



Testimony of Tyson Slocum, Director

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Excessive Speculation & Compliance with the Dodd-Frank Act, Permanent Subcommittee on Investigations, U.S. Senate Committee on Homeland Security & Governmental Affairs

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I am Tyson Slocum, Director of Public Citizen's Energy Program. Public Citizen celebrates its 40th Anniversary in 2011, and we advocate on behalf of our more than 250,000 members and supporters across the country for policies that provide households access to clean, reliable and affordable energy.

The occasion of this hearing is prompted by recent CFTC rules implementing Dodd-Frank instructions on curbing excessive speculation in energy commodity markets. These rules, long delayed, are the product of a sharply divided Commission and, while they will improve the wild west feature of these markets, simply do not go far enough to protect consumers. My testimony will review how excessive speculation by financial and energy corporation traders have pushed prices beyond the supply-demand fundamentals, and what additional steps Congress must take to protect households from high prices.

Public Citizen recommends the following reforms to address the harmful impact excessive speculation has for families:

- Enhance position limits – as articulated in S.1598 and HR 3006. This legislation not only defines excessive speculation, but establishes a statutory 5% position limit level. This statutory threshold provides greater certainty and better establishes strong consumer protections into law.
- Restrict communication between petroleum energy infrastructure affiliates and trading affiliates. A starting place for legislation could be 18 CFR §358,¹ which limits communications between natural gas pipeline and energy trading affiliates. Such rules do not exist for petroleum product pipelines/storage, and need to be.

¹ http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title18/18cfr358_main_02.tpl



- Improve trading market data disclosure by publishing trader-specific positions. This summer Public Citizen worked with the office of Senator Bernie Sanders to help make public trader-specific energy trading position data. Regular public disclosure of such data is essential for market transparency and to educate the public on who the individual traders are who help set energy prices.
- Modify SEC disclosure to require companies to detail energy trading activities in their financial reporting. Currently, companies are under no obligation to disclose commodity-specific information on their volumes, prices, or profits from energy trading.
- Impose financial disincentives to speculate, including the establishment of a Financial Transaction Tax or disallow favorable capital gains tax treatment for energy commodity trading (such as S.1588 from the 111th Congress).
- Disallow index funds and mutual funds from investing directly or indirectly (thru ETFs) from commodity markets.

Background

Despite flattening demand in industrialized countries due to the economic recession and ample global supplies and storage, world oil prices remain stubbornly high. Of course, longer-term trends do give some justification for higher prices than during the 1990s: easy-to-access and cheaper-to-produce, conventional oil fields are declining in production, leaving more expensive deepwater, oil shale and tar sands to fill in the gaps. Combine this with the US economy's continued reliance on oil consumption, and it is clear that Congress must take aggressive steps to detach our dependence on oil through the promotion of alternative fuels (namely the electrification of the transportation sector), greater sustainable planning of our communities, investments in distributed renewable e generation and investments in building energy efficiency.

But despite these longer-term trends, it is clear that oil prices have distanced themselves from the supply-demand fundamentals. The Commodity Futures Modernization Act of 2000 deregulated energy trading, undermining CFTC authority over broad swaths of the market and 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 826% from 2004 to 2010 (from 35 million contracts to 329 million) and the company's OTC platform has seen volume grow 976%, from 31 million contracts in 2004 to 333 million in 2010.²

The bulk of the “speculators” are financial institutions, such as Goldman Sachs, JP Morgan Chase/Bear Stearns, Morgan Stanley and Bank of America/Merrill Lynch. Such firms have

² www.sec.gov/Archives/edgar/data/1174746/000119312511028245/d10k.htm The founding members of ICE include Goldman Sachs, BP, Shell and TotalFinaElf.



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.

Dodd-Frank

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. On that occasion, he declared that the reforms passed Congress despite “the furious lobbying of an array of powerful interest groups...[the legislation will] rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis...for these new rules to be effective, regulators will have to be vigilant...in the end, our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check excess...and that’s what these reforms are designed to achieve—no more, no less. Because that’s how we will ensure that our economy works for consumers.”³

Congress passed the Dodd-Frank Act, including mandatory position limits, with the understanding that unregulated derivatives play a significant role in encouraging excessive speculation on the part of Wall Street banks. Such speculation increases prices paid by households for staple goods such as food and gasoline, and also increases systemic risks to the financial system.

