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Consumer Concerns with Natural Gas and LNG

Thank you, Mr. Chairman and members of the Senate Subcommittee on Competition, Foreign Commerce, and Infrastructure for the opportunity to testify on the issue of natural gas markets. My name is Wenonah Hauter and I am Director of Public Citizen's Energy Program. Public Citizen is a 30-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 Senate Commerce Committee in April 2002, when I documented how Enron exploited deregulation to manipulate West Coast energy markets.

Since I gave that testimony, federal and state governments have authorized $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 155% increase in natural gas prices for consumers since 1999.

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*.

The two main types of abuse by natural gas companies are manipulation of energy trading markets (where prices are set) and storage data (which influence prices). Congress can restore accountability to natural gas markets and protect consumers by supporting Public Citizen's 5-point reform plan:

- Re-regulate natural gas trading exchanges to restore transparency.
- Order trading exchanges to reform natural gas trading price limits.
- Establish a "just and reasonable" standard for natural gas.
- Mandate natural gas storage requirements.
- Improve local control over LNG siting.

Restore Transparency of Natural Gas Trading Exchanges

Beginning in 2000, natural gas companies 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% from January 1999 to January 2001. This increase was not justified by the underlying market conditions: adequate supply matching moderately growing demand. 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 two years, two federal agencies (the Commodity Futures Trading Commission and the Federal Energy Regulatory Commission) have obtained $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 trading markets do not warrant the 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 2003, the global OTC market has grown to over $2 *trillion*, a 150% increase from 1998.

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 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 has supported efforts to re-regulate energy trading by subjecting OTC markets to tougher oversight and enhanced consumer protections. But the latest such effort, an amendment to the energy bill, was rejected by the Senate by a vote of 55-44 in June 2003 (Amendment 876 to S.14). The amendment would largely repeal 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 underreguated derivatives markets "weapons of mass destruction" in March 2003, and Greenspan took the unusual step of publicly disputing Buffett's assertions.

As if deregulation by the CFTC and Congress were not bad enough, the CFTC has experienced a 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 may 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 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 0.4% of the current trading price of live cattle—a very low threshold that protects consumers and producers from volatility. Even commodities unafflicted 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¢ (about 5% 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 roughly *half* the current price of natural gas (compared to the much smaller range of 0.4% 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 Senate Commerce Committee to pass a law forcing NYMEX to set stricter price limits for natural gas in order to better protect consumers.

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 strongly urges the Senate Commerce Committee to support legislation that would establish a "just and reasonable" standard for all natural gas production.

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.

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.

Improve Local Control Over LNG Siting

Last year, Federal Reserve chairman Alan Greenspan called on the U.S. to quickly approve a “major” increase in Liquefied Natural Gas (LNG) import facilities, claiming that domestic supply and demand trends require increases in natural gas importation.

Such an analysis, however, ignores the benefits of reducing projected natural gas demand through improvements in energy efficiency and the encouragement of alternative energy.

The Department of Energy projects that natural gas demand will grow at a rate of 1.4% a year from now through 2025, with domestic production growing at a rate of 1.0% a year. But the DOE projections assume little to no improvements in natural gas consumption efficiency, and only limited development of alternative electricity generation during that time. If America’s energy policies are prioritized to reduce demand and increase renewable fuels, the need to import LNG will greatly diminish.

Indeed, one of the biggest debates in energy policy is reducing America’s dependence on foreign sources of energy. But importing LNG will make us more dependent on such imports, particularly from volatile regions of the world.

In 2003, we obtained 98% of our natural gas needs from domestic production and pipeline shipments from Canada and Mexico (83% of our natural gas needs are derived from domestic production). The reminder come from LNG imports, with 23% of those imports coming from OPEC nations (Algeria, Qatar and Nigeria). Increasing reliance on LNG will result in the U.S. becoming more dependent on OPEC.

Nonetheless, even assuming the need for an expansion of LNG facilities, the Senate Commerce Committee should make sure that such an expansion contains new protections for states to have adequate jurisdiction over safety, environmental and consumer protections. Given the concerns raised by state officials and at least 20 U.S. Senators regarding improper FERC assertion of jurisdiction over traditional state domains on electricity markets, it would seem that Congressional action asserting the rights of states on LNG siting may be required.

In March 2004, FERC denied California (and other states) the right to adequately regulate LNG import facilities located or proposed in the state. In July, the California Public Utilities Commission voted to appeal FERC's ruling. Public Citizen feels FERC has overstepped its authority under the Natural Gas Act. This is probably why a bill has been introduced in the U.S. House of Representatives (HR 4413) that would clarify FERC's exclusive jurisdiction over such LNG facilities. If FERC were on stronger ground, such proposed legislation would be unnecessary.

Finally, FERC has not provided adequate guarantees regarding the security concerns of LNG import facilities. LNG tankers and marine terminals pose significant terrorist targets due to the sheer magnitude of the amount of fuel carried by LNG tankers (they carry up to ten times the amount of fuel in a typical crude oil ship) and the risk of fires (and subsequent thermal radiation) and hazards associated with the heating of the LNG at the marine terminals. States have already raised serious questions about the adequacy of FERC's security assessments. This is particularly important given assertions by the United States' former deputy counterterrorism czar that Al Qaeda operatives, trained in Afghanistan, came to the U.S. smuggled aboard LNG tankers from Algeria and considered Boston a "logistical hub" for the terror network's activities in the U.S. prior to the September 11 attacks. Al Qaeda has already demonstrated the capacity to strike at sea, with the boat bombings of the USS Cole in 2000 and the oil tanker Limburg in 2002. It is therefore clear that Congress must increase its oversight of FERC's current security analyses of LNG importation.