Gas Price Disconnect

By Mark Cooper

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IN A RECENT report entitled "The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral," the attorneys general of Illinois, Iowa, Missouri and Wisconsin challenged the conventional wisdom on natural gas prices. The report showed the oft repeated refrain of "financial markets send efficient price signals to balance supply and demand in a market with soaring demand and supply constrained by nature and public policy" is a simple story that is easy to sell, but half true at best.

If we do not look behind the half-truth, half-hype smokescreen of the headlines, consumers will continue to pay a lot more for natural gas than they should. There are policy measures that can and should be taken in the future to reduce the upward spiral. When we look for answers, we end up in Washington, where there's jurisdiction over the interstate natural gas system, and where the price of natural gas is largely determined.

Physical market fundamentals that implement a tight supply/demand balance are not adequate to explain the short-term or long-term behavior of natural gas prices. This does not mean that tight markets do not matter, but identifying physical market fundamentals is only the beginning of the issue.

Demand has not been surging, soaring or skyrocketing like headlines suggest; instead, over the past 10 years it has been relatively flat, with a slight moderation of the winter peak. Over the past three years, it has even declined slightly.

Although supply reserves were drawn down in the late 1980s and 1990s and have become harder to find, in recent years reserve additions have been growing. The reserve-to-production ratio has been increasing for the past six years. Moreover, the long-run cost of producing gas is far below the current price being paid. We find a gap greater than $3 per million British thermal units between the U.S. Energy Information Administration cost of production and the NYMEX five-year futures, a gap that could cost consumers $185 billion over a five-year period. The EIA's projection of costs is actually well above other estimates.

Short-term conditions of supply and demand also do not support the current high price of gas. Notwithstanding the effects of recent hurricanes, supply and demand are now about where they were last year or two years ago — both down a little, with demand down more than supply. A significant part of lost supplies were offset by demand destruction in the Gulf. All of this while gas in storage is at or near record levels for this time of year — up more than 50 percent compared to the last couple of years.

Tight markets reflect public policies and strategic behaviors, not just Mother Nature. Inadequate investment in exploration over the course of a decade or more contributed to the tight supply conditions. The massive windfall of cash flow in recent years dulls the incentive for the majors to supply gas to the market. They can keep it in the ground and hold out for higher prices and are under no pressure to sign long-term contracts, except at extremely high prices.

THE PROBLEM OF FINANCIAL MARKETS

Financial markets play an important role in the price spiral. The reliance on natural gas commodity markets to set the price paid by consumers is an extremely recent phenomenon. These markets have exhibited erratic behavior. Natural gas has supply and demand characteristics that make it vulnerable to abuse and volatility, yet the markets in which wholesale natural gas prices are set are less regulated than many other commodity markets.

Incentive structures and distribution of bargaining power in the physical and financial markets for natural gas are unnecessarily tilted against the consumer. There is a striking correlation between large increases in trading and increases in the volatility and level of natural gas prices. Each time trading ramps up, prices ramp up as well. Prices rise rapidly, then decline, but eventually come to rest at a steadily higher base price.

Financial markets are ratcheting up the prices in several ways. They thrive on volatility and volume, and volatility and volume have costs. Producers of gas demand to be paid a higher premium to bring their gas to market sooner rather than later. Traders demand to be rewarded for the risks they incur — risks that are increased by the trading process itself.

Also, the influx of traders fuels volatility and raises concerns about abusive or manipulative trading practices. Econometric analyses of the natural gas markets in recent years raise important questions as to

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TVA SHEDS DEBT

The Tennessee Valley Authority intends to cut its debt load, Bill Baxter, chairman of the federal entity, told Congress. TVA had two rate increases in six months totaling 17 percent.

TVA debt is $25.6 billion, down from $27.7 billion in 1997, the *Associated Press* reported.

how well the natural gas markets work. Risk premiums, which raise the price substantially — 10 percent to 20 percent — are high and rising.

Trading reflects the rules that are established, by law and through self-organization. The most troubling aspect of natural gas trading is that policymakers really cannot decipher what goes on. The majority of transactions take place in markets that are largely unregulated. These over-the-counter markets, reported in unaudited, unregulated indices, are a major factor in setting the price of natural gas. They have behaved poorly in recent years, with numerous instances of misreporting of prices.

Even where light-handed regulation is present, the rules are inadequate to protect the public. A small number of large players can influence the price that consumers pay in a very short period of time and under circumstances that place the consumer at risk. Also, index prices are often based on a small number of self-reported transactions with no mechanisms for determining if such transactions represent an accurate sampling of the natural gas market.

PUBLIC POLICY

While the story is complex, things do not have to be this bad. The steps necessary to improve the situation do not involve the usual prescription about biting the bullet until the supply-side comes around.

The position of the major oil companies with large holdings of natural gas physical assets, dominance of natural gas marketing, and active involvement in natural gas financial markets poses a serious threat to consumers. The fact that the majors straddle these markets, several of which are lightly regulated or entirely unregulated, compounds the problem, because their ability to profit by taking contrary positions in various markets is hidden from regulators.

A joint task force of federal and state antitrust and regulatory authorities should be formed to examine the regional concentration of natural gas supplies; the behavior of the majors as marketers; and behaviors of the major oil companies across all of the markets in which they are involved in physically as marketers, over-the-counter and in exchanges as traders.

While some may be satisfied with recent market reforms and enforcement efforts, many others are not. The natural gas market lacks the most basic elements of transparency that are necessary to send proper price signals.

> "The natural gas market lacks the most basic elements of transparency ..."

Over-the-counter markets need better oversight. The industry can increase scrutiny by requiring that traders in all the natural gas markets register and report their transaction and positions. Natural gas traders should have the resources to meet their commitments and stand behind their trades, as bankers are required to do. In addition, regulators should be able to see all markets so they can detect efforts to manipulate or exploit any individual market, including large transactions and large positions.

Market rules should discourage unproductive trading and be particularly on guard at moments of vulnerability in the natural gas markets by establishing reasonable limits on positions and ensuring that settlement periods are liquid and long. Vigorous oversight and stiff punishment of manipulation and abuse should be meted out swiftly.

Because state policy deals with local distribution utilities, it is difficult to drive change in the system from the buying end, where the primary concern is to make sure consumers have adequate gas to heat their homes. Nevertheless, state governments can take action to address the market concerns. States can create pressure for trading reforms by requiring their utilities to deal only with traders who are subject to oversight and who register, report and are audited, while mechanisms to promote long-term stability of commitments, transportation, storage and supply should be explored. States should also encourage utilities to be more aggressive in holding costs down. The challenge is to find approaches to make these modifications without exposing consumers to excessive risk.

Mark Cooper, research director of the Consumer Federation of America, recently completed a six-month study of natural gas prices for the attorneys general of Illinois, Iowa, Missouri and Wisconsin.

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LANDFILL GAS IN KANSAS

Several Kansas landfills are exploring the possible use of landfill generated methane to produce electricity.

One landfill will use its methane to supply power to the National Beef Packing Co., while another will pipe its methane 15 miles to an ethanol plant in Colwich, the *Associated Press* reported.

One $100,000 investment in methane production is expected to pay for itself in six months.

The federal government said that about 400 out of 2,300 operating or recently closed landfills are planning to capture and use methane.

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