Section 737 of Dodd-Frank orders that the CFTC “shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract

³ www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act



market...[in order] to diminish, eliminate, or prevent excessive speculation...[and] to deter and prevent market manipulation, squeezes, and corners.”

Lobbyists for industry and some CFTC commissioners question whether the language mandates that the CFTC impose position limits or whether it provides some discretion. We believe the language cannot be clearer. The Commission is required to establish position limits as Congress intentionally used the word, “shall,” to impose the mandatory obligation.

Congress made the express decision to change the permissive language in an earlier version of the Wall Street Reform and Consumer Protection Act to a mandate. When the House version of the bill was introduced on December 2, 2009, Section 3113 on Position Limits stated: “The Commission may, by rule or regulation, establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in contracts based upon the same underlying commodity (as defined by the Commission) that may be held by any person, including any group or class of traders[.]” However, before the Act passed the House, the word “may” was replaced by “shall” pursuant to an amendment proposed by former House Agriculture Committee Chairman Collin Peterson. This language was incorporated into the bill, survived the conference negotiations, and was eventually enacted into law.

Not only did Congress mandate position limits, it specified the goals position limits were to fulfill. Section 4a(a)(3) of the Commodities and Exchange Act states that position limits shall serve to:

Diminish, eliminate or prevent excessive speculation as described under this section; Deter and prevent market manipulation, squeezes, and corners; Ensure sufficient market liquidity for bona fide hedgers; and Ensure that the price discovery function of the underlying market is not disrupted.

Note that this statement explicitly lists the prevention of excessive speculation and the protection of market price discovery as separate goals from the deterrence of direct market manipulation such as squeezes and corners. This indicates that Congress intended position limits to reduce the overall role of speculation in the market, not simply prevent direct market manipulation by individual traders.

Speculation Documentation



In our comments submitted to the CFTC on the position limits rulemaking, we summarize several studies finding that excessive speculation in energy commodity markets has increased prices to consumers.⁴ An excellent report by Dr. Mark Cooper of the Consumer Federation of America⁵ documents that speculation adds \$600 to the average family's gasoline expenditures for 2011 – heaping harm on an already troubled economy, and discusses how recent correlations between the cost of acquiring and refining crude oil and the market price have become detached in recent years as deregulation and speculative money have flooded the market. Jeff Rubin explains how high oil prices likely served as the trigger for the 2008 financial downturn.⁶

One Wall Street bank, Citigroup, was forced to divest its highly lucrative commodity trading division, Phibro, in 2009 (selling it to Occidental) after reports that the head of the unit's oil trading desk, John Hall, was due a \$100 million bonus triggered by the massive profits made speculating on crude oil during the record price run-up.

Better Markets establishes, after reviewing nearly 30 years of data, that the explosion of index funds into the market in just the last few years has pushed prices beyond the supply-demand fundamentals.⁷ Recent investigations, most notably one conducted by this Committee⁸ 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 \$1.5 billion in assets as of June 30, 2011.⁹ At the end of 2010, nearly 2/3 of the 24 different commodities comprising the GSCI index are energy commodities, with agricultural commodities representing 22.6% and metals the remaining 11.4%. As of January 30, 2011, there were 49,120 entities which owned shares of GSCI – up from just 135 just 2 years earlier.

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

⁴ <http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/03/AFR-CFTC-Position-Limits-Comment-Letter-3-28-11.pdf>

⁵ www.consumerfed.org/pdfs/SpeculationReportOctober13.pdf

⁶ http://research.cibcwm.com/economic_public/download/soct08.pdf

⁷ www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices

⁸ 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

⁹ www.sec.gov/Archives/edgar/data/1332174/000119312511214416/d10q.htm



change and sale, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.¹⁰

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. *The Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, Ok.¹¹ 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.

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.”¹²

And in a story about leaked documents detailing Chevron’s \$360 million profit from energy trading in the first half of 2011, *The Wall Street Journal* reported that “companies’ traders take advantage of their inside view of the oil market to place speculative bets on the direction of prices. Commodities markets such as crude oil are not subject to the strict insider trading rules that govern equities trading.”¹³

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.¹⁴

¹⁰ Heather Timmons, “Change in Goldman Index Played Role in Gasoline Price Drop,” *The New York Times*, September 30, 2006

¹¹ Ann Davis, “Where Has All The Oil Gone?” October 6, 2007, Page A1.

