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**Testimony of Tyson Slocum, Director
Public Citizen's Energy Program
Before the U.S. Commodity Futures Trading Commission
Energy Position Limits and Hedge Exemptions**

Dear Chairman Gensler and Members of the Commission,

Thank you for the opportunity to testify today on ways the CFTC can strengthen oversight of energy markets. Public Citizen is a 38-year old non-partisan organization that supports policies to help ensure households have access to competitively-priced energy. We receive our financial support from the contributions of our 90,000 members and from charitable foundations. We do not accept money from government or corporate sources, and we do not operate a political action committee.

My testimony today will describe how recent legislative and regulatory actions deregulated energy trading markets, which removed transparency and allowed powerful financial corporations to engage in harmful levels of speculation, resulting in higher and more volatile energy prices for families. Section 4(a) of the Commodity Exchange Act requires the CFTC to establish and maintain "position limits" on traders to prevent "sudden or unreasonable fluctuations or unwarranted changes" in commodity prices as a result of excessive speculation.¹ Public Citizen recommends the CFTC take the following actions to restore market integrity and protect consumers from anti-competitive behavior:

1. Enact position limits across all energy products and markets for all index traders, swaps dealers and proprietary traders. Such limits must be aggregate—applying across all energy contracts in all markets for all months. Exemptions from such limits should only be granted for bona fide commercial hedgers, and swaps dealers and index traders should not qualify for exemptions. If the CFTC does grant exemptions from position limits, such actions should be made public.

¹ www4.law.cornell.edu/uscode/html/uscode07/usc_sec_07_00000006---a000-.html

- a. The CFTC should anticipate that market participants will attempt to evade such position limits by creating confusing webs of affiliates to which trading could be shifted. Strict guidelines must be issued to prevent traders from creating such affiliates for the sole purpose of evading position limits.
2. The CFTC must recognize that deregulation of the OTC market has resulted in swaps dealers replacing pit exchanges and floor traders as a mechanism for commercial interests to meet their hedging needs. As a result, increasing transparency over the OTC market is critical.
 - a. Since the CFTC has the authority to invoke emergency authority to address an event “which prevents the market from accurately reflecting the forces of supply and demand,”² the Commission should use this authority to require all standardized OTC contracts to clear through an exchange regulated by the CFTC, and impose margin requirements on non-standardized OTC contracts and ensure that it—and not exchanges—makes the determination of what is a standard vs non-standard OTC contract.
 - b. Currently the CFTC’s Commitment of Traders reports detail activities that occur on CFTC-regulated exchanges.³ The CFTC should expand this reporting to include similar information about the trading details for swaps dealers—providing weekly data to the public on a dealer-specific basis—and index funds.
 3. To the maximum extent possible, the CFTC must require ECMs and swaps dealers to provide daily data mirroring the Large Trader Reports and ensure that such data is properly integrated with the CFTC’s market monitoring software.
 4. The CFTC should investigate and produce a public report on potential market integrity concerns raised by:
 - a. The trading volume and coordinated role that entities operating as swaps dealers, index traders and proprietary trading.
 - b. Speculators that control, through lease or ownership, physical energy assets such as storage, pipelines, refineries and production facilities. Of particular concern are when control over such assets are used to assist with an affiliate’s proprietary trading operations.

² www4.law.cornell.edu/uscode/html/uscode07/usc_sec_07_00000012---a000-.html

³ www.cftc.gov/marketreports/commitmentsoftraders/

For years, Public Citizen has led efforts to protect consumers by promoting transparent, well-regulated energy markets. Legislative and regulatory actions over the last two decades deregulated energy markets, restricting the ability of government regulators to protect consumers from abuses, with the rationale that corporations could more efficiently regulate themselves than could federal agencies. As the world continues to suffer through a severe economic crisis caused in part by a lack of regulation over derivative markets, it is important to recall the mea culpa of former Federal Reserve Chairman Alan Greenspan, told during his October 2008 Congressional testimony: "I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms."⁴

Public Citizen is encouraged by recent CFTC actions and pronouncements that appear to place the agency on a path of strengthening regulations over energy markets. We specifically note the Commission's July 24 determination that ICE's Henry Hub natural gas contract serves a "significant price discovery" function, thereby subjecting this electronic exchange's natural gas contract to stronger regulation.⁵ Public Citizen strongly supports treating contracts traded on electronic exchanges (or "Exempt Commercial Markets") the same as those traded on traditional pit exchanges and other so-called "Designated Contract Markets."

Public Citizen was similarly encouraged by the Obama Administration's plan—developed with the support of the CFTC—to establish regulatory proposals for Over-the-Counter (OTC) derivative markets that would require, among other things, standardized OTC energy contracts to clear through exchanges regulated by the CFTC.⁶ Public Citizen continues to work with the Administration and Congress to help ensure that the details of such a proposal will restore needed transparency that existed in these markets prior to the Enron-supported Commodity Futures Modernization Act of 2000 (for example, that the exception for non-standardized contracts does not turn into a harmful loophole by requiring strong capital requirements for non-standardized OTC contracts and placing the CFTC in charge of making the determination of what a standard vs. a non-standard OTC product is.)

