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Electric Utilities and the Natural Gas Put

A put option is a financial instrument used in stock and commodity trading. One party pays another party a premium for the right, but not the obligation, to "put" or sell assets at an agreed upon price before a certain date. The seller of the put option is obligated to buy the underlying security at a specified strike price.

For example: A developer of natural gas wells may need to assure his lenders of sufficient cash flow to meet future principle and interest payments. He can do this by purchasing put options with a strike price that assures the necessary cash flow in future periods.

Back in the 1990s the term "Greenspan put" was used to describe the policy of Federal Reserve Chairman Alan Greenspan to always bail out stock market investors of their losing positions by adding liquidily. This policy gave investors the perception that asset prices would always increase and encouraged excessive risk taking. The Greenspan put would protect risk-takers from the consequences of a falling market.

Using the same liberty with the use of the term "put" we see that America's electric utilities have the protection of a regulatory-granted put on bad natural gas investments.

The dramatic and unforeseen drop in natural gas prices has caused serious harm to investors in gas production. Even the big oil companies made sizable investments in shale gas production that now are valued far less than their purchase price. So the drop in gas prices has been and continues to be tough on those enterprises in the unregulated sector of the economy.

Not so for the country's electric utilities that invested their customers' money in natural gas futures when the market was high. While natural gas prices plunged, electricity customers were still paying yesteryear's high prices with no harm coming to the utilities themselves. We're talking billions of dollars here so far, and the bleeding continues.

Fuel costs are passed through utilities to their customers at the utilities' costs. In effect the utilities have a regulatory situation that closely resembles a put option. Paying the premium of schmoozing politicians and being part of the political establishment has given utilities the right to put high-priced gas on their customers even as the market prices fall.

It gets worse. Utilities also justified, at least in part, huge capital investments assuming ever-rising natural gas prices. Many companies in the oil and gas patch are going under. Even Exxon is taking a beating. Regulated utilities are assured that they can pass the costs of their bad investments on to their customers. The justification for nuclear plants in South Carolina and Georgia used high gas prices when rationalizing the original construction cost projections. The projects are now way over the original budgets. However the regulatory-created put option will pass these cost on to retail customers.

The most dramatic exercise of the utility put is Southern Company's Mississippi Power Kemper Plant that was supposed to be fired by gasified coal as a substitute for natural gas.

According to Watchdog.org:

The records, unsealed after a two-year court fight, showed the company had its consultant, Energy Venture Associates, alter its forecasts with additional data to justify building Kemper, now billions over budget and years behind schedule.

EVA predicted in 2009 that natural gas prices would be between $12.50 and $13 per one million British Thermal Units by 2016. A filing before the PSC by Entegra Power Group says the break-even point for ratepayers on Kemper would require natural gas prices at $11 to $12 per MMBtu. Today, natural gas is $1.80 per MMBtu.

The Kemper project is in financial trouble for a number of reasons. The question here is would the investment have been made if the utility did not have the ability to put the cost, a mistaken investment based on high-priced gas, on customers?

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