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Protecting Families From Another Energy Price Shock: Restoring Transparency and Regulation to Futures Markets To Keep The Speculators Honest

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Thank you, Mr. Chairman and members of Committee on Agriculture for the opportunity to testify on the issue of energy futures regulation. My name is Tyson Slocum and I am Director of Public Citizen's Energy Program. Public Citizen is a 38-year old public interest organization with over 100,000 members nationwide. We represent the needs of households by promoting affordable, reliable and clean energy.

The extraordinary volatility in energy prices, particularly crude oil—which soared from \$27/barrel in September 2003 to a high of \$147/barrel in July 2008 before plummeting to its current price of \$40/barrel—wreaked havoc with the economy while making speculators rich. The spectacular 75% decline in oil prices in just five months cannot be explained purely by supply and demand; rather, a speculative bubble burst, triggered by the Wall Street financial crisis. Strapped of their credit that had been fueling their highly leveraged trading operations, the credit crisis ended the speculators' ability to continue driving up prices far beyond the supply demand fundamentals. This speculation was made possible by legislative and regulatory actions that deregulated these energy futures markets. Although energy prices are no longer at record highs, it must be assumed that it is a matter of when, not if, a return to high prices will occur. Absent reregulation of the energy futures markets, aggressive government efforts to restore liquidity and unfreeze the credit markets will give new life to the Wall Street financial speculators, ushering a return to an energy commodity speculative bubble.

Restoring transparency to futures markets is all the more urgent given the wave of consolidation that has occurred among the financial firms that were leading the speculative frenzy. Several major energy trading firms merged their operations in response the credit crisis:

- In 2007, ABN Amro was purchased by the Dutch national government, the Royal Bank of Scotland and Spain's Banco Santander.
- In April 2008, JP Morgan Chase acquired Bear Stearns and its trading operations.
- In September 2008, Bank of America acquired Merrill Lynch
- Électricité de France arranged to purchase all of Lehman Bros. energy trading operations in October 2008.
- Wells Fargo agreed to buy Wachovia in October 2008.
- In January 2009, UBS sold its energy trading operations to Barclays.

Congress can take two broad actions to provide relief: providing incentives to households to give them better access to alternatives to our dependence on oil, and restoring transparency to the futures markets where energy prices are set. The former option is of course an effective long-term investment, as providing incentives to help families afford the purchase of super fuel efficient hybrid or alternative fuel vehicles, solar panel installation, energy efficient improvements to the home and greater access to mass transit would all empower households to avoid the brunt of high energy prices.

The second option—restoring transparency to the futures markets where energy prices are actually set—is equally important. Stronger regulations over energy trading markets would reduce the level of speculation and limit the ability of commodity traders to engage in anti-competitive behavior that is contributing the record high prices Americans face. And as Congress considers market-based climate change legislation that would create a pollution futures trading market, the priority of establishing strong regulatory oversight over all energy- and pollution-related futures trading is the only way to effectively combat climate change, in order to ensure price transparency.

Of course, supply and demand played a role in the recent rise and decline in oil prices. Gasoline demand in America is down, with Americans driving 112 *billion* less miles from November 2007 to November 2008,¹ and global demand—even in emerging economies like China, India and oil exporting nations in the Middle East—has slackened in response to the global economic downturn, thereby offsetting the fact that mature, productive and easily-accessible oil fields are in decline. Claims of Saudi spare capacity are questioned due to the Kingdom's refusal to allow independent verification of the country's oil reserve claims. Simply put, oil is a finite resource with which the world - until recently - has embarked on unprecedented increased demand.

But there is no question that speculators and unregulated energy traders have pushed prices beyond the supply-demand fundamentals and into an era of a speculative bubble in oil markets. While some speculation plays a legitimate function for hedging and providing liquidity to the market, the exponential rise in market participants who have no physical delivery commitments has skyrocketed, from 37 percent of the open interest on the NYMEX West Texas Intermediate (WTI) contract in January 2000 to 71 percent in April 2008.²

Rather than demonize speculation generally, the goal is to address problems associated with recent Congressional and regulatory actions that deregulated energy trading markets that has opened the door to these harmful levels of speculation. Removing regulations has opened the door too wide for speculators and powerful financial interests to engage in anti-competitive or harmful speculative behavior that results in prices being higher than they would otherwise be. When oil was at \$145/barrel, many estimated that at least \$30 of that price was pure speculation, unrelated to supply and demand.