The Need to Restore Competition to Energy Commodity Markets

The Commodity Futures Modernization Act of 2000 deregulated energy trading, undermining CFTC authority over broad swaths of the market and

⁴ <http://oversight.house.gov/documents/20081024163819.pdf>

⁵ www.cftc.gov/newsroom/generalpressreleases/2009/pr5683-09.html

⁶ www.financialstability.gov/docs/regs/FinalReport_web.pdf

ushering an explosion in volume in unregulated OTC markets and underregulated electronic exchanges, or Exempt Commercial Markets (ECMs)—as evidenced by one such entity, ICE, which operates both as an ECM as an OTC market operator. ICE’s electronic exchange volume increased 567% from 2004 to 2008 (from 35 million contracts to 237 million) and the company’s OTC platform has seen volume grow 700%, from 31 million contracts in 2004 to 247 million in 2008.⁷

Numerous government and private sector investigations conclude that these deregulated energy markets have reduced transparency and increased harmful levels of speculation that result in higher and more volatile prices for consumers. One recent U.S. Senate investigation found that:

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 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 oversight. 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.⁸

⁷ <http://idea.sec.gov/Archives/edgar/data/1174746/000095014409001156/g17549e10vk.htm>. The founding members of ICE include Goldman Sachs, BP, Shell and TotalFinaElf.

⁸ *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, June 27, 2006, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf

Indeed, the CFTC has indicated that next month it will release a report “suggesting speculators played a significant role in driving wild swings in oil prices.”⁹

The bulk of the “speculators” are financial institutions, such as Goldman Sachs, JP Morgan Chase/Bear Stearns, Morgan Stanley, Citigroup and Bank of America/Merrill Lynch. Such firms have turned energy markets into lucrative profit centers for the firms, taking full advantage of the lack of regulatory oversight over their operations to maximize market power and control information. Specifically, banks dominate energy trading markets through their role as swaps dealers and as managers of index funds, which facilitates successful proprietary trading operations.

Index funds, which provide payments or shares based on the price movement of a basket of different commodities. These index funds purchase large volumes of commodity futures contracts in the OTC market on behalf of institutional investors and wealthy individuals and then typically seek hedge exemptions from regulated exchanges like NYMEX to purchase an offsetting portfolio of futures contracts to hedge their exposure in the OTC markets. Similarly, many of these same investment banks that operate index funds also function as swaps dealers, purchasing contracts on behalf of clients and then requesting similar hedge exemptions in regulated exchanges.

Recent investigations, most notably one conducted by the U.S. Senate,¹⁰ conclude that index funds are a major source of harmful speculation in commodity markets, resulting in higher prices to end consumers and reducing the ability of legitimate hedgers to manage their risk.

For example, Goldman Sachs operates the GSCI index fund, which held more than \$660 million in assets as of March 31, 2009.¹¹ At the end of 2008, more than 65% of the 24 different commodities comprising the GSCI index are energy commodities, with agricultural commodities representing 25% and metals the remaining 10%. As of January 30, 2009, there were 135 entities which owned shares of GSCI.¹² CME imposes position limits of 10,000 contracts, but GSCI has received a hedging exemption that allows them to hold up to 20,000 contracts, thereby accommodating GSCI’s 18,737

⁹ Ianthe Jeanne Dugan and Alistair MacDonald, “Traders Blamed for Oil Spike,” *The Wall Street Journal*, July 28, 2009.

¹⁰ *Excessive Speculation in the Wheat Market*, Majority & Minority Staff Report, Permanent Subcommittee on Investigations, June 24, 2009, http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=fb439667-dcd3-4025-b95b-1b91f8ea29d1

¹¹ <http://idea.sec.gov/Archives/edgar/data/1332174/000119312509106960/d10q.htm>

¹² <http://idea.sec.gov/Archives/edgar/data/1332174/000119312509040488/d10k.htm>

long position contracts. These positions are in addition to the value of commodities held by Goldman Sachs' trading unit J.Aron, which the company estimated to exceed \$29 billion as of November 2008. That helps to explain how Goldman's Fixed Income, Currency and Commodities unit represented 58% of the company's revenues for the first half of 2009 (\$13.4 billion of \$23.2 billion), helping the company to enjoy \$5.3 billion in pre-tax earnings in the first two quarters of 2009.

In the summer of 2006, Goldman Sachs announced it was radically changing its GSCI index's weighting of gasoline futures, selling about \$6 billion worth. As a direct result of this weighting change and sale, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.¹³

Energy Infrastructure Affiliate Abuse Potential

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 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."¹⁴

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.¹⁵

¹³ Heather Timmons, "Change in Goldman Index Played Role in Gasoline Price Drop," *The New York Times*, September 30, 2006.

¹⁴ 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

¹⁵ www.cftc.gov/newsroom/enforcementpressreleases/2007/pr5405-07.html

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."¹⁶ 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."¹⁷ 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.¹⁸ 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.¹⁹

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.²⁰

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.

¹⁶ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf, page 26.

¹⁷ <http://idea.sec.gov/Archives/edgar/data/895421/000119312509013429/d10k.htm>

¹⁸ Paul Merolli, "Two Morgan Stanley M&A deals show bullish stance on gas," *Natural Gas Week*, Volume 19; Issue 28, July 14, 2003.

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

²⁰ Brian Baskin, "SemGroup Loses Bets on Oil; Hedging Tactics Coincide With Ebb In Price of Crude," July 24, 2008, Page C14

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.²¹

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 invested \$500 million in Cobalt International Energy, an oil exploration firm run by former Unocal executives.

Conclusion

The evidence is clear: deregulation has eroded transparency over energy trading markets, opening the door to harmful levels of speculation that deny consumers access to adequately competitive markets. The CFTC must use its authority to strengthen its oversight over swaps dealers, index funds and other players in OTC markets to protect families from unfair energy prices and preserve market integrity.

²¹ Ann Davis, "Where Has All The Oil Gone?" October 6, 2007, Page A1.