RESPONSES OF PEGGY A. LAUTENSCHLAGER, WISCONSIN ATTORNEY GENERAL, TO SUPPLEMENTAL QUESTIONS FROM MEMBERS OF THE SENATE JUDICIARY COMMITTEE

Re: March 14, 2006 Committee Hearing: "Consolidation in the Energy Industry: Raising Prices at the Pump? Part II"

Supplemental Question Posed by Chairman Specter

Question for Attorney General Peggy Lautenschlager:

1. You testified that natural gas prices can not be entirely explained by supply and demand and spike during periods of heavy trading activity. Please discuss the link between trading and price volatility.

   Response by Attorney General Lautenschlager:

   Our report found a very strong correlation between increased trading activity of natural gas and increased upward price volatility of natural gas. As illustrated by chart ES-7 attached to my written testimony, trading activity and natural gas prices were relatively stable during the first 10 years of deregulation, beginning in the early 1990s. Volatility increased dramatically, however, beginning around the year 2000 and continuing to the present. This volatility corresponds directly to the emergence of high-volume trading of natural gas, first by Enron and later by the brokerage houses and hedge funds. In addition, the volatility is characterized by a "ratchet" effect. In other words, the price goes up and down dramatically, but both the peaks and the valleys seems to constantly rise, so that the price of natural gas is not only more volatile, its average price is constantly rising.

Supplemental Question Posed by Senator Leahy

Question for Attorney General Peggy Lautenschlager:

1. Do you think there needs to be more transparency on the commodity exchanges, particularly natural gas transactions? If so, what steps can Congress take to increase transparency in the natural gas market? Should Congress require traders to register?

   Response by Attorney General Lautenschlager:

   I definitely believe that we need more transparency in the natural gas markets, and virtually every company we spoke with in the course of our study, including utilities and producers, agreed that greater transparency would benefit everyone,

including consumers. Our study recommends the following steps that can be taken at the federal level:

- Increased oversight of the over-the-counter markets for natural gas, including requirements for registration of traders and reporting of all trades;

- Stricter limits on positions held by any one entity and expanded settlement periods for short- and long-term contracts, and restrictions on how much the price of natural gas can move on the markets before trading is temporarily halted for a "cooling off" period; and,

- Formation of a joint federal-state task force to examine critical questions about the supply-side of the physical market and the role of major oil companies, which straddle the physical and financial markets.

I believe that these measures are reasonable steps that the federal government can take that would increase the transparency of natural gas markets. Senator Feinstein has proposed an amendment to S. 1566 that would move us in the direction of the measures noted above.

Supplemental Questions Posed by Senator Kohl

Questions for Attorney General Peggy Lautenschlager:

1. Your office and three other Midwest Attorneys General recently released a report on the causes of higher natural gas prices. Your report found that commodity market speculation, rather than supply and demand, was responsible for much of the sharp increases in natural gas prices we have seen. What is it about the natural gas marketplace that makes it so vulnerable to price swings caused by commodity trading? And what specific legislative reforms would you recommend?

   Response by Attorney General Lautenschlager:

   Natural gas markets are particularly vulnerable to price swings for several reasons. First, demand for natural gas is relatively inelastic. When the weather is cold, consumers need to heat their homes and businesses, and most will not choose to simply turn their furnaces off if the price of natural gas goes up. Second, natural gas is not an easily substituted fuel. Most users of natural gas cannot easily substitute another fuel source, such as coal, fuel oil or propane; their equipment is generally designed to just burn natural gas. Third, because natural gas demand is relatively inelastic, upward pressure on the price of natural gas caused by increased trading can have an exponential, rather than an incremental,

effect. The legislative reforms I would recommend are noted above in my response to Senator Leahy's question.

2. I have introduced a bill to direct the Secretary of Energy to establish and operate a strategic refining reserve. This reserve should have the capacity to produce at least 5 percent of the domestic demand for gasoline, diesel and aviation fuel. I believe this reserve would be an important step to ending the oil companies' stranglehold over the market, and their ability to manipulate supply in order to have market power. What do you think of this idea?

Response by Attorney General Lautenschlager:

As you are aware, our study focused primarily on natural gas, but I do think that your proposal makes a great deal of sense in that it would help temper the effects of future crises, such as last fall's hurricanes. I also think it would help provide a buffer, as you suggest, against any attempts by major oil companies to manipulate the market by withholding supply.

3. I have introduced legislation to give the Secretary of Energy the authority to prohibit the export of any refined petroleum product when supply is expected to fall below demand. In my view, in times of high demand and severe pressures on supply – such as we saw in the aftermath of the Hurricane Katrina and Rita disasters last fall – it is simply unacceptable that U.S. oil refiners should ship their products out of the country. What do you think of this legislation?

