SENATE PONDERS LEGISLATIVE OPTIONS TO CURB EXCESS SPECULATION IN ENERGY MARKETS; FERC BACKS PREEMPTIVE "CEASE AND DESIST" AUTHORITY

27 March 2009
Foster Natural Gas Report
English

Members of the Senate's Energy and Natural Resources Committee are mulling proposals to strengthen the oversight and transparency of energy markets in order to curb excess speculation. On 3/25/09 the Subcommittee on Energy entertained witnesses speaking to energy markets and oversight: EIA's Acting Administrator Howard Gruenspecht, FERC's Acting Director of the Office of Enforcement Anna Cochrane, Robert McCullough of McCullough Research, and Gerry Ramm, Senior Executive, Inland Oil Co. and representing the Petroleum Markets Association of America (PMAA). On the table are two complementary proposals - S. 672, the Natural Gas and Electricity Review and Enforcement Act, and the Energy Market Transparency Act (EMTA) of 2009. The Senate may add both proposals to a comprehensive energy bill that also addresses electricity siting issues, energy innovation, workforce development, and a federal renewable energy standard, among other items.

A Senate committee markup may be scheduled after Congress' customary Easter recess next month.

S. 672, introduced by Sen. Maria Cantwell (D-Wash.) on 3/24/09, would give FERC "cease and desist" authority to augment the anti-manipulation authority it was granted in the Energy Policy Act of 2005. The draft version of EMTA, which has not been formally introduced, would call for the Energy Information Administration (EIA) to collect data on energy speculation activities, would create a new office within EIA to conduct financial market analyses, and would develop a federal working group to assess the impact on prices of increased financial investments in energy commodities.

At the March 25 hearing, FERC's enforcer, Cochrane, emphasized her function at the agency to promote transparency in energy markets in the context of the Commission's obligation to ensure just and reasonable rates and to protect customers. She pledged the Commission's continuing vigilance and recited some of the many steps to increase transparency in wholesale electric and natural gas markets already taken by the Commission.

If Congress does provide FERC with expanded authorities to protect against market manipulation, "it is likely that they would be used only in rare circumstances, if at all." However, Cochrane emphasized the deterrent effect such statutory power would have. Congress could give the Commission "cease and desist" authority - under both the Federal Power Act (FPA) and Natural Gas Act (NGA) - and FERC would use this authority if it determines that a market participant's behavior was ongoing and significantly harming the public interest. Although the Commission currently has the ability to seek U.S. District Court injunctive relief, direct "cease and desist" authority would expand the Commission's enforcement tool box to match those of the

Security and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), Cochrane argued.

Cochrane next asked Congress to consider giving the Commission authority to prevent the dissipation of assets by a company under investigation. If the Commission is able to freeze assets, she explained, then a violator of anti-manipulation laws will be blocked from frustrating the Commission's ability to order disgorgement or restitution after determining there was in fact a violation. The SEC and the CFTC already have comparable authority.

Finally, Cochrane suggested the Commission is seeking authority - in emergency circumstances - to be able to temporarily modify or suspend market rules on file at the Commission under the FPA if those rules unexpectedly allow market power to be exercised or cause other serious problems in organized markets. This could be followed by normal FPA procedures for long-term changes to the market rules. Legislation

Cantwell's S. 672 bill would amend both the Federal Power Act (FPA) and the Natural Gas Act (NGA). The bill would enable FERC to exercise an injunction in order to prevent a market participant from engaging in behavior that was likely to result in significant harm to electricity and natural gas consumers or to the public interest. FERC could issue a temporary order requiring a respondent to take action to prevent the violation or threatened violation. The law aims to prevent the frustration of the ability of the Commission to conduct proceedings or to redress the violation at the conclusion of enforcement proceedings. Such authorization would empower the Commission to suspend the participant's market activity until a final judgment has been issued. A respondent who is the subject of an investigation and enforcement action may resort to judicial review of such an order in the jurisdictional U.S. circuit court (determined based on where the respondent resides) or in the U.S. Court of Appeals for the District of Columbia Circuit, but only after a hearing and decision by the Commission. The law would be changed to permit a potential refund for natural gas rates paid in excess of the amount that would have been paid under just and reasonable rates to accrue from the time that FERC actually initiates a case. Similarly, the bill grants the Commission emergency authority to change or temporarily suspend electricity rates.

According to Sen. Jeff Bingaman (D-N.M.), Chairman on the Committee, Cantwell's bill includes language "very similar to what FERC had proposed" and is modeled after the authority that the CFTC and the SEC already have.

From a more general perspective, the EMTA aims "to ensure the transparency of information related to energy infrastructure and product ownership." That legislative vehicle would direct the EIA to develop a plan to collect information identifying the ownership of all commercially held oil and natural gas inventories in the U.S., including "volumes of product under ownership," and storage and transportation capacity (including owned and leased capacity). In the case of any person holding or controlling energy futures contracts or energy commodity swaps, information must be identified on the quantity of physical stocks owned, the quantity of fixed price purchase commitments open, the quantity of fixed price sales commitments open, and the physical storage capacity owned or leased.

