loom large in the outlook for electricity producers, too. **Gas**-fired plants provide 23% of America's power, and in much of the country set the market price for electricity. So, higher **gas** prices often mean higher profit margins for suppliers that own coal, nuclear or hydropower plants. Their fuel costs are often lower than those of suppliers relying on **gas**-fired plants, but market prices for electricity are still tied to the price of **gas**.

Like the **gas** producers, utilities have been hoping an economic rebound would fire up demand for energy. Further help was supposed to come from Washington in the form of comprehensive climate-change legislation. The hope was that by making carbon-intensive fuels like coal more expensive, the new rules would force many such power plants to shut down and tighten electrical capacity—raising prices and profits.

But a lack of legislation and slack demand has complicated that picture. Indeed, analysts at Barclays Capital believe demand for electricity will not return to prerecession levels for some years yet, weighing on prices.

Greg Gordon, who heads Morgan Stanley's utilities-research team, reckons this environment favors regulated utilities, which have their rates set periodically by state officials with the aim of allowing the utilities to make a decent return on their investment. (Merchant generators, in contrast, take a market price for their electricity, and diversified utilities have both regulated and unregulated businesses.)

Over the past year, regulated-**utility** stocks have risen 17%, compared with just a 2% rise for the MSCI World Utilities Index overall. Driving the growth: low **gas** prices and Treasury yields. Low fuel costs keep prices down and regulators happy. Low yields, meanwhile, make regulated utilities' dividends attractive to investors.

Neil Wynne at Sanford C. Bernstein calculates that over the past 40 years, regulated utilities have on average beaten the S&P 500 during 12-month periods of falling inflation, such as we have now. He writes that the evidence suggests strongly that "utilities would function well as defensive investments in the event of further disinflation or eventual deflation."

So, keeping an eye on where the consumer price index is going could help investors decide which **utility** stocks to buy and sell. Investors who believe in falling inflation or outright deflation should consider investing in stocks of regulated utilities. Those taking the opposite view, that the economic recovery will strengthen, and with it **gas** prices, might do better to bet on merchant generators and diversified utilities.

A caveat: Should tax rates on dividends rise substantially at the end of the year, it could hurt regulated-**utility** stocks. That said, Credit Suisse analyst Dan Eggers argues that if you compare the stocks' dividend yields with bond and Treasury yields, the sector already is pricing in a reset in the tax rate to more than 30% from today's 15%.

Nuclear Power

Decades after the Three Mile Island and Chernobyl disasters, nuclear power is generating renewed interest these days, thanks in large part to one simple fact: Nuclear plants do not emit carbon dioxide. Some 60 nuclear reactors are under construction around the world, according to the International Atomic Energy Agency.

Investing directly in nuclear power's renaissance is not straightforward, however. Utilities that own nuclear plants often hold a variety of other types as well, which dilutes your exposure. Likewise, construction and engineering firms that build new plants do not focus just on the nuclear-power sector

Then there's timing. Nuclear plants take many years to construct, in part because of high regulatory hurdles but also the costs involved, with Standard & Poor's putting the average bill at upward of \$7.5 billion.

There are some nearer-term opportunities. "The real way to play nuclear right now is mining," says Ben Elias, an analyst at Sterne Agee. Uranium prices joined in the commodities bubble of a few years ago, hitting nearly \$140 per pound in 2007, according to Ux Consulting Co. Today, the price is about \$47.

Mr. Elias says this price reflects the fact that utilities, the main buyers, have big stockpiles right now. Looking ahead, he sees the uranium market tightening as China and India, which account for almost half the world's nuclear plants under construction, come to market to secure supplies. Canadian miner Cameco Corp., for example, plans to double its uranium output by 2018.

In the near term, investors should watch for any news out of China or India that they are signing long-term supply contracts for uranium, which could be a sign that the market is about to heat up.

