

**IER Comments on
FTC Rulemaking under Section 811 of
The Energy Independence and Security Act of 2007**

1. About IER: The Institute for Energy Research (IER) is a not-for-profit organization that conducts intensive research and analysis on the functions, operations, and government regulation of global energy markets. IER maintains that freely-functioning energy markets provide the most efficient and effective solutions to today's energy and environmental challenges and, as such, are critical to the well-being of individuals and society.

Founded in 1989 from a predecessor nonprofit organization, IER is a public foundation under Section 501(c)(3) and Section 501(c)(4) of the Internal Revenue Code and is funded entirely by contributions from individuals, foundations and corporations. Headquartered in Washington, D.C., IER supports public policies that simultaneously promote the welfare of energy consumers, energy entrepreneurs, and taxpayers.

IER believes that attempts to correct "market failure" in energy markets must be tempered with the reality of "government failure" given that regulation/regulators, as market incentives/actors, are not perfect. In other words, it is inappropriate to compare idealized government actions with real-world market outcomes.

In this regard, IER is concerned that the present inquiry into market manipulation in energy markets may lead to new regulation that would have unintended consequences and injure rather than promote the public welfare.

2. Summary: IER believes that existing statutes provide the Federal Trade Commission (FTC), Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), and the Federal Energy Regulatory Commission (FERC) with adequate powers to deal with legitimately anti-competitive and/or fraudulent practices in the petroleum and financial markets which hamper consumer welfare. Some of the new rules being proposed, especially if their language is construed broadly, could interfere with healthy market operations, leading to higher volatility in oil and gasoline

prices and less efficiency in distribution. This Comment will first explain the role of healthy entrepreneurship and speculation in promoting consumer welfare, and then address specific portions of the suggested rules under the EISA that could undermine these benign activities.

3. The Superiority of Markets Over Central Direction: Both theory and history attest to the general superiority of decentralized market economies in contrast to top-down centrally planned ones. Even putting aside problems of corruption, it is inefficient to leave economic decisions to the political arena, simply because there is too much information, which needs to be processed very rapidly, for any group of experts to draw up a relevant plan to be imposed on the rest of the economy. The advantage of a market economy is its reliance on individual initiative and the price system to harness the “dispersed knowledge”¹ of everyone in society to be deployed in solving the economic problem. As one leading economics textbook declares, “In country after country, markets have replaced centralized control for the simple reason that they tend to allocate goods and services so much more effectively.”²

It is true that there are many ways in which market outcomes fail to achieve perfect efficiency. Many of the issues of market power and price manipulation discussed herein rely on the possibility of such “market failure.” However, to correctly judge the relative costs and benefits of government intervention, the danger of market failure should be contrasted with the equally real possibility of *regulatory* failure. Even if the market outcome is imperfect, it does not necessarily follow that further regulation will actually improve the situation.³

4. The Healthy Role of Arbitrage and Speculation in Markets: In modern economies, the important data such as consumer preferences, resource supplies, and technology are in constant flux. It is here where the speed of adaptation offered by decentralized markets, guided by a freely floating price system, is decisive.

The terms *arbitrage* and *speculation* are separated only by differences of degree on the same spectrum. They both refer to earning profits by seizing on price discrepancies, the proverbial buying low and selling high. The only difference is that

arbitrage is considered to be virtually risk-free, while speculation is seen as a more active gamble on future events. So long as the operation is successful (and does not depend on theft or fraud), speculative activity promotes efficiency and helps consumers.

In cases of shipped goods, this is obvious. Speculators (or simply “middlemen”) buy a good from the wholesaler for a certain price, then sell it to retailers for a higher price, if they have purchased wisely. Without middlemen very few consumers would get their needed goods, whether electronic goods from China or fruit from Florida.

Entrepreneurs serve consumers not merely through geographical arbitrage, but also through intertemporal arbitrage. A housing developer might buy a plot of virgin land, hire architects and construction crews, and purchase vast amounts of lumber, shingles, and other materials. Perhaps a year or more later, he then sells the finished homes to customers. If he has anticipated the needs of the market correctly, the developer will earn a return on his investment. “Speculation” occurs not just when an investor buys a finished home and hopes to flip it, but also whenever a developer begins building. The layperson’s notion of speculation is far too narrow, for speculation pervades everything that occurs in a market economy.

Entrepreneurs engage in speculation too when they introduce a new product onto the market. Bold innovators look at the array of market prices for various inputs, and believe that consumers would be willing to pay enough for a new item that would more than cover these costs of production. In the beginning, the innovator reaps an above-average return. But over time, prices adjust, and soon the returns in the new product line are comparable to other lines, and what was once considered an innovation becomes a standard feature of everyday life. The process is just another example of entrepreneurship or speculation at work, with prices adjusting to steer resources into different channels and thereby increase consumer satisfaction.