While the Commodity Futures Trading Commission (CFTC) and Congress have taken recent small steps in the right direction, more must be done to protect consumers. While the CFTC has been disparaged by consumer advocates as being too deferential to energy traders, it has responded to recent criticism by ordering the United Kingdom to set limits on speculative trading of WTI contracts, proposing stronger disclosure for index traders and swap dealers, spearheading an

¹ www.fhwa.dot.gov/ohim/tvtw/tvtpage.htm

² http://energycommerce.house.gov/Investigations/EnergySpeculationBinder_062308/15.pdf

interagency task force to more closely monitor energy markets and strengthening disclosure requirements in its amended Dubai Mercantile Exchange no-action letter. But these actions are hardly enough to rein in the harmful levels of speculation and anti-competitive behavior that are causing energy prices to rise. A new CFTC chairman presents important opportunities for the agency to take a more assertive role in policing these markets.

Recent Congressional action, too, has been beneficial to consumers, but the legislation has not gone nearly far enough. Title XIII of H.R. 6124 (the "Farm Bill") that became law in June 2008, closed some elements of the so-called "Enron Loophole," which provided broad exemptions from oversight for electronic exchanges like ICE. But the Farm Bill only provides limited protections from market manipulation, as it allows the CFTC, "at its discretion," to decide on a contract-by-contract basis that an individual energy contract should be regulated only if the CFTC can prove that the contract will "serve a significant price discovery function" in order to stop anti-competitive behavior.

In December 2007, H.R. 6 was signed into law. Sections 811 through 815 of that act empower the Federal Trade Commission to develop rules to crack down on petroleum market manipulation.³ If these rules are promulgated effectively, this could prove to be an important first step in addressing certain anti-competitive practices in the industry.

Public Citizen recommends four broad reforms to rein in speculators and help ensure that energy traders do not engage in anti-competitive behavior:

- Subject Over-the Counter (OTC) trading to the same transparency and regulatory requirements to which regulated exchanges, such as NYMEX, must adhere, including the submission of Large Trader Reports which disclose key information of a trader's activities. Requiring investment banks, hedge funds and other market participants to provide more information to the government will provide regulators and policymakers with the data necessary to quickly determine the exact cause of price swings.
- Raise margin requirements so market participants will have to put up more of their own capital in order to trade energy contracts, and impose aggregate position limits on non-commercial trading to reduce speculation. Currently, margin requirements are too low, which encourages speculators to more easily enter the market by borrowing, or leveraging, against their positions. And aggregated limits over all markets—not just select ones—would preclude an energy trader from dipping their hands in multiple futures market cookie jars with the intent to speculate.
- Require foreign-based exchanges that trade U.S. energy products to be subjected to full

Who Are the Speculators?

While everyone talks about speculators, rarely are names named. Following are some of the largest financial players in commodity markets that largely hold financial positions, and the trade groups that help promote their deregulation agenda:

ABN Amro · Bank of America/Merrill Lynch · Barclays Capital · Citadel Investment Group · Citigroup · Crédit Agricole · Credit Suisse · D.E. Shaw · Deutsche Bank · Électricité de France · IntercontinentalExchange · International Swaps & Derivative Assn · Goldman Sachs · HSBC · JP Morgan Chase-Bear Stearns · Man Financial · Managed Funds Assn · Morgan Stanley · Prudential Global Funding · Securities Industry & Financial Markets Assn · Vitol · Wells Fargo-Wachovia

³ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_public_laws&docid=f:publ140.110.pdf

U.S. regulatory oversight.

- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations.

Legislation introduced by U.S. Representative Collin C. Peterson, "The Derivatives Markets Transparency and Accountability Act of 2009,"⁴ does a great job addressing most of Public Citizen's recommendations. There are three areas, however, upon which the legislation could be improved. First, the bill should immediately subject OTC markets to the same regulatory oversight to which regulated exchanges like NYMEX must adhere. Second, the legislation should impose aggregate speculation limits over all markets to limit the ability of traders to engage in harmful speculation. Third, limiting the ability of speculators to own or control energy infrastructure should be considered.

Energy Trading Abuses Require Stronger Oversight

Background

Two regulatory lapses are enabling anti-competitive practices in energy trading markets where prices of energy are set. First, oil companies, investment banks and hedge funds are exploiting recently deregulated energy trading markets to manipulate energy prices. Second, energy traders are speculating on information gleaned from their own company's energy infrastructure affiliates, a type of legal "insider trading." These regulatory loopholes were born of inappropriate contacts between public officials and powerful energy companies and have resulted in more volatile and higher prices for consumers.

