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Mortgaging the Future with the Natural Gas Myth

California depends on natural gas to generate about 40 percent of its electricity, and a bevy of new gas-fired power plants are in the works. Gas has many advantages which make the fuel the industry favorite. The biggest advantage is that utilities don't have to worry about how much gas costs.

Consumers do.

Utilities refuse to guarantee the price of gas-fired power. As with variable rate mortgages, consumers' rates for gas-fired power are adjusted periodically to cover the utilities' costs, no matter how high the price of gas.

Why aren't utilities required to offer fixed rates for gas-fired power? Why do regulators force consumers to bear the risk that gas prices will increase? Why do consumers put up with it?

Because of the myth that natural gas is expected to be cheaper in the future than it is now, or at least not more expensive. The myth is patently absurd, as the chart below shows. Nevertheless, the myth is perpetuated by industry, regulators and "experts" who know it isn't true.

As the trend in the data shows, the price of gas has tripled in the last decade on average, even when adjusted for inflation. (Inflation has added another 30 percent or so to prices during this time.)

Prices have spiked twice during this period. During the winter of 2000-2001 fears that storage would be inadequate for the heating season drove prices sharply higher. The subsequent recession forced prices back down when supplies proved to be more than adequate. Havoc caused by hurricanes Katrina and Rita was responsible for the second spike.

Can any reasonable person look at this chart and believe that the price of gas is likely to remain at $8 on average for the next 20 years? I think not.

Based on the historical record, is it reasonable to believe that gas prices will likely decline? No.

Nevertheless, “official” projections from the U.S. Energy Information Administration expect that utilities will be paying 30 percent less for gas in 2020 than they paid in 2005. Estimates made by the California Public Utilities Commission are similarly optimistic.

Every year for the last decade these august institutions have told us that the price of gas is expected to go down. As the chart shows, they have been wrong every year but one. You’d think they would be at least a little embarrassed.

The apparent cause of their continued belief in the myth of cheap gas--despite all evidence to the contrary--is their supreme faith that markets are all-knowing. By golly, if the market says the price today for delivery next year is less than for immediate delivery, the price next year should be lower than the price now.

The truth is that markets nearly always discount prices for future delivery, a normal condition referred to as “backwardation.” Today, for example, you can buy gas for delivery in June 2009 for about 14 percent less than for June 2008 when projected inflation is considered.

The reasons for backwardation are complex but have as much to do with the cost of storing commodities and the time value of money as with expectations of the actual future price.

A bird in the hand really is worth more than a bird in the bush.

The mere fact that commodity markets almost always discount prices for future delivery does not mean that we should expect everything to cost less next year.

The result of this absurd myth is that our dependence on natural gas continues to increase. Like homeowners signing sub-prime variable rate mortgages with low teaser rates, we consumers are forced to accept the very tangible risk that cheap natural gas will remain as much a fantasy in the future as it has in the past decade.

Why should utilities--which make the power procurement decisions--be allowed to foist the risk of rising gas prices off on consumers?

If regulators and utilities really believe the myth of cheap gas, utilities should accept the risk of being wrong. Just as homeowners can obtain fixed-rate mortgages, consumers should have the option of a guaranteed fixed price for gas-fired power.

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Opinions expressed by DrF are not necessarily those of any organization with which he is affiliated.