

**Testimony of Tyson Slocum, Research Director
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September 14, 2005

**Before the House Government Reform Subcommittee on Energy and
Resources**

The Need for Stronger Regulation of U.S. Natural Gas Markets

Thank you, Mr. Chairman and members of the Subcommittee on Energy and Resources for the opportunity to testify on the issue of natural gas markets.

My name is Tyson Slocum and I am Research Director of Public Citizen's Energy Program. Public Citizen is a 34-year old public interest organization with over 160,000 members nationwide. We represent consumer interests through research, public education and grassroots organizing.

I last testified before the House Committee on Government Reform in May 2004, when I documented how recent mergers and lax regulation in the petroleum industry created uncompetitive markets, leading to higher retail gasoline prices for consumers—a fact later confirmed by the Government Accountability Office.

With record high energy prices and a natural gas industry with a terrible track record of manipulating markets, it is a no-brainer that stronger regulations are needed to protect consumers from ongoing market manipulation. Strengthening transparency empowers market participants and makes for more efficient, competitive markets, which in turn lead to fair prices for consumers.

Of course, reducing demand must be a crucial part of any reform. The American Council for an Energy-Efficient Economy has outlined a number of cost-effective efficiency measures that would collectively save more than 10% of U.S. natural gas usage by 2020. The more natural gas saved through improving efficiency in America's homes and businesses, the less pressure there is to produce or import more natural gas.

But unfortunately, the energy bill passed by Congress and signed by President Bush in August does little to address America's energy problems. After all, if it did, there wouldn't be a need for this hearing today. As long as Congress does nothing to address natural gas demand or reform America's dysfunctional natural gas markets, clear signals are sent to the industry that the sky's the limit for prices.

Remember, environmental regulations are not restricting the drilling of natural gas in the United States. An Interior Department study concludes that federal leasing restrictions—in the form of wilderness designations and other leasing restrictions—completely block

drilling of only 12% of the natural gas in the five major U.S. production basins on 104 million acres stretching from Montana to New Mexico. While only 12% is totally off-limits, 63% of America's natural gas reserves on federal land are fully available for drilling, with the remaining 25% featuring partial limitations on drilling.¹ This is significant, as about 35% of America's natural gas production is on federal land. This report contradicts industry claims that environmental laws are squelching natural gas production.

While rising demand is clearly playing a role higher natural gas prices, there is also no question that lax regulations over natural gas markets are also hitting consumers hard. Why do we think this? Well, just take a look at the track record of the natural gas industry. Federal and state governments have authorized over \$2 *billion* in fines, penalties, refunds and other enforcement actions against natural gas companies for manipulating domestic natural gas markets—an amount far less than the amount by which natural gas companies are alleged to have manipulated prices. Anti-competitive actions by the handful of natural gas companies—made possible by inadequate regulation over the industry—are a determining factor in the 187% increase in natural gas prices since 1999 (the wellhead price has soared from \$2.14 per thousand cubic feet in June 1999 to \$6.15 per thousand cubic feet in June 2005).

In the wake of Enron's collapse, Congress recognized that strengthening regulations over corporations was necessary to protect consumers and investors. In the summer of 2002, Congress wisely passed the Sarbanes-Oxley Act, imposing regulations on the accounting industry and the auditing process for corporations. The majority of recent corporate accounting scandals have been concentrated in the energy industry. But the Sarbanes-Oxley Act addresses what is arguably the "secondary" problem: natural gas and power companies primarily engaged in accounting fraud as a means to hide the enormous revenues they were earning from price-gouging consumers. Congress has thus far ignored the glaring need for a Sarbanes-Oxley-type reform of *energy regulations*.

Congress can restore accountability to natural gas markets and protect consumers by supporting Public Citizen's 5-point reform plan:

- Establish a "just and reasonable" standard for natural gas.
- Re-regulate natural gas trading exchanges to restore transparency.
- Order trading exchanges to reform natural gas trading price limits.
- Mandate natural gas storage requirements.
- Improve energy efficiency to reduce demand.

The American Council for an Energy Efficient Economy has submitted comments for the record describing the benefits of energy efficiency on reducing natural gas demand. I will now discuss the market regulation reforms necessary to protect consumers from high natural gas prices.

¹ *Scientific Inventory of Onshore Federal Lands' Oil and Gas Resources and Reserves and the Extent and Nature of Restrictions or Impediments to Their Development*, BLM/WO/GI-03/002+3100, January 2003, www.doi.gov/news/030116a.htm; www.blm.gov/nhp/spotlight/epca/EPCA_fact_sheet_draft06.htm

Establish a “Just and Reasonable” Standard for Natural Gas

While the CFTC regulates the natural gas futures markets, the Federal Energy Regulatory Commission is in charge of regulating other aspects of natural gas markets. While FERC has a legal mandate to ensure that electricity prices under its jurisdiction are “just and reasonable,” it has no such “fair price” standard for natural gas. As natural gas continues to have a bigger impact on the U.S. economy—not to mention setting the de facto price of electricity due to its use as fuel for power—Public Citizen urges the Subcommittee on Energy and Resources to support legislation that would establish a “just and reasonable” standard for all natural gas production.