Contrary to some public opinion, oil prices are not set by the Organization of Petroleum Exporting Countries (OPEC); rather, they are determined by the actions of energy traders in markets. Historically, most crude oil has been purchased through either fixed-term contracts or on the "spot" market. There have been long-standing futures markets for crude oil, led by the New York Mercantile Exchange and London's International Petroleum Exchange (which was acquired in 2001 by an Atlanta-based unregulated electronic exchange, ICE). NYMEX is a floor exchange regulated by the U.S. Commodity Futures Trading Commission (CFTC). The futures market has historically served to hedge risks against price volatility and for price discovery. Only a tiny fraction of futures trades result in the physical delivery of crude oil.

The CFTC enforces the Commodity Exchange Act, which gives the Commission authority to investigate and prosecute market manipulation.⁵ But after a series of deregulation moves by the CFTC and Congress, the futures markets have been increasingly driven by the unregulated over-the-counter (OTC) market over the last few years. These OTC and electronic markets (like ICE) have

⁴ http://agriculture.house.gov/inside/Legislation/1111/PETEMN_001_xml.pdf

⁵ 7 USC §§ 9, 13b and 13(a)(2).

been serving more as pure speculative markets, rather than traditional volatility hedging or price discovery. And, importantly, this new speculative activity is occurring outside the regulatory jurisdiction of the CFTC.

Energy trading markets were deregulated in two steps. First, in response to a petition by nine energy and financial companies, led by Enron⁶, on November 16, 1992, then-CFTC Chairwoman Wendy Gramm supported a rule change—later known as Rule 35—exempting certain energy trading contracts from the requirement that they be traded on a regulated exchange like NYMEX, thereby allowing companies like Enron and Goldman Sachs to begin trading energy futures between themselves outside regulated exchanges. Importantly, the new rule also exempted energy contracts from the anti-fraud provisions of the Commodity Exchange Act.⁷ At the same time, Gramm initiated a proposed order granting a similar exemption to large commercial participants in various energy contracts that was later approved in April 2003.⁸

Enron had close ties to Wendy Gramm's husband, then-Texas Senator Phil Gramm. Of the nine companies writing letters of support for the rule change, Enron made by far the largest contributions to Phil Gramm's campaign fund at that time, giving \$34,100.⁹

Wendy Gramm's decision was controversial. Then- chairman of a House Agriculture subcommittee with jurisdiction over the CFTC, Rep. Glen English, protested that Wendy Gramm's action prevented the CFTC from intervening in basic energy futures contracts disputes, even in cases of fraud, noting that that "in my 18 years in Congress [Gramm's motion to deregulate] is the most irresponsible decision I have come across." Sheila Bair, the CFTC commissioner casting the lone dissenting vote, argued that deregulation of energy futures contracts "sets a dangerous precedent."¹⁰ A U.S. General Accounting Office report issued a year later urged Congress to increase regulatory oversight over derivative contracts,¹¹ and a congressional inquiry found that CFTC staff analysts and economists believed Gramm's hasty move prevented adequate policy review.¹²

Five weeks after pushing through the "Enron loophole," Wendy Gramm was asked by Kenneth Lay to serve on Enron's Board of Directors. When asked to comment about Gramm's nearly immediate retention by Enron, Lay called it "convoluted" to question the propriety of naming her to the board.¹³

Congress followed Wendy Gramm's lead in deregulating energy trading *contracts* and moved to deregulate energy trading *exchanges* by exempting electronic exchanges, like those quickly set up by Enron, from regulatory oversight (as opposed to a traditional trading floor like NYMEX that remained regulated). Congress took this action during last-minute legislative maneuvering on behalf of Enron by former Texas GOP Senator Phil Gramm in the lame-duck Congress two days after the

⁶ The other eight companies were: BP, Coastal Corp (now El Paso Corp.) Conoco and Phillips (now ConocoPhillips), Goldman Sachs' J. Aron & Co, Koch Industries, Mobil (now ExxonMobil) and Phibro Energy (now a subsidiary of CitiGroup).

⁷ 17 CFR Ch. 1, available at www.access.gpo.gov/nara/cfr/waisidx_06/17cfr35_06.html

⁸ "Exemption for Certain Contracts Involving Energy Products," 58 Fed. Reg. 6250 (1993).

⁹ Charles Lewis, "The Buying of the President 1996," pg 153. The Center for Public Integrity.

¹⁰ "Derivatives Trading Forward-Contract Fraud Exemption May be Reversed," *Inside FERC's Gas Market Report*, May 7, 1993.

¹¹ "Financial Derivatives: Actions Needed to Protect the Financial System," GGD-94-133, May 18, 1994, available at <http://archive.gao.gov/t2pbat3/151647.pdf>

¹² Brent Walth and Jim Barnett, "A Web of Influence," *Portland Oregonian*, December 8, 1996.

¹³ Jerry Knight, "Energy Firm Finds Ally, Director, in CFTC Ex-Chief," *Washington Post*, April 17, 1993.