The EMTA provides for the establishment of a Financial Market Analysis Office within EIA that would oversee the analyses of the financial aspects of energy markets. A working group comprised of representatives of the Secretary of the Department of Energy (DOE), the Secretary of the Treasury, FERC's Chairman, the Chairman of the Federal Trade Commission, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the EIA Administrator would investigate the effect of increased investments in energy commodities on energy prices and the U.S. energy security implications of developments in international energy markets. Their recommendations to the President and Congress would serve to guide the modeling of laws or regulations needed to prevent excessive speculation in such energy commodity markets.

Data Collection Prospects

In order to prepare analyses on the effects of trading on crude oil prices, EIA's Acting Director Howard Gruenspecht told Congress EIA needs better data and "a much stronger theoretical approach." The CFTC publishes data on trading positions, but that data is separated into categories of commercial and non-commercial traders, and does not map "cleanly" to hedgers and speculators. "Without a way of identifying traders and positions taken for speculative purposes, direct analysis of the effects of speculation on price formation is not really possible," he said. EIA and the CFTC maintain a cooperative relationship. However, the CFTC has been struggling with this problem, it may have made some advances, but the agency so far has not made its findings public.

Steps are underway to improve EIA's understanding of the effects of the interaction between energy and financial markets. A recent workshop held jointly by the EIA, CFTC, the Federal Reserve Board, the Government Accountability Office, and the International Monetary Fund, considered methods to quantify the uncertainty surrounding short-term price forecasts. EIA's Short-Term Energy Outlook (STEO) team presented research into the use of implied volatilities from the New York Mercantile Exchange options markets as a measure of uncertainly in short-term forecasts. According to Gruenspecht, the American Statistical Association's Committee on Energy Statistics will provide a further review of methods to calculate probability distributions for future oil prices "using implied volatilities reflected in prevailing prices of options contracts" at its April meeting. "By mid-year, we intend to report these calculations in each edition of the STEO to provide additional context for our own analysis," he reported.

Concerning the EMTA, EIA "strongly supports data transparency" and agrees that additional data on physical and financial oil and natural gas markets "would be helpful in increasing understanding of oil price discovery." However, EIA's initial assessment is that the data collection efforts proposed in the EMTA could be both "difficult and expensive." Congress should consider other more readily obtainable data as a resource to provide comparable or even better insights. Nor does the draft legislation describe the intended uses of the data, noted Gruenspecht.

Other weaknesses in the draft legislation, from EIA's perspective, is the absence in many cases of clear identification of ownership of energy commodities and therefore of who should report data to EIA. EIA currently surveys stocks at petroleum terminals, for instance, but those stocks are held on a custody basis, not an ownership basis. Terminal operators may not know who the owners of the stocks are. These operators would know who brought the product to the terminal and who leases the tanks, but the product could have been subsequently sold - something that can occur daily - and still remain in the same tanks.

Ownership rights also would be difficult to identify in cases of minority position owners and joint ventures. The universe of actual owners (i.e., intended survey respondents) is unknown and perhaps unknowable, particularly outside of the physical market participants EIA usually deals with such as refiners, pipelines, and terminal operators. With the assistance of other agencies, EIA might be able to identify and survey at least a subset of owners, but such an activity should be recognized as involving far more difficulty than simply adding questions about ownership to the surveys that are currently completed by those having custody of inventories.

Data confidentiality is the other problem not fully addressed by the draft legislation. Data held by the government is subject to Freedom of Information Act (FOIA) requests by private, non-governmental parties, who may seek such information for private gains. To address this, data collections should be subject to the Confidential Information Protection and Statistical Efficiency Act (CIPSEA), which requires additional safeguards for protecting the identity of reported information and for sharing individual respondent (i.e., company-specific) information.

"Ultimately, the choice of which data collection authority to cite will depend on the level of protection that is required, the intended use of the data, how sensitive the reported information is to respondents in identifiable form, and the purposes for which the information may be shared with other agencies," Gruenspecht stated. "These considerations are not specified in the draft legislation."

Finally, instead of Congress creating a special Analysis Office within EIA, Gruenspecht said EIA would prefer to have the latitude to restructure itself. EIA's expertise in energy markets is located across several EIA offices, and staff works well together across office lines to produce forecasts and analyses, Gruenspecht told the committee members.

"Although we fear that the oil market may have become dominated by speculators, we do not know who they are, or their possible impacts," explained Robert McCullough. Oil, natural gas and the electricity industry are interconnected with commensurate effects on the entire economy. According to McCullough, the inability of the federal government to fully investigate oil price behavior in 2008 is fundamentally a data problem, and the legislation that Congress is considering "is a step in the right direction," as it will expand the EIA's ability to track oil inventories within the U.S. by owner. EIA should also pursue data-sharing arrangements with trading partners, especially with Canada. FERC should create an Oil Quarterly Report modeled after their Electric Quarterly Report, that would give regulators, decision-makers, and the public a better sense of whether oil markets are dysfunctional. "We know so little at this point that any information is useful," McCullough emphasized.