Broadly defined, speculation means risking one’s capital in an effort to make profit, based on a perceived favorable arrangement of market prices. Under normal circumstances, competition whittles away the pure gains from speculation so that we aren’t even aware of its presence. This is testament to the relative stability of a market economy. People only notice speculation when its gains or losses are large, yet it is always present and indeed underpins the market economy itself.⁴

In general, policymakers should encourage healthy entrepreneurship, which means allowing prices to shift with changing conditions and expectations. “Overall, a social and economic milieu that allows entrepreneurship to flourish appears to promote economic growth and rising productivity, perhaps especially so in high-technology eras like our own.”⁵

With this broad description as backdrop, these comments turn to specific examples of healthy speculation in the petroleum industry, and how these benign practices could be hampered by overly broad interpretations of EISA provisions.

5. Potentially Harmful Interpretations of EISA: In the FTC’s request for public comments, it lists areas in need for further clarification. The concern of IER is that on some matters, overly broad construal would jeopardize the healthy adaptation by participants in the petroleum industry to unexpected developments. Below we list some of the specific passages prompting our concern.

A. *“The Commission seeks comment on the circumstances, if any, under which a firm’s decision regarding supplying a market (including whether to reduce, increase, or maintain the amount supplied) should be considered manipulative or deceptive.”*

IER urges the Commission to adopt a commonsense interpretation of deceptive practices, in which they involve actual fraud, as interpreted through the common law and courts. (Under our suggested interpretation, no further regulatory power is needed to provide remedy.) Beyond that, regulators should not engage in second-guessing the decisions of producers in the petroleum industry (the collective knowledge of “the market”). The market economy works through decentralized decision-making, where individual firms enjoy the profits from successful decisions and suffer the losses from errors. An extra layer of government penalties for actions that harm consumers (or worse, for actions that *help* consumers, as explained below) will lead to an inefficient amount of risk-taking among producers. Investors will divert funds from the petroleum industry to other, less politically charged lines. This will result in lower output, and hence higher prices, which is not in the interests of consumers.

B. *“Some have argued that market participants with terminal or other storage inventory should be under an affirmative obligation to release inventory during price spikes when the participant knows, or should know, that the release of the product will be profitable. The Commission seeks comment on when such an obligation should be imposed; what possible intent standard should be used as a test for liability; how one should measure profitability in such a circumstance; and, the costs and benefits to consumers of placing such an obligation on potential market suppliers.”*

There are several problematic aspects with the suggestions above. A requirement that owners should sell their inventories when doing so would be profitable, is at best superfluous and at worst detrimental to both producers and consumers. In cases where the government’s criteria for a “profitable” release are in agreement with the judgment of the inventory’s owner, the rule is unnecessary; people in the petroleum industry do not need to be ordered to make money.

On the other hand, in cases where the government criteria and the owner disagree about the profitability of a release of inventories, the discrepancy will be due to the fact that the owner anticipates prices will rise *even further*, such that keeping the inventory off the market will yield a greater return than releasing it in the present. If the discrepancy between regulator and owner intentions is due to a simple disagreement on the future direction of spot crude prices, with private owners anticipating further increases while government regulators expect flat or falling prices, IER believes it is more prudent to leave the ultimate responsibility in the hands of the owners of the inventory. They stand to reap the benefits from correct forecasts, and suffer the losses from faulty ones; there is thus an evolutionary process that over time ensures the most accurate forecasters command the most resources with which to influence oil inventories and futures prices. Standard economic models show the benefits of futures markets on resource allocation and consumer welfare,⁶ and the government should be very careful when altering the incentives for participants on these markets.

Because of the lack of accountability and objective measures, in practice it is likely that any codified criteria for the proper release of inventories will be based on historical acquisition prices and current selling prices. Thus the owner of crude

inventories may be legally compelled to sell at a book profit, even though he anticipates a higher profit would have been achieved had he been allowed to postpone the sale while prices rose further. In such cases—assuming the private forecast is correct—consumers will be harmed by the regulation. Speculative gains from inventory are beneficial to consumers, because the process takes oil off of the market when it is relatively plentiful (prices are low), and delivers it to the market when oil is relatively scarce (prices are high). In addition, the speculative action helps to smooth out price volatility over the cycle, because the very act of buying low pushes up the low prices, and selling high pushes down the high prices. If speculators holding inventory are forced to sell earlier than they believe is most profitable, their benign influence on oil availability and price volatility are considerably reduced.

In summary regarding the above excerpt, IER's position is that holders of inventory serve consumers in direct proportion to their success at anticipating future price movements (and hence in direct proportion to their earned profits). The rewards and penalties of the market are the economically efficient level, neither encouraging too much speculative holding nor discouraging it too harshly. Government efforts to fine-tune the profit-and-loss criterion of the market can at best mimic its outcomes and at worst hamper its operation.

C. *“The Commission seeks comment as to what extent or in what circumstances should the distinction between forbidden and permitted business behavior be primarily a function of the intent, purpose, or knowledge of the actor? For example, if a firm holds back inventory during a supply shortage with the intent to raise or expectation of raising immediate prices, but the effect is that the inventory is sold later, when the shortage is more severe, should that be a violation? If a firm decreases the amount of product sold in a tight market in order to grow its business elsewhere, regardless of whether prices in the tight market will rise, should that be a violation?”*

IER would strongly urge the Commission to adopt criteria for compliance that are based on objective actions, rather than the subjective knowledge or intentions of market participants. If market participants know that a certain decision may be legal or illegal, depending on a regulator's opinion as to the unobservable motivations that led to the

decision, then this introduces an extra element of uncertainty into business planning. Even those participants whose motivations meet the government criteria may be discouraged from acting, because if challenged, it may be quite difficult to prove one's good intentions.