Supreme Court ruled in *Bush v Gore*, buried in 712 pages of unrelated legislation.¹⁴ As Public Citizen pointed out back in 2001,¹⁵ this law deregulated OTC derivatives energy trading by “exempting” them from the Commodity Exchange Act, removing anti-fraud and anti-manipulation regulation over these derivatives markets and exempting “electronic” exchanges from CFTC regulatory oversight.

This deregulation law was passed against the explicit recommendations of a multi-agency review of derivatives markets. The November 1999 release of a report by the President’s Working Group on Financial Markets—a multi-agency policy group with permanent standing composed at the time of Lawrence Summers, Secretary of the Treasury; Alan Greenspan, Chairman of the Federal Reserve; Arthur Levitt, Chairman of the Securities and Exchange Commission; and William Rainer, Chairman of the CFTC—concluded that energy trading must not be deregulated. The Group reasoned that “due to the characteristics of markets for nonfinancial commodities with finite supplies ... the Working Group is unanimously recommending that the [regulatory] exclusion not be extended to agreements involving such commodities.”¹⁶ In its 1999 lobbying disclosure form, Enron indicated that the “President’s Working Group” was among its lobbying targets.¹⁷

As a result of the Commodity Futures Modernization Act, trading in lightly-regulated exchanges like NYMEX is declining as more capital flees to the unregulated OTC markets and electronic exchanges such as those run by the IntercontinentalExchange (ICE). Trading on the ICE has skyrocketed, with the 138 million contracts traded in 2007 representing a 230 percent increase from 2005.¹⁸ This explosion in unregulated and under regulated trading volume means that more trading is done behind closed doors out of reach of federal regulators, increasing the chances of oil companies and financial firms to engage in anti-competitive practices. The founding members of ICE include Goldman Sachs, BP, Shell and TotalfinaElf. In November 2005, ICE became a publicly traded corporation.

The Players

Goldman Sachs’ trading unit, J. Aron, is one of the largest and most powerful energy traders in the United States, and commodities trading represents a significant source of revenue for the company. Goldman Sachs’ most recent 10-k filed with the U.S. Securities and Exchange Commission show that Fixed Income, Currency and Commodities (which includes energy trading) generated 17 percent of Goldman’s \$22 billion in revenue for 2008.¹⁹ That share, however, masks the role that energy trading plays in Goldman’s revenue as the company lumps underperforming activities such as securitized mortgage debt, thereby dragging down revenues for the entire segment. Indeed, Goldman touted the performance of its commodity trading activities in 2008, noting that it “produced particularly strong results and net revenues were higher compared with 2007.”

¹⁴ HR 5660, an amendment to H.R.4577, which became Appendix E of P.L.106-554 available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ554.106.pdf

¹⁵ *Blind Faith: How Deregulation and Enron’s Influence Over Government Looted Billions from Americans*, available at www.citizen.org/documents/Blind_Faith.pdf

¹⁶ “Over-the-Counter Derivatives Markets and the Commodity Exchange Act,” *Report of The President’s Working Group on Financial Markets*, pg. 16. www.ustreas.gov/press/releases/docs/otcact.pdf

¹⁷ Senate Office of Public Records Lobbying Disclosure Database, available at http://sopr.senate.gov/cgi-win/opr_gifviewer.exe?/1999/01/000/309/000309331130, page 7.

¹⁸ Available at www.theice.com

¹⁹ <http://idea.sec.gov/Archives/edgar/data/886982/000095012309001278/y74032e10vk.htm>

In 2005, Goldman Sachs and Morgan Stanley—the two companies are widely regarded as the largest energy traders in America—each reportedly earned about \$1.5 billion in net revenue from energy trading. One of Goldman's star energy traders, John Bertuzzi, made as much as \$20 million in 2005.²⁰

In the summer of 2006, Goldman Sachs, which at the time operated the largest commodity index, GSCI, announced it was radically changing the index's weighting of gasoline futures, selling about \$6 billion worth. As a direct result of this weighting change, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.²¹

Morgan Stanley held \$18.7 billion in assets in commodity forwards, options and swaps at November 30, 2008. As the company noted in its annual report: "Fiscal 2008 results reflected . . . record revenues from commodities Commodity revenues increased 62%, primarily due to higher revenues from oil liquids and electricity and natural gas products."

