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What's bad for oil can be good for gas

OFF THE CHARTS

Crude oil prices have shot up over the past two weeks, briefly touching $100 a barrel for the first time since 2008.

But not everyone felt the pinch. While gasoline prices were rising in the United States, the cost of heating most homes was actually falling a bit. Prices of natural gas continued to decline.

As the accompanying charts show, natural gas fell to a historic low relative to oil in the past week. The price of natural gas is now less than one-quarter that of oil on an energy-equivalent basis.

That divergence reflects the fact that while natural gas and oil can substitute for each other, for the most part they are two different markets. One is global, while the other is continental. And that can make all the difference.

As the charts show, the prices of the two can vary sharply. In the early 1990s, natural gas was relatively cheap, because of what was called the "gas bubble" in the United States. Then excess supply held down the price. The U.S. economy picked up steam, and the price difference all but vanished.

By late 2000, the price advantage had moved sharply in the other direction. That was when California briefly experienced a shortage of electricity generation, and prices for natural gas to fuel power plants went through the roof. But the advantage did not last long, and with the U.S. economy in recession, the price of gas fell rapidly in 2001.

More recently, something similar has happened. In mid-December 2008, with world trade flows plunging and virtually all economies stumbling, oil and natural gas prices neared parity. But since then, oil prices have risen about 175 percent, adjusted for inflation, while gas prices are down about 30 percent.

A generation ago, the developed world, and particularly the United States, provided the marginal demand for oil. That gave the United States a self-correcting mechanism. If high oil prices damaged the U.S. economy, the prices would reduce demand and help bring world oil prices back down.

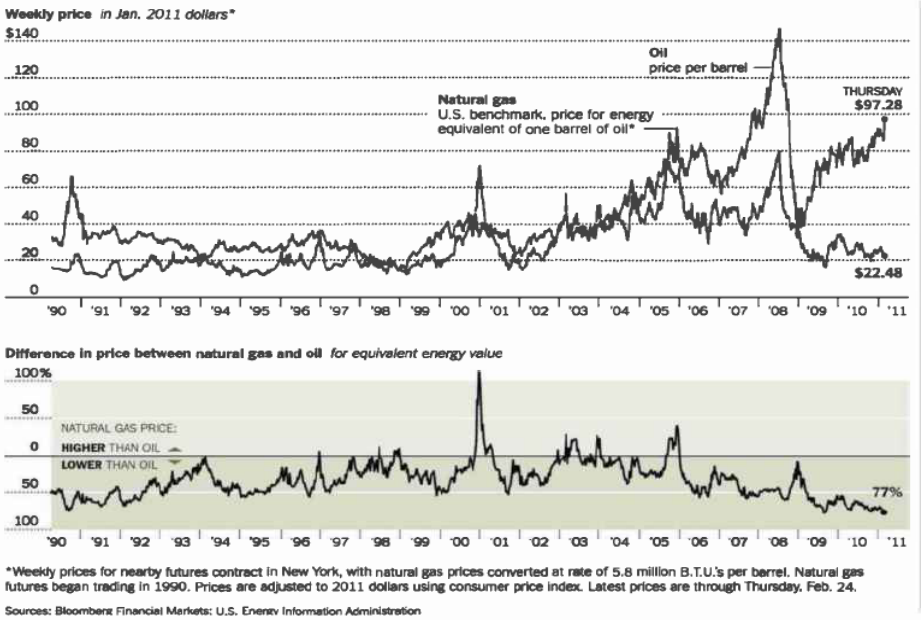
But now the marginal demand is more likely to come from China. In 2009, the last year for which figures are available, the world consumed 11 percent more oil than it had used a decade earlier. But the regional pattern changed sharply. The United States, Japan and the developed countries of Europe all used less oil. The rest of the world increased consumption by about a third.

As a result, the stronger recovery in developing countries has helped push oil prices up over the past 15 months, even though the Western economies have been stumbling. Oil can be shipped anywhere in the world, and tankers can be diverted from one country to another if demand patterns change.

Natural gas, by contrast, moves largely through pipelines. The gas consumed in the United States and Canada could not have been sent overseas, and as a result, the weak economies of those countries have depressed prices.

Over the past several weeks, the upward price pressure on oil from a booming China has been supplemented by worries about a reduction of supply as a result of revolutions in the Middle East. The buildup to $100 oil came as Libyan production was falling. The price retreated a bit when Saudi Arabia promised to produce more if necessary to offset a cutoff of Libyan exports.

Signs of stability in the Middle East would no doubt reduce upward pressure on oil prices. But sharp price declines may be unlikely unless, and until, Asian economies stumble and decrease their demand for oil.



*Weekly prices for nearby futures contract in New York, with natural gas prices converted at rate of 5.8 million B.T.U.'s per barrel. Natural gas futures began trading in 1990. Prices are adjusted to 2011 dollars using consumer price index. Latest prices are through Thursday, Feb. 24.

Sources: Bloomberg Financial Markets; U.S. Energy Information Administration