Regarding the specific scenarios outlined by the Commission in the excerpt above, we repeat that such speculative behavior is on net beneficial to consumers. When inventory is held off the market today because of expectations of even lower availabilities of supply in the future, it is efficient for current prices to rise. The increase in spot prices encourages conservation by consumers, and provides impetus for producers (who may be ignorant of the impending scarcity) to find more supply. Far from the Commission's apparent belief, then, speculative hoarding of inventories is performing a service both by delivering supplies during future crises *and* by raising prices in the near-term. It would therefore be counterproductive to punish speculators who are motivated by the latter process, even assuming regulators had access to their psychological motivations.

D. *“The Commission seeks comment on how to determine an artificial price. For example, if an entity with market power that was not obtained by improper means, sets its prices above what would have been a competitive level, and as a result, prices in the market are higher than competitive prices, is this an artificial price? Commenters are encouraged to explain how the competitive price should be determined, including during a period in which capacity has declined unexpectedly because of a disaster. Commenters are encouraged to assess, in particular, whether setting the prices above a competitive level should be considered a manipulative device or contrivance...”*

In textbook models of competitive markets, economists can draw smooth curves and pinpoint the ideal price at which producers use resources efficiently to satisfy consumer preferences. It can be easily shown with such geometric figures that when firms reduce output and charge a price higher than this “competitive” price, consumers lose more than the producers gain, and thus efficiency is sacrificed.

In the real world, analysts do not know the demand and cost curves facing each firm, and so the textbook “competitive price” cannot be known. Yet so long as there are no institutional barriers to entry, and consumers are free to patronize any seller they

choose, the dynamic process of the market economy provides a tendency for resources to be deployed more and more efficiently over time.⁷ The situation at any given moment may not accord with the idealized graphs of the textbooks, but that is because we are always taking snapshots of the dynamic market as it adapts to ever-changing conditions.

The ability of the market to respond to disasters depends crucially on the free movement of market prices, which act as signals to everyone in the economy. For example, a hurricane may disrupt refineries and cause thousands of residents to drive further inland. Such crises involve a reduction in supply and increase in demand for gasoline. In an unfettered market, the price at the pumps in the affected region rises to reflect the new economic reality. The high price encourage conservation by motorists; people fleeing the region may carpool, and will not fill up their tanks but rather just buy enough to get to another station farther along the interstate. This rations the available supply so that as many people as possible can flee. In addition, the high price attracts supply from other regions, to help offset the loss due to the damaged refineries.

The market price balances the forces of available supply with current demand. If sellers in the petroleum industry are vulnerable to penalties from vague prohibitions on price manipulation, they will be reluctant to adjust their prices upward during or after a natural disaster. The below-market prices will then simply lead to shortages, where consumers want to buy more product than is available. This can result in tragedy, for example where gasoline stations in the path of a hurricane can literally run out precisely when motorists urgently need just a few gallons to escape.

It should be stressed that these are not merely theoretical possibilities. There are well-documented cases of the unintended consequences of price ceilings during and after natural disasters.⁸ Market prices perform a vital role in coordinating efforts in a market economy, and such coordination is all the more essential when a natural disaster disrupts everyday operations.

¹ See Friedrich Hayek (1945) "The Use of Knowledge in Society," *American Economic Review*, XXXV, No. 4, September, pp. 519-530.

² Bernanke, Ben S. and Robert H. Frank. (2001) *Principles of Economics*. Boston: McGraw-Hill. Quote from page 76.

³ Coase, Ronald (1994). *Essays on Economics and Economists*. Chicago: The University of Chicago Press, pp. 10-11.

⁴ “Some persons are so troubled by some effects of the market order that they overlook how unlikely and even wonderful it is to find such an order prevailing in the greater part of the modern world, a world in which we find thousands of millions of people working in a constantly changing environment, providing means of subsistence for others who are mostly unknown to them, and at the same time finding satisfied their own expectations that they themselves will receive goods and services produced by equally unknown people.” From Friedrich Hayek (1988) *The Collected Works of F.A. Hayek, The Fatal Conceit*, ed. By W.W. Bartley, Chicago: The University of Chicago Press, Vol. I, p. 84.

⁵ Bernanke and Frank, p. 527.

⁶ Grossman, Sanford. (1989) *The Informational Role of Prices*, MIT Press.

⁷ See Israel Kirzner (2000), *The Driving Force of the Market*, New York: Routledge, pp. 21-22.

⁸ See for example: Gwartney, James et al. (2000), *Economics: Private and Public Choice*, 9th edition, Thomson-South Western, page 98, and David Laband (1989), “In Hugo’s Path, a Man-Made Disaster,” Wall Street Journal page A22, September 27. On Katrina see Culpepper, Dreda and Walter Block, (forthcoming), “Price Gouging in the Katrina Aftermath,” *International Journal of Social Economics*.