A deregulation action by the Federal Reserve in 2003—at the request of Citigroup and UBS—allows commercial banks to engage in energy commodity trading.²² Since then commercial banks have become big players in the speculation market. The total value of commodity derivative contracts held by the Citigroup's Phibro trading division increased 384 percent from 2004 through 2008, rising from \$44.4 billion to \$214.5 billion.²³ Bank of America held \$58.6 billion worth of commodity derivatives contracts as of September 2008.²⁴ Merrill Lynch, which BoA acquired in September 2008, experienced "strong net revenues for the [third] quarter [2008] generated from our . . . commodities businesses."²⁵

Just a year after Enron's collapse, the Commodity Futures Trading Commission finalized rules allowing hedge funds to engage in energy trading without registering with the CFTC, opening the door to firms like Citadel and D.E. Shaw.²⁶

The Consequences of Deregulation

A recent bipartisan U.S. Senate investigation summed up the negative impacts on oil prices with this shift towards unregulated energy trading speculation:

Over the last few years, large financial institutions, hedge funds, pension funds, and other investment funds have been pouring billions of dollars into the energy commodity markets—perhaps as much as \$60 billion in the regulated U.S. oil futures market alone...The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner

²⁰ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf, pages 24 and 26.

²¹ Heather Timmons, "Change in Goldman Index Played Role in Gasoline Price Drop," *The New York Times*, September 30, 2006.

²² Regulation Y; Docket No. R-1146, www.federalreserve.gov/boarddocs/press/bcreg/2003/20030630/attachment.pdf

²³ <http://idea.sec.gov/Archives/edgar/data/831001/000104746908011506/a2188770z10-q.htm>

²⁴ <http://idea.sec.gov/Archives/edgar/data/70858/000119312508228086/d10q.htm>

²⁵ <http://idea.sec.gov/Archives/edgar/data/65100/000095012308014369/y72170e10vq.htm>

²⁶ 17 CFR Part 4, RIN 3038-AB97, "Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors," final rule issued August 1, 2003.

that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market...Several analysts have estimated that speculative purchases of oil futures have added as much as \$20–\$25 per barrel to the current price of crude oil...large speculative buying or selling of futures contracts can distort the market signals regarding supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the overall economy...At the same time that there has been a huge influx of speculative dollars in energy commodities, the CFTC's ability to monitor the nature, extent, and effect of this speculation has been diminishing. Most significantly, there has been an explosion of trading of U.S. energy commodities on exchanges that are not regulated by the CFTC...in contrast to trades conducted on the NYMEX, traders on unregulated OTC electronic exchanges are not required to keep records or file Large Trader Reports with the CFTC, and these trades are exempt from routine CFTC oversights. In contrast to trades conducted on regulated futures exchanges, there is no limit on the number of contracts a speculator may hold on an unregulated OTC electronic exchange, no monitoring of trading by the exchange itself, and no reporting of the amount of outstanding contracts ("open interest") at the end of each day.

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Thanks to the Commodity Futures Modernization Act, participants in these newly-deregulated energy trading markets are not required to file so-called Large Trader Reports, the records of all trades that NYMEX traders are required to report to the CFTC, along with daily price and volume information. These Large Trader Reports, together with the price and volume data, are the primary tools of the CFTC's regulatory regime: "The Commission's Large Trader information system is one of the cornerstones of our surveillance program and enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation."²⁸ So the deregulation of OTC markets, by allowing traders to escape such basic information reporting, leave federal regulators with no tools to routinely determine whether market manipulation is occurring in energy trading markets.

One result of the lack of transparency is the fact that even some traders don't know what's going on. A recent article described how:

Oil markets were rocked by a massive, almost instant surge in after-hours electronic trading one day last month, when prices for closely watched futures contracts jumped 8%...this spike stands out because it was unclear at the time what drove it. Two weeks later, it is still unclear. What is clear is that a rapid shift in the bulk of crude trading from the raucous trading floor of the New York Mercantile Exchange to anonymous computer screens is making it harder to nail down the cause of price moves...The initial jump "triggered more orders already set into the system, and with prices rising, people thought somebody must know something," Tom Bentz, an analyst and broker at BNP Paribas Futures in New York who was watching the screen at the time, said the day after the spike. "The more prices rose, the more it seemed somebody knew something."²⁹

²⁷ *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat*, Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf

²⁸ Letter from Reuben Jeffrey III, Chairman, CFTC, to Michigan Governor Jennifer Granholm, August 22, 2005.

²⁹ Matt Chambers, "Rise in Electronic Trading Adds Uncertainty to Oil," *The Wall Street Journal*, April 10, 2007.

