Markets vulnerable to manipulation: Testimony

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US electricity and natural gas markets remain vulnerable to Enron-style manipulation because of weak regulatory oversight, an energy consultant and others testified at a Democratic Policy Committee hearing Monday.

The testimony of Robert McCullough, manager of Oregon-based **McCullough Research**, took aim at inadequate information reported on regulated exchanges, inconsistent oversight and lack of transparency.

"More than a decade ago, the Commodity Futures Trading Commission determined there was little reason to be the nation's watchdog because Enron, Reliant, and other energy companies convinced Congress to eliminate regulatory oversight," he said during an oversight hearing on energy trading and gas prices. The committee called the hearing because of speculation the recent run-up of gas prices may be related to market manipulation.

In a recent report, McCullough said he uncovered a market anomaly that indicates manipulation remains a threat to electricity markets. Last winter, the 12-month forward prices for natural gas increased while the 12-month forward prices for oil decreased. "Since oil and gas are close substitutes, the divergence in forward prices should have provided an incentive for consumers to switch between the two fuels. However, the forward price differential continued for several months, and the divergence may even have proven costly for consumers who were attempting to mitigate their risk at the time," he said. "Given the ability of 18% of U.S. generating capacity to switch between the two fuels, it is odd that the different fuels would diverge sharply in futures trading."

One problem, he said, is that federal government does not regulate today's complex software and electronic trading platforms in energy. It took years to accumulate necessary information on the Enron scheme, he said, and such market information remains difficult for regulators, policy makers and consumers to obtain.

McCullough called for transaction reporting on regulated exchanges to match the "specificity and breadth" of the Electric Quarterly Reports required by FERC.

He also said that the CFTC' must be allowed a greater hand in regulating and registering electronic platforms. "Absent consistent regulation, malefactors will pursue trades on unregulated platforms, effectively eliminating the protections that market participants require. Regulating only a few electronic trading platforms is similar to allowing some travelers to skip security checks," he said. "Everyone become less secure if obvious shortcuts around regulation exist."

A transparent marketplace in which all participants are regulated equally is the best insurance against manipulation and fraud. "Secrecy usually works against us," McCullough said.

McCullough was part of a group testifying that federal regulators are not given nearly enough information about energy trading on electronic platforms such as the IntercontinentalExchange to properly oversee the markets.

In other testimony before the committee, officials from a Washington state public utility district, a California electricity consumer oversight board and the Illinois attorney general asserted that the reemergence of heavy over-the-counter trading of futures and derivatives on platforms operating independent of the regulated NYMEX is falling further under the radar screens of regulators.

"I certainly do not have access to enough information to assure the people who I work for that those markets are working competitively and fair market dynamics are setting those prices," said Erik Saltmarsh, director of the California Electricity Oversight Board, an agency charged with investigating wholesale natural gas and electricity markets.

"It is my belief that there is no single federal regulator that could come in and tell you honestly that they have all the information that would allow them to do that."

By his estimation, Saltmarsh told the senators, regulators could see about 70% of significant trading as they assessed the Western gas and electric markets. Now, he said, "I would say we can see something like 25% of the important trading, and I am not confident that we can really determine what and who are setting prices much of the time."

A pending bill (S. 2642) cosponsored by Republican Senator Olympia Snowe of Maine and Democratic Senators Dianne Feinstein of California, Maria Cantwell of Washington and Carl Levin of Michigan, would require reporting of OTC contracts trading on off-NYMEX exchanges, with a goal of bringing the rapidly growing IntercontinentalExchange, or ICE, under the federal regulatory umbrella. ICE operates a substantial natural gas trading business on an electronic platform based in Atlanta.

The bill is designed to do away with an existing provision that has been dubbed the "Enron loophole" by requiring electronic exchanges to keep records for at least five years and report large positions held by specific traders to the Commodity Futures Trading Commission. Existing law exempts the OTC electronic market from that requirement, a rule by which NYMEX must adhere.

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