Ferguson: Energy Matters

December 1, 2006

Price Risk – Who Pays?

As we enter the last month of the year, natural gas storage levels remain at record highs. As I write this, 3.4 trillion cubic feet of natural gas are stored underground. Thanksgiving levels were 100 billion cubic feet higher this year than at any other time in the last decade or so.

As U.S. consumption of natural gas continues to fall - down 5 percent in the last four years - the number of gas wells drilled annually has doubled. How, then, does one explain the fact that gas is trading at such a high cost - close to $9/MMBtu?

Despite the record amount of gas in storage, weakening demand, and the boom in exploration, the NYMEX near-month contract (for delivery in January 2007) is higher than at any time except during last year's hurricane season and its aftermath. Winter prices are generally higher, but the average contract price for delivery over the next 12 months is $8.60/MMBtu. The contract price for delivery one year from now is around $9.60/MMBtu.

There are those who believe that the gas market is being manipulated by scurrilous traders exercising market power. I have no data with which to evaluate this claim. Whatever the reasons for current prices are, the market evidently doesn't believe that prices are going to come down in the near future.

A decade ago, conventional wisdom held that gas prices would remain around $2/MMBtu forever. Five years ago they had moved up to over $4/MMBtu, and folks thought those "high" prices would be around a while. Now prices have doubled again.

Is an $8/MMBtu price too high? Will massive imports of liquefied natural gas lower the price back to $4/MMBtu? Will gas remain at $8/MMBtu for many years, or will it double again? If I knew the answer to these questions, I'd be counting my dough on the beaches of Hawaii rather than writing columns.

What I find most irritating is the utility industry's persistent use of lowball future gas price estimates. According to the official Western Electricity Coordinating Council (WECC) forecast, gas in 2010 will cost around $6.50/MMBtu, moving up only to $7/MMBtu by 2015.

The consequence of these low forecasts - which are routinely used by utilities, transmission planners, and regulators - is to make future gas-fired electricity look like a bargain. However, the risk that these rosy forecasts are wrong is foisted off on ratepayers. Utilities are allowed to pass through fuel costs, even if they are much higher than the estimates the utilities relied on when building power plants.

Electricity from renewable energy resources - wind, geothermal, solar, and biomass - have no fuel costs but are capital intensive. The cost of this power is known up front because it's all capital and no fuel. If renewables developers run into problems that create additional costs, there is no regulator to bail them out by increasing the cost to ratepayers. Whatever price risk renewables developers face, they must bear it themselves.

California now has a law on the books, AB 32, which declares that the state will reduce greenhouse gas emissions, of which carbon dioxide from fossil-fueled power plants is a major part. Nevertheless, utility proposals for more gas-fired power keep coming in. Apparently no one is taking AB 32 seriously yet.

If the California Public Utilities Commission decides that the law means what it says and limits the use of fossil fuels for power generation, what happens to fossil-fueled investments now being made? Unless I miss my guess, the utilities will not be required to accept this risk, either. Ratepayers will be on the hook again.

At some point this Kafkaesque nonsense must cease. The utility industry must start shouldering the risks that continued reliance on fossil fuels poses.

If you or I take a market position betting that gas prices will fall and we lose that bet, we lose our money. Utilities should be held to the same standard. If they continue to bet on natural gas-fired electricity, they shouldn't be allowed to foist their losses off on ratepayers.

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