Oil companies, investment banks and hedge funds are exploiting the lack of government oversight to price-gouge consumers and make billions of dollars in profits. These energy traders boast how they're price-gouging Americans, as a recent *Dow Jones* article makes clear: energy "traders who profited enormously on the supply crunch following Hurricane Katrina cashed out of the market ahead of the long weekend. 'There are traders who made so much money this week, they won't have to punch another ticket for the rest of this year,' said Addison Armstrong, manager of exchange-traded markets for TFS Energy Futures."³⁰

The ability of federal regulators to investigate market manipulation allegations even on the lightly-regulated exchanges like NYMEX is difficult, let alone the unregulated OTC market. For example, as of August 2006, the Department of Justice is still investigating allegations of gasoline futures manipulation that occurred *on a single day in 2002*.³¹ If it takes the DOJ four years to investigate a single day's worth of market manipulation, clearly energy traders intent on price-gouging the public don't have much to fear.

That said, there have been some settlements for manipulation by large oil companies. In January 2006, the CFTC issued a civil penalty against Shell Oil for "non-competitive transactions" in U.S. crude oil futures markets.³² In March 2005, a Shell subsidiary agreed to pay \$4 million to settle allegations it provided false information during a federal investigation into market manipulation.³³ In August 2004, a Shell Oil subsidiary agreed to pay \$7.8 million to settle allegations of energy market manipulation.³⁴ In July 2004, Shell agreed to pay \$30 million to settle allegations it manipulated natural gas prices.³⁵ In October 2007, BP agreed to pay \$303 million to settle allegations the company manipulated the propane market.³⁶ In September 2003, BP agreed to pay NYMEX \$2.5 million to settle allegations the company engaged in improper crude oil trading, and in July 2003, BP agreed to pay \$3 million to settle allegations it manipulated energy markets.³⁷

In August 2007, Oil giant BP admitted in a filing to the Securities and Exchange Commission that "The US Commodity Futures Trading Commission and the US Department of Justice are currently investigating various aspects of BP's commodity trading activities, including crude oil trading and storage activities, in the US since 1999, and have made various formal and informal requests for information."³⁸

In August 2007, Marathon Oil agreed to pay \$1 million to settle allegations the company manipulated the price of West Texas Intermediate crude oil.³⁹

³⁰ Leah McGrath Goodman, "Oil Futures, Gasoline In NY End Sharply Lower," September 2, 2005.

³¹ John R. Wilke, Ann Davis and Chip Cummins, "BP Woes Deepen with New Probe," *The Wall Street Journal*, August 29, 2006.

³² "U.S. Commodity Futures Trading Commission Assesses Penalties of \$300,000 Against Shell-Related Companies and Trader in Settling Charges of Prearranging Crude Oil Trades" available at www.cftc.gov/newsroom/enforcementpressreleases/2006/pr5150-06.html

³³ "Commission Accepts Settlement Resolving Investigation Of Coral Energy Resources," available at www.ferc.gov/news/news-releases/2005/2005-1/03-03-05.asp

³⁴ "Order Approving Contested Settlement," available at www.ferc.gov/whats-new/comm-meet/072804/E-60.pdf

³⁵ "Coral Energy Pays \$30 Million to Settle U.S. Commodity Futures Trading Commission Charges of Attempted Manipulation and False Reporting," available at www.cftc.gov/opa/enf04/opa4964-04.htm

³⁶ www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5405-07.html

³⁷ "Order Approving Stipulation and Consent Agreement," 104 FERC ¶ 61,089, available at <http://elibrary.ferc.gov/idmws/common/opennat.asp?fileID=10414789>

³⁸ www.sec.gov/Archives/edgar/data/313807/000115697307001223/u53342-6k.htm

³⁹ www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5366-07.html

There is near-unanimous agreement among industry analysts that speculation is driving up oil and natural gas prices. Representative of these analyses is a May 2006 Citigroup report on the monthly average value of speculative positions in American commodity markets, which found that the value of speculative positions in oil and natural gas stood at \$60 billion, forcing Citigroup to conclude that “we believe the hike in speculative positions has been a key driver for the latest surge in commodity prices.”⁴⁰

Natural gas markets are also victimized by these unregulated trading markets. Public Citizen has testified before Congress on this issue,⁴¹ and a March 2006 report by four state attorneys general concludes that “natural gas commodity markets have exhibited erratic behavior and a massive increase in trading that contributes to both volatility and the upward trend in prices.”⁴²

The Industrial Energy Consumers of America wrote a January 2005 letter to the Securities and Exchange Commission “alarmed at the significant increase in unregulated hedge funds trading on the NYMEX and OTC natural-gas markets.”⁴³ In November 2004 the group wrote Congress, asking them to “increase energy market oversight by the Commodity Futures Trading Commission.”⁴⁴

