The Politics of Natural Gas Use

Jim Clarkson July, 2009

For decades users of natural gas have suffered federal and state government distortions of the gas market. Occasionally market forces have broken through and created benefits, some of which have endured. Misguided beliefs have all too often overridden natural market forces. In the 1930's and 1940's when interstate natural gas pipelines were being installed, it was federal policy to discourage having multiple pipelines serving the same territory. The results of this policy would cause problems when it later became federal policy to encourage competition.

It was also federal policy to discourage large gas users from receiving direct service from pipelines and be served instead by local distributors. This too was to be a problem later as distributors overcharged large users in order to the provide revenues for uneconomic but politically popular over-expansions of their piping systems.

It is well-known that price controls on wellhead gas led to shortages and the abandonment of such controls. During the 1970's when federal policy was based on the belief that gas was running out, the pipelines had been ordered to secure long-term supply contracts from gas producers. To entice the producers to enter into these arrangements, the pipelines agreed to "take or pay" provisions requiring them to accept certain volumes of gas even if the prices were out of the market. This created a growing spread between old gas and new gas prices. Meanwhile state utility regulators and local gas distributors decided to impose large rate increases on gas used for manufacturing. Industrial customers were told gas was running out and they would soon be forced to switch to oil but in the meantime they would be overcharged to both discourage the use of gas and cross-subsidize residential customers. Many end users invested in back up oil systems, a move later regretted by the gas industry.

In the early 1980's as the alarm over gas supplies subsided, the price of oil went down enough to be competitive on the retail level with the overpriced gas purchased by industrial customers. As the industrials switched to oil, the pipelines first responded by shutting in their lower priced gas without take or pay contracts. This drove their blended cost of gas even higher thus driving away even more sales. Then the regulators accepted the idea of letting distressed industrials buy gas directly from the shut-in suppliers. A key court ruling ordered the pipelines not to discriminate and the whole regulatory regime began to unravel.

There were problems on the state level also. The gas distributors and their regulators hated the idea of industrials having the right to buy their own gas and use the pipelines as common carriers. They fought a losing rear-guard action against the industrials and their new allies, the gas marketers. Make no mistake about it - while state regulators would later become enamored of energy marketers for bringing benefits to electricity customers, the gas marketing business was developed under hostile conditions.

As the pipelines became open access, true market prices developed and the futures market in gas was initiated, the federal regulators struggled to keep up with market developments. Some new federal regulations merely recognized what had already taken place in the market. End users, or at least the big ones, enjoyed falling prices, better service and

appreciation of their business. Small users, after being subsidized under the old regulatory framework, still had problems before them.

In the 1980's the advance of technology and brighter prospects in other countries started a decline in U.S. smokestack industries. Some of the biggest users of gas were going away. High-energy chemicals could be produced cheaper in the Caribbean. Aluminum could be produced cheaper in Iceland, Canada and Australia. Copper use went down with the application of the silicone chip and copper recycling moved to the Pacific Rim. The textile industry began its slow decline and shift to areas with lower labor costs. Retail industrial gas use was not expanding enough to provide the subsidies that state regulators were accustomed to giving the faster growing but voting residential customers. Every time the regulators raised rates on the slow-growing industrial sales, those sales slowed further; and the industrials tried harder to obtain direct connections to the interstate pipelines.

After seeing the innovations in service and the cost reductions that accompanied the third party gas marketer business, gas utility distributors and the state regulators flip-flopped and touted open access for all retail customers. Many utilities created their own marketing companies, but these proved far more adept at developing sweetheart deals with their sister utilities than at beating their independent competitors.

While industrial load was shrinking and residential heating load increasing, fortune smiled on the gas industry as gas for peaking power generation grew. This gave the industry a summer load to balance the winter peak.

At this time, the remaining year-round industrial load is appreciated more than ever before, gas supplies are clearly plentiful and the futures market is well developed. For the future, federal discouraging gas exploration and development mean supply problems are not far away.

Price fluctuations, supply shortages and monopoly abuse are a direct result of federal and state regulation. Reduced prices, supply increases and improved service come with competition. The struggle between the forces of regulation and the market continue. Sometimes one getting ahead of the other; one falls back, the other surges forward; then they switch. Customers receive false price signals, business shifts to less regulated areas and the regulatory premium over market prices grows. The long history of government failure should convince the pragmatic to join the advocates of free markets to liberate the natural gas business.