April 26, 2013

Dear clients and colleagues,

Are we still bullish on natural gas?

In our February 12, 2012 commentary we listed the reasons why we thought the price of natural gas would move higher. At that time, natural gas prices were below US$2.50 per mcf, the first time in 10 years that gas had been this cheap in the winter heating season. A lot of industry analysts and speculators were forecasting even lower prices.

As we speak today, after a long and cold winter, natural gas prices are at $4.20. We are now starting to see forecasts of $5.00.

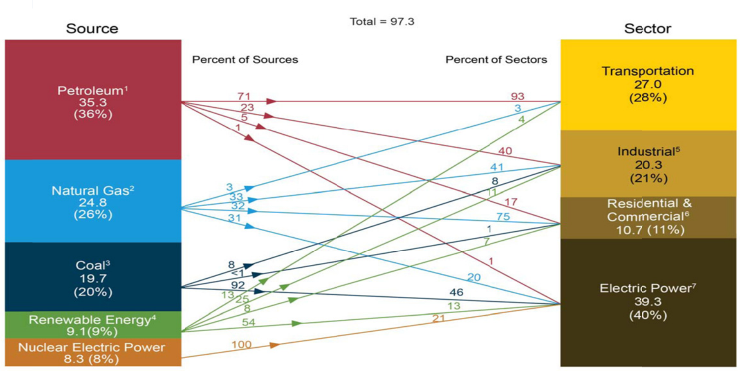
We are still optimistic on medium- to long-term natural gas prices. Why?

Capital re-allocation

US natural gas producers quickly reallocated capital away from dry gas to liquids. The natural gas rig count has declined from 936 in October 2011 to 375 last week, the lowest since 1999. And producers are in no hurry to drill for dry gas, even at current prices, given the better economics for liquids.

Bears argued that drilling liquids still produces a lot of gas, not alleviating the supply problem. The last two months were the first since 2009 when production actually went down year-on-year.

Demand



Source: US Energy Information Administration

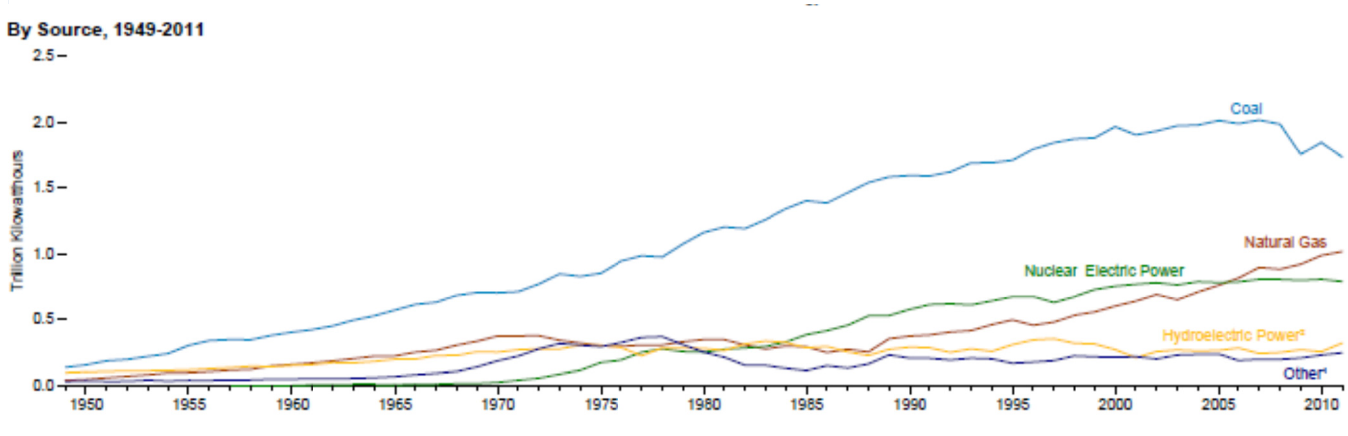
The chart above shows the supply and demand of energy by sources.

Growing industrial demand

US natural gas prices are the lowest in the industrialized world and well below heavy fuel and oil-based naphtha. As a comparison, prices are above $15 per mcf in China and Japan and above $8 in Europe. The US economy is continuing its recovery and many industrial companies are moving production back to the USA. Even the petrochemical industry has announced investment in the US, for the first time in over 10 years.

Electricity generation

With very low gas prices in 2012, the switch from coal to natural gas accelerated. In 2013, natural gas usage should approach that of coal and will be the source of approximately 27% of electricity generation in the US. Natural gas produces about 30% less carbon dioxide than burning heavy fuel and 45% less than burning coal. In 2012, over 50 coal plants were retired due to EPA regulations. We do not expect any switching back to coal in the short term especially given that natural gas prices would need to be above $4.50 to make coal economical.



Source EIA

Natural gas as a transportation fuel

In the past year, major companies from Shell to Clean Energy Fuels to Chesapeake have accelerated their investments for the natural gas highway. The US now has over 3,000 fueling stations for various forms of natural gas. All major truck engine makers now offer a natural gas engine, and many car manufacturers are introducing compressed natural gas models. With diesel prices at over $4 today, the savings opportunity with natural gas is enormous. Consumers can save $1.50 per gallon, a payback of 1 year for a heavy truck equipped with a natural gas engine.

Conversion of LNG import to export facilities

By 2015, the US and Canada will become exporters of liquid natural gas (LNG). The first export terminals have already been approved. One can see natural gas become a global market just like oil is today. You may want to look at BG Group PLC or Cheniere Energy to get more details.

In conclusion, ***we believe that natural gas prices will continue to go up and should find an equilibrium around $5.50-$6.00***

Our portfolio is well positioned to benefit from the upcoming rise in the price of natural gas with Comtock Resources (CRK US), Unit Corp (UNT US), TravelCenter of America (TA).

Have a good week.

The Global Alpha Team