Response by Attorney General Lautenschlager:

I think such legislation makes a great deal of sense, not only from a standpoint of protecting our economy, but for reasons of national security, as well.

Supplemental Questions Posed by Senator DeWine

Questions for Attorney Alioto, Attorney General Lautenschlager, Professor Borenstein, Attorney Boies and Assistant Attorney General Green:

1. We heard from the oil companies that the recent mergers have been important to give them the scale they need to engage in increasingly expensive and risky development projects. In fact, United States oil companies have consolidated and grown at roughly the same rate as other global players around the world. In most cases, the FTC allowed oil company mergers only after imposing a number of limitations on these mergers to prevent them from decreasing competition. First, what more should the FTC do to prevent oil industry mergers from lessening competition? Second, how should U.S. energy policy work to prevent consolidation that leads to higher prices while still addressing the risk that an

aggressive merger policy could keep U.S. companies relatively small in a way that puts them at a competitive disadvantage to other global players?

Response by Attorney General Lautenschlager:

While our study did not look at oil company mergers *per se*, I am not convinced that bigger is always better and more efficient in the oil industry any more than it is in government, for example. As regards the effect of mergers on competition, I think there is already ample evidence that the oil industry no longer produces competitive markets, as far as consumers are concerned. With respect to the ability of U.S. companies to remain competitive, judging by the record profits of U.S. oil companies over the past year, they would have a hard time convincing me that they are suffering from an inability to be competitive.

2. If there was one change you could make to the antitrust laws to make oil and gasoline markets more competitive, what would that be?

Response by Attorney General Lautenschlager:

The oil and gasoline markets have a number of characteristics that make them particularly vulnerable to collusive behavior. These characteristics include, but are certainly not limited to, an unconcentrated group of buyers with relatively inelastic demand for a product where prices can quickly change, and a relatively high concentration of suppliers with similar production processes and high barriers to entry. In this sort of market, enforcement of the antitrust laws is particularly difficult, because firms do not necessarily need to enter into a formal "agreement" in order to profit from tacit collusive behavior.

The recent experience with gasoline and natural gas markets following last fall's hurricanes provides an example. Markets in the western part of the U.S. saw the price of gasoline and natural gas rise dramatically, even though virtually none of their supplies of these two commodities comes from the Gulf production area that was affected by the hurricanes. If we had truly competitive markets, this would not have happened. With regard to specific changes to the antitrust laws that would address this issue, I would support the recommendations that California Assistant Attorney General Thomas Greene made in his testimony before the Committee on March 14, 2006.

Supplemental Questions Posed by Senator Charles E. Schumer

Questions for Attorney Alioto, Attorney General Lautenschlager, Professor Borenstein, Attorney Boies and Assistant Attorney General Green:

1. We often hear the justification for consolidation that resources abroad are more expensive to develop, but why does that mean we have to consolidate downstream

at refining and retail levels? In 2004 the GAO found that market concentration in the downstream sector had increased significantly, and that oil company merger activity had in fact had an upward effect on gasoline retail prices. Wouldn't the market benefit from more independent activity in the downstream sector? Wouldn't competition and the consumer be better served by a higher degree of competition at each segment of the supply chain?

Response by Attorney General Lautenschlager:

The increasing trend towards vertical integration of ownership in energy markets is certainly of great concern. Common ownership of each level in the production and distribution chain creates fewer points at which competition can work to keep prices low for the eventual end user. In addition, vertical integration can also reduce efficiency incentives. Consumers would certainly be well-served by a more competitive structure from top to bottom in the energy industry.

2. In a market this tight on supply and this concentrated, where is the disincentive for oil companies to "take their foot off of the pedal" by only barely keeping place with market trends? Is it realistic with so much vertical integration, to assume that if a company does not act swiftly to a price signal another company will competitively respond?

Response by Attorney General Lautenschlager:

Our recent experience tells us the current structure of the energy markets does not create downward pressure on prices. Oil companies know, for example, that they can sell plenty of gasoline, even when the price remains artificially high. Therefore, there is no incentive for them to lower prices, even in instances in which there otherwise might be competition.

3. We've seen a lot of the so called "rockets and feathers" phenomenon where prices spike, supposedly because retailers have to instantly react to the wholesale price, but then when the wholesale drops retail lags at the high price. What do you believe is the explanation for this phenomena and what role has consolidation played in creating it?

Response by Attorney General Lautenschlager:

I believe that consolidation plays a major role in perpetuating the "rocket and feather" syndrome. Mega-mergers and the vertical integration of the energy industry have lessened competition and created disincentives for efficiencies and competitive strategies. Inelasticity of demand for energy products makes market manipulation and anticompetitive behavior easier to accomplish. If the trend towards consolidation in energy industries continues, it will only make matters worse.