While most industry analysts agree that the rise in speculation is fueling higher prices, there is one notable outlier: the federal government. In a widely dismissed report, the CFTC recently concluded that there was “no evidence of a link between price changes and MMT [managed money trader] positions” in the natural gas markets and “a significantly negative relationship between MMT positions and prices changes...in the crude oil market.”⁴⁵

The CFTC study (and similar one performed by NYMEX) is flawed for numerous reasons, including the fact that the role of hedge funds and other speculators on long-term trading was *not* included in the analysis. The *New York Times* reported that “many traders have scoffed at the studies, saying that they focused only on certain months, missing price run-ups.”⁴⁶

Latest Trading Trick: Energy Infrastructure Affiliate Abuses

Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an “insider’s peek” into the physical movements of energy products unavailable to other energy traders. Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on

⁴⁰ *The Role Of Market Speculation In Rising Oil And Gas Prices: A Need To Put The Cop Back On The Beat*, Staff Report prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate, June 27, 2006, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf

⁴¹ “The Need for Stronger Regulation of U.S. Natural Gas Markets,” available at www.citizen.org/documents/Natural%20Gas%20Testimony.pdf

⁴² *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, available at www.ago.mo.gov/pdf/NaturalGasReport.pdf

⁴³ www.ieca-us.com/downloads/natgas/SECLetter013105.doc

⁴⁴ www.ieca-us.com/downloads/natgas/111704LettertoCongr%23AAC2.doc

⁴⁵ Michael S. Haigh, Jana Hranaiova and James A. Overdahl, “Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex,” available at www.cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf

⁴⁶ Alexei Barrionuevo and Simon Romero, “Energy Trading, Without a Certain ‘E’,” January 15, 2006.

energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.

For example, In January 2007, Highbridge Capital Management , a hedge fund controlled by JP Morgan Chase, bought a stake in an energy unit of Louis Dreyfus Group to expand its oil and natural gas trading. Glenn Dubin, co-founder of Highbridge, said that owning physical energy assets like pipelines and storage facilities was crucial to investing in the business: "That gives you a very important information advantage. You're not just screen-trading financial products."⁴⁷

Indeed, such an "information advantage" played a key role in allowing BP's energy traders to manipulate the entire U.S. propane market. In October 2007, the company paid \$303 million to settle allegations that the company's energy trading affiliate used the company's huge control over transportation and storage to allow the energy trading affiliate to exploit information about energy moving through BP's infrastructure to manipulate the market.

BP's energy trading division, North America Gas & Power (NAGP), was actively communicating with the company's Natural Gas Liquids Business Unit (NGLBU), which handled the physical production, pipeline transportation and retail sales of propane. A powerpoint exhibit to the civil complaint against BP details how the two divisions coordinated their manipulation strategy, which includes "assurance that [the] trading team has access to all information and optionality within [all of BP]...that can be used to increase chance of success [of market manipulation]... Implement weekly meetings with Marketing & Logistics to review trading positions and share opportunities."⁴⁸

And in August 2007, BP acknowledged that the federal government was investigating similar gaming techniques in the crude oil markets.

BP is not alone. A Morgan Stanley energy trader, Olav Refvik, "a key part of one of the most profitable energy-trading operations in the world...helped the bank dominate the heating oil market by locking up New Jersey storage tank farms adjacent to New York Harbor."⁴⁹ As of November 2008, Morgan Stanley committed \$452 million to lease petroleum storage facilities for 2009. As the company notes: "In connection with its commodities business, the Company enters into operating leases for both crude oil and refined products storage and for vessel charters. These operating leases are integral parts of the Company's commodities risk management business."⁵⁰ In 2003, Morgan Stanley teamed up with Apache Corp to buy 26 oil and gas fields from Shell for \$500 million, of which Morgan Stanley put up \$300 million in exchange for a portion of the production over the next four years, which it used to supplement its energy trading desk.⁵¹ Bloomberg reported that in January 2009, investment banks like Morgan Stanley and Citigroup were the leaders in keeping 80 million barrels of oil in storage in takers at sea—nearly enough oil to supply the world for a day.⁵²

⁴⁷ Saijel Kishan and Jenny Strasburg, "Highbridge Capital Buys Stake in Louis Dreyfus Unit," Bloomberg, January 8, 2007, www.bloomberg.com/apps/news?pid=20601014&sid=aBnQy1botdFo

⁴⁸ www.cftc.gov/files/enf/06orders/opa-bp-lessons-learned.pdf

⁴⁹ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf, page 26.

⁵⁰ <http://idea.sec.gov/Archives/edgar/data/895421/000119312509013429/d10k.htm>

⁵¹ Paul Merolli, "Two Morgan Stanley M&A deals show bullish stance on gas," Natural Gas Week, Volume 19; Issue 28, July 14, 2003.