While FERC does regulate the transportation of natural gas through pipelines (and can enforce “just and reasonable” rates there), this is a tiny portion that ultimately determines the price of natural gas.

The largest portion, production, was deregulated by two Congressional acts. First, the Natural Gas Policy Act of 1978 phased-in the removal of most wellhead price controls. This was followed up by the 1989 Wellhead Decontrol Act, which ended the last remaining price controls.

While there was merit to getting rid of price controls, Congress made the mistake of completely removing FERC jurisdiction over wellhead prices. So we went from having strict price controls to having markets dictate the price, with no opportunity for FERC to step in and regulate the rates being charged by producers. That’s why a “just and reasonable” standard comparable to electricity does not exist for natural gas.

The solution is to extend FERC regulation over wellhead prices, which would include subjecting producers to “just and reasonable” standards—just as FERC has the current authority to subject electricity producers to “just and reasonable” standards.

Indeed, the National Association of Gas Consumers (a coalition of municipal gas systems) filed a complaint with FERC in 2001² arguing that skyrocketing natural gas prices were not “just and reasonable,” and requested that FERC either: a) set an emergency nationwide price ceiling; or b) initiate an investigation into whether or not refunds could be ordered for those prices above the “just and reasonable” standard.

FERC dismissed the complaint: “A number of parties contend the Commission should also take action to limit the prices at which natural gas can be sold. However, under the Wellhead Decontrol Act, and the Commission regulations implementing that Act, natural gas prices have been effectively decontrolled. Therefore, the Commission declines to take the requested action on the instant complaints.”

So what is the solution? Amending the Natural Gas Act³ to expand FERC’s “just and reasonable” jurisdiction over wellhead prices. Changing this statute to include “the

² docket RP01-223, <http://elibrary.ferc.gov/>

³ 15 USC § 717 (“Regulation of natural gas companies”), www.gpoaccess.gov/uscode/

production or gathering of natural gas” would help hold natural gas producers accountable.

The 9th Circuit Court of Appeals recently ruled that FERC had broader power than it currently exercises to force energy companies to provide refunds to consumers for overcharging. The ability of FERC to order such refunds, however, is contingent upon the existence of the “just and reasonable” standard enshrined in the Federal Power Act. Without such a standard for natural gas, consumers are left unprotected.

Restore Transparency of Natural Gas Trading Exchanges

Natural gas companies have exploited energy industry deregulation to engage in one of the largest consumer rip-offs in history. Despite only moderately rising demand (which grew only 4.2% from 1999 to 2000), natural gas prices increased 245% over that short time period. This market manipulation trend may be continuing since Congress and the two federal regulatory commissions with jurisdiction have not reformed the rules that allowed the manipulation to occur.

Over the last three years, the federal government has obtained over \$2 billion in settlements against natural gas companies for market manipulation. These fines cover manipulation of energy trading markets, but only represent a fraction of the total amount by which consumers have been price-gouged. For example, California alone estimates that it is owed \$9 billion for energy market overcharging. This wide discrepancy between what consumers are owed and what the government has forced natural gas companies to pay exists because the federal government, through legislative and regulatory action, has severely limited its ability to effectively oversee the industry.

Both the CFTC and FERC have been negligent in policing these markets effectively. The CFTC is directly responsible for regulating commodities trade on futures exchanges (such as the New York Mercantile Exchange), but also has the power under the Commodity Exchange Act to intervene against traders in the under-regulated over-the-counter (OTC) markets. FERC is responsible for most non-exchange natural gas market issues.

Natural gas futures trading only began in November 1989, and it is clear that the significant problems that continue to plague these immature trading markets do not warrant today’s weak federal oversight. Contracts representing billions of BTUs of natural gas are traded every day on NYMEX. An increasing share of this trading, however, has been moving off regulated exchanges like NYMEX and into unregulated OTC exchanges. The Bank of International Settlements estimates that in 2004, the global OTC market has grown to over \$248 *trillion*. Growth in global OTC derivatives markets has averaged 31.6% since 1990.⁴

Traders operating on exchanges like NYMEX are required to disclose details of their trades to federal regulators. But traders in OTC exchanges are not required to disclose

⁴ www.financialpolicy.org/fpfsp25.htm

such information, allowing energy companies, investment banks and hedge funds to escape federal oversight and more easily engage in manipulation strategies. The need for stronger consumer protections is more urgent as powerful new players—led by hedge funds and investment banks—now dominate natural gas trading.

Energy trading on these OTC exchanges was greatly expanded at the beginning of 1993 when the CFTC, under the chairmanship of Dr. Wendy Gramm, granted an exemption requested by Enron and eight other companies for energy contracts (including natural gas) from exchange-trading requirements and anti-fraud provisions of the Commodity Exchange Act. By doing so, the CFTC voluntarily limited its ability to police energy trading markets.