And while new nuclear-power plants can take a decade to be approved and built, there is money to be made in the meantime refitting old stations to increase their output. Since the start of 2000, the NRC has approved 82 of these so-called uprates. Shaw Group Inc., which provides uprating services for nuclear plants, estimates the domestic market alone at \$25 billion in revenue.

Wind Power

In keeping with its name, the outlook for the wind-power industry seems "up in the air," says Geoff

Styles, who runs energy consultancy GSW Strategy Group, based in Vienna, VA.

Wind-power stocks surged along with the rest of renewables from 2006 into 2008, and then crashed with the broader market in late 2008—and have suffered since. So far this year, the sector is down 19%.

What's going on? The credit crunch has raised financing costs and made it difficult to justify building new wind farms in the U.S. and Europe. Weak demand for electricity also means fewer turbines are needed to meet renewable-energy targets.

Another big factor: U.S. political commitment to reining in carbon emissions has wavered. A comprehensive energy bill would have made renewable-energy technologies more competitive as the price of electricity produced from fossil fuels like coal increased. This now looks unlikely, "at least until next year," says Mr. Styles. Meanwhile, in a recent note to clients, Jason Mitchell, a manager at hedge fund GLG Partners, says a "lack of long-term U.S. energy policy" hinders investment there.

The result of all this: Over the next three years, analysts at UBS expect global wind-power capacity to grow 19% annually, down from 27% annual growth over the past five years. That sounds pretty healthy. But those faster, earlier growth rates have attracted new competitors into the market. In China, for example, foreign manufacturers have seen their share of new installations shrink to just 13% in 2009 from about 80% in 2004, according to Goldman Sachs.

Aside from the potential passage of a climate-change bill, which would give the industry a big lift, what can investors watch for? One trend to keep an eye on amid all this uncertainty is which turbine makers are getting the most orders. UBS expects larger companies with better technology, economies of scale and access to bank financing, such as Germany's Siemens AG and China's Goldwind Science & Technology, to take market share. Goldman, meanwhile, thinks smaller companies may be forced to sell themselves in the merger market.

Solar Power

Similar to the wind sector, solar-power stocks have seen a boom-and-bust cycle in the past three years. Down 14%, solar has been the second-worst-performing renewable-energy sector so far this year, behind wind. "Fundamentally, these are more expensive, less reliable forms of energy," says Mr. Styles of GSW Strategy Group.

And when it comes to renewables, solar is often far more expensive than wind. Without subsidies, wind power costs \$50 to \$100 per megawatt-hour, according to Goldman Sachs. That's competitive with some coal- and **gas**-fired plants. The cost of solar power, however, starts at \$90 per megawatt-hour and ranges up to \$200, even though equipment costs have fallen rapidly in recent years.

Little wonder, then, that the financial crisis has tempered the pace of development. This year, solar capacity totaling 12,000 megawatts is due to be installed globally, says Lazard Capital Markets. That's more than seven times the level of 2006. But new capacity next year is pegged at 14,500 megawatts, a distinct slowdown in the growth rate.

What's more, governments have been reining in subsidies for solar power. Solar stocks were weighed down in the first half of 2010 as Germany, the world's biggest solar market, began negotiating such cuts. But Mark Wienkes, a Goldman analyst, says that this had more to do with the falling cost of solar power than austerity measures. Solar stocks have recovered some ground since Germany announced subsidy plans in June.

Growth markets over the next year are likely to include the U.S., Italy, China, France and Japan, says Lazard. Of these, China could offer the biggest positive surprise if, as expected, Beijing introduces a "feed-in tariff," effectively a guaranteed minimum electricity price for renewable-energy producers. A decision is expected next year.

Investors should also look at which bits of the solar industry are over- or under-supplied, says Chris Ruppel, a banker with investment bank Execution Noble, based in Greenwich, Ct. He explains that while there is excess capacity for producing solar panels, for example, supplies of inverters, which convert the direct current produced by the panels to the alternating current used in homes, are tight.

Mr. Denning writes for The Wall Street Journal's Heard on the Street column. He can be reached at liam.denning@wsj.com.

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