⁵² Alaric Nightingale, "Morgan Stanley Hires Supertanker to Store Oil in Gulf," January 19, 2009, www.bloomberg.com/apps/news?pid=newsarchive&sid=aIbVHft2R3SE

The *Wall Street Journal* suggested that the bankruptcy of a single firm, SemGroup, served as the initial trigger of crude oil's price collapse this summer. The company operated 1,200 miles of oil pipelines and held 15 million barrels of crude storage capacity, but was misleading regulators and its own investors on the extent of its hedging practices. Data suggests that SemGroup was taking out positions far in excess of its physical delivery commitments, becoming a pure speculator. When its bets turned sour, the company was forced to declare bankruptcy.⁵³

This shows that the energy traders were actively engaging the physical infrastructure affiliates in an effort to glean information helpful for market manipulation strategies. And it is important to note that BP's market manipulation strategy was extremely aggressive and blatant, and regulators were tipped off to it by an internal whistleblower. A more subtle manipulation effort could easily evade detection by federal regulators, making it all the more important to establish firewalls between energy assets affiliates and energy trading affiliates to prevent any undue communication between the units.

Financial firms like hedge funds and investment banks that normally wouldn't bother purchasing low-profit investments like oil and gasoline storage have been snapping up ownership and/or leasing rights to these facilities mainly for the wealth of information that controlling energy infrastructure assets provides to help one's energy traders manipulate trading markets. The *Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, Ok.⁵⁴

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the \$22 billion acquisition of Kinder Morgan, Inc., which controls 43,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals.

Prior to this huge purchase, Goldman Sachs had already assembled a long list of oil and gas investments. In 2005, Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas operated by CVR Energy, and entered into an oil supply agreement with J. Aron, Goldman's energy trading subsidiary. Goldman's Scott L. Lebovitz & Kenneth A. Pontarelli and Kelso's George E. Matelich & Stanley de J. Osborne all serve on CVR Energy's Board of Directors.

In May 2004, Goldman spent \$413 million to acquire royalty rights to more than 1,600 natural gas wells in Pennsylvania, West Virginia, Texas, Oklahoma and offshore Louisiana from Dominion Resources. Goldman Sachs owns a six percent stake in the 375-mile Iroquois natural gas pipeline, which runs from Northern New York through Connecticut to Long Island. In December 2005, Goldman and Carlyle/Riverstone together are investing \$500 million in Cobalt International Energy, a new oil exploration firm run by former Unocal executives.

Conclusion

This era of high energy prices isn't a simple case of supply and demand, as the evidence suggests that weak or non-existent regulatory oversight of energy trading markets provides opportunity for energy companies and financial institutions to price-gouge Americans. Forcing consumers suffering from inelastic demand to continue to pay high prices—in part fueled by uncompetitive actions—not

⁵³ Brian Baskin, "SemGroup Loses Bets on Oil; Hedging Tactics Coincide With Ebb In Price of Crude," July 24, 2008, Page C14

⁵⁴ Ann Davis, "Where Has All The Oil Gone?" October 6, 2007, Page A1.

only hurts consumers economically, but environmentally as well, as the oil companies and energy traders enjoying record profits are not investing those earnings into sustainable energy or alternatives to our addiction to oil. Reforms to strengthen regulatory oversight over America's energy trading markets are needed to restore true competition to America's oil and gas markets.

Solutions

- Re-regulate energy trading markets by subjecting OTC exchanges—including foreign-based exchanges trading U.S. energy products—to full compliance under the Commodity Exchange Act and mandate that all OTC energy trades adhere to the CFTC's Large Trader reporting requirements. In addition, regulations must be strengthened over existing lightly-regulated exchanges like NYMEX.
- Impose legally-binding firewalls to limit energy traders from speculating on information gleaned from the company's energy infrastructure affiliates or other such insider information, while at the same time allowing legitimate hedging operations. Congress must authorize the FTC and DOJ to place greater emphasis on evaluating anti-competitive practices that arise out of the nexus between control over hard assets like energy infrastructure and a firm's energy trading operations. Incorporating energy trading operations into anti-trust analysis must become standard practice for federal regulatory and enforcement agencies to force more divestiture of assets in order to protect consumers from abuses.
- Raise margin requirements so market participants will have to put up more of their own capital in order to trade energy contracts, and impose aggregate position limits on non-commercial trading to reduce speculation. Currently, margin requirements are too low, which encourages speculators to more easily enter the market by borrowing, or leveraging, against their positions. And aggregated limits over all markets - not just select ones - would preclude an energy trader from dipping their hands in multiple futures market cookie jars with the intent to speculate.