The growth of these OTC exchanges exploded in 2000 when Congress passed the Commodity Futures Modernization Act which, among other things, largely exempted trading of energy commodities on OTC exchanges from federal government oversight. As a result, many investment banks and energy companies opened their own electronic exchanges where the bulk of their activities were unregulated. Since the law took effect, the industry has been plagued by dozens of high-profile scandals attributed to the lack of adequate regulatory oversight over trader's operations.

Public Citizen supports efforts to re-regulate energy trading by subjecting OTC markets to tougher oversight and enhanced consumer protections.

But the latest such effort in the Senate, an amendment to the energy bill, was rejected by a vote of 55-44 in June 2003 (Amendment 876 to S.14). The amendment would have largely repealed the 1993 CFTC and 2000 Congressional deregulation acts.

The measure was defeated after a public spat between Warren Buffett, chairman of Berkshire Hathaway, and Federal Reserve Chairman Alan Greenspan. Buffett called the under-regulated derivatives markets “weapons of mass destruction” in March 2003, and Greenspan took the unusual step of publicly disputing Buffett's assertions.

In the House, Public Citizen supports HR 1638, introduced in April 2005 by Missouri Republican Rep. Sam Graves. His legislation takes important steps to improve transparency of these deregulated natural gas trading markets, and would also forbid CFTC members from working for any organization subject to Commission regulation for one year.

Graves' legislation is clearly aimed at the CFTC's troublesome streak of “revolving door” appointments and hiring which may further hamper the ability of the agency to effectively regulate the energy trading industry. In August 2004, CFTC chairman James Newsome left the Commission to accept a \$1 million yearly salary as president of NYMEX, the world's largest energy futures marketplace. Just weeks later, Scott Parsons, the CFTC's chief operating officer, resigned to become executive vice-president for government affairs at the Managed Funds Association, a hedge-fund industry group that

figures prominently in energy derivatives markets. Such prominent defections hamper the CFTC's ability to protect consumers.

It is prudent to enhance regulatory oversight over natural gas trading markets considering the new breed of trader that is beginning to dominate these markets. Public Citizen's research has identified more than 200 hedge funds that have developed significant positions in natural gas trading markets. In addition, investment banks—led by Goldman Sachs and Morgan Stanley—have already firmly established themselves as dominant players in natural gas trading. Given the sheer size and political muscle behind these hedge funds and investment banks, greater transparency over their actions is needed now more than ever.

Reform NYMEX Natural Gas Trading Price Limits

Trading exchanges can impose price limits on daily trading as a way to protect consumers. For example, in response to the Mad Cow scare, the Chicago Mercantile Exchange (CME) imposed a price limit on cattle of 3¢ per pound—so if the price fluctuates more than that amount, trading on cattle is stopped until the next day. The 3¢ limit is about 0.04% of the current trading price of live cattle—a very low threshold that protects consumers and producers from volatility. Even commodities unaffiliated with Mad Cow- like “scares” have strict price limits. Trading in milk futures contracts is suspended until the following day if the price changes more than 75¢ (5.3% of the current price). Trading in lumber futures is halted for the day if the price swings more than \$10.00 per thousand board feet (3% of the current price). These severe price limits help control volatility and reduce damaging speculation. The CME implemented these strict price limits typically at the request of producers, since many of the price swings were hurting their bottom line.

But NYMEX has weak price limits on natural gas trading. If the price changes by \$3/Btu during a daily session, then trading is suspended for only 5 *minutes*. This \$3 limit is 27% of the current price at Henry Hub (\$11 per thousand cubic feet), compared to the much smaller range of 0.04% to 5% listed in the above agricultural commodities. This means that NYMEX tolerates more volatility in natural gas trading markets, making it a more attractive market for speculators to profit at the expense of consumers. But, unlike agricultural products with tough price limits, the natural gas producers and speculators are making billions of dollars off these volatile natural gas markets.

Public Citizen urges the Subcommittee on Energy and Resources to pass legislation forcing NYMEX to set stricter price limits for natural gas in order to better protect consumers.

Mandate Natural Gas Storage Requirements

While under-regulation of energy trading markets allows market gaming to set natural gas prices, published natural gas storage levels influence the price. If natural gas storage levels are at historically high levels, the market typically will lower the price of natural gas, since more natural gas is available to release in response to demand fluctuations.

For years there has been a strong correlation between the amount of working gas in storage and the wellhead price of natural gas. But in recent years, the natural gas industry has kept less product in storage, which in turn has sent strong signals to markets to help drive the price of natural gas higher. Acknowledging that there may be flaws in allowing natural gas companies to set storage levels by themselves, Public Citizen recommends the creation of a “Strategic Natural Gas Reserve,” perhaps modeled on the Strategic Petroleum Reserve. A federally-controlled and regulated natural gas storage system would help ensure that natural gas storage levels are adequate to meet demand.

It is important to note that in recent years, the correlation between storage levels and prices has become less strong. This trend may be attributable to an over-reliance of natural gas users on futures trading, rather than physical storage, as a hedging tool. In addition, the less-transparent natural gas trading markets since 2000 may also be contributing to this deviation from standard correlations, as market manipulation—rather than true supply and demand—sets prices.