Little is actually known about the oil commodity because U.S. regulators do not collect data on spot transactions, and data is available on only a portion of forward transactions. No agency of the U.S. government is currently investigating and explaining the extraordinary price changes of last year. Current responsibilities are allocated among FERC (pipelines), the CFTC (some, but not all, forward contracts), and the EIA (forecasting). Although the CFTC formed an interagency task force last June to study commodity markets, the group only managed to expeditiously publish an interim report and then stopped its activities. Reviews of pricing anomalies largely rely upon third parties - such as private companies like McCullough Research that are retained to examine whether the markets are reflecting fundamental supply and demand conditions.

Reflecting on the accuracy of forecasting, McCullough described EIA's forecasts of oil quantities "statistically significant at 99%," but forecasts of prices "were not statistically significant at any level." Basic assumptions underlying the EIA's forecasts require careful examination, McCullough noted. "It appears likely that price responses to changes in supply and demand are more complex than those modeled in the EIA's price forecast."

Very little research has been performed concerning the degree of competition in the oil market, according to McCullough. Understanding the degree of competition is crucial, because economic theory gives very different predictions under different market structures, such as under perfect competition or oligopoly. Given the data now available from the EIA, the assumption of oligopoly is a better candidate for a model of the world oil market than perfect competition. Inventories rose during the period of rising prices and then fell when prices were falling. Given the extreme levels reached during July 2008, the oil market very possibly had one or more pivotal suppliers.

Agreeing with McCullough to some extent that competitive forces have been stymied but putting the blame more heavily on market speculators, Gerry Ramm of Inland Oil (PMAA) testified that the dramatic rise ($150/barrel in July for December delivery) and the dramatic fall ($33/barrel in December) of crude oil prices were not entirely the result of supply and demand market fundamentals. The market, he argued, "was unduly influenced by excessively-leveraged speculators, index investors and hedge funds." These large-scale institutional investors are a driving force behind energy prices.

During the first half of 2008, index speculators and hedge funds poured around $55 billion into commodity indices that resulted in the buying of between 130 and 170 million barrels of West Texas Intermediate crude oil in the futures market. However, by late July and early August, index speculators began to pull money out of commodity indices. Approximately $70 billion was withdrawn from these indices, resulting in the selling of around 230 million barrels of crude oil by the end of the year. Investors were looking not to actually buy oil futures, but to make a fast buck in a "paper trade." This practice caused oil prices to rise faster and fall harder than could ever be explained by ordinary market forces alone, and American consumers, small businesses and the broader economy were forced onto a roller coaster ride of greed and fear.

Commodity markets, in Ramm's view, were not designed as an investment class. They were set up for physical hedgers to manage price risk by entering into a futures contract in order to lock in a price for actual future deliveries. The index funds managers who believe commodities are an asset class are actually "unwitting speculators." They are so large and lack fundamental commodity market knowledge that they have dramatically distorted the markets that the industry relies on. "This abuse of this original intent must end now," Ramm demanded, and urged Congress to expedite the commodity markets reform legislation.

PMAA wants more data on storage availability and to that end previously had "strongly" supported language in the 2005 Energy Policy Act that required DOE to examine the amount of useable storage that is available in the U.S. PMAA believes there has been a dramatic reduction in the amount of useable storage and policy makers aren't aware of it. The shrinking portfolio of storage options has been caused in part by overly aggressive underground storage tank requirements, specifically related to spill regulations that render much storage unuseable. In addition, the amount of commercially held oil should be managed within a minimum threshold.

Another needed legislative fix, from the PMAA's perspective, is a provision that imposes aggregate position limits at the control entity level on non-commercial traders, and across all trading environments, including over-the-counter markets that do not have physical connection to the underlying commodity. It is necessary that such legislation distinguish between legitimate hedgers in the business of actually delivering the fuel to consumers, and those who are in the market for purely speculative purposes.

Finally, Ramm asked Congress to close the "London Loophole" by requiring foreign exchanges with energy contracts for delivery in the U.S. and/or that allow U.S. access to their platforms to be subject to comparable U.S. rules and regulations. The "Swaps Loophole," which allows so-called "index speculators" (who now amount to one-third of the market) an exemption on position limits which enable them to control unlimited amounts of energy commodities, must also be closed. To handle these matters, Ramm suggested that the CFTC's staff and resources be increased.

The free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of laws and accountability is crucial to the entire petroleum industry and the American economy. However, Ramm concluded, "PMAA and our customers need our public officials to take a stand against abusive trading practices that artificially inflate energy prices and severely damage our economy."