¹² Saijel Kishan and Jenny Strasburg, “Highbridge Capital Buys Stake in Louis Dreyfus Unit,” *Bloomberg*, January 8, 2007, www.bloomberg.com/apps/news?pid=newsarchive&sid=aBnQy1botdFo

¹³ Brian Baskin & Ben Lefebvre, “Chevron’s Email ‘Oops’ Reveals Energy Giant’s Sway Over Markets,” July 16, 2011. <http://online.wsj.com/article/SB10001424052702304521304576448202801087220.html>

¹⁴ www.cftc.gov/PressRoom/PressReleases/pr5405-07



BP is not alone. This Committee noted that 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.”¹⁵ Morgan Stanley committed \$313 million to lease petroleum storage facilities for this year alone. 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.”¹⁶

In January 2009, investment banks like Morgan Stanley and Citigroup were the leaders in keeping 80 million barrels of oil in storage in tankers at sea—nearly enough oil to supply the world for a day.¹⁷

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.¹⁸

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.

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the \$22 billion acquisition of Kinder Morgan, Inc., which controls 67,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals, thanks in part to last months’

¹⁵ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf, page 26.

¹⁶ www.sec.gov/Archives/edgar/data/895421/000119312511050049/d10k.htm

¹⁷ Alaric Nightingale, “Morgan Stanley Hires Supertanker to Store Oil in Gulf,” January 19, 2009, www.bloomberg.com/apps/news?pid=newsarchive&sid=albVHft2R3SE

¹⁸ Brian Baskin, “SemGroup Loses Bets on Oil; Hedging Tactics Coincide With Ebb In Price of Crude,” July 24, 2008, Page C14



\$37.8 billion acquisition of El Paso Corp.¹⁹ Goldman has two managing partners on Kinder's Board.

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. Just days ago CVR Energy announced it would acquire a 70,000 barrel per day refinery in Oklahoma.²⁰

In December 2005, Goldman and Carlyle/Riverstone together invested \$500 million in Cobalt International Energy, an oil exploration firm run by former Unocal executives, and Goldman has two members on the Board.²¹

Goldman's Fixed Income, Currency and Commodities unit represented 53% of the company's revenues for the first half of 2011 (\$10.2 billion of \$19.2 billion), helping the company to enjoy \$2.5 billion in pre-tax earnings for this division.²²

Public Citizen Reforms

- The 25% threshold in the CFTC's final position limits rule is simply too high. Based on the data released by the office of Senator Bernie Sanders this summer, it appears as though the top 5 financial firms (Goldman Sachs, Vitol, Morgan Stanley, Barclays and Deutsche Bank) trading WTI crude on a single day in June 2008 (just as prices were spiking to an all-time high of \$147/barrel) each held long positions of between 5.3% and 8.7% of the outstanding contracts. As a result, Public Citizen endorses S.1598/HR 3006 which establishes a statutory position limit of 5%.
- Our documentation of major investments by financial firms with proprietary trading into owning or controlling energy infrastructure assets requires Congress to restrict communication between petroleum energy infrastructure affiliates and trading affiliates. A starting place for legislation could be 18 CFR §358,²³ which limits communications between natural gas pipeline and energy trading affiliates. Such rules do not exist for petroleum product pipelines/storage, and need to be.

¹⁹ www.bloomberg.com/news/2011-10-16/kinder-to-buy-el-paso-for-21-1-billion-making-biggest-u-s-pipe-company.html

²⁰ <http://phx.corporate-ir.net/phoenix.zhtml?c=203637&p=irol-newsArticle&ID=1625296>

²¹ www.cobaltintl.com/about-us/corporate-governance/board-of-directors

²² www2.goldmansachs.com/investor-relations/financials/current/10q/10-q-2q-2011.pdf

²³ http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title18/18cfr358_main_02.tpl



- Improve trading market data disclosure by publishing trader-specific positions. This summer Public Citizen worked with the office of Senator Bernie Sanders to help make public trader-specific energy trading position data. Regular public disclosure of such data is essential for market transparency and to educate the public on who the individual traders are who help set energy prices. We support a time delay in the release of such information to protect genuine proprietary concerns, but concealing such data from the public indefinitely simply aides the banks' control over a non-transparent market.
- Modify SEC disclosure to require companies to detail energy trading activities in their financial reporting. Currently, companies are under no obligation to disclose commodity-specific information on their volumes, prices, or profits from energy trading. Public revelation of such data will help shareholders and the general public assess the role and risks associated with firms' investments and income from commodity trading.
- Impose financial disincentives to speculate, including the establishment of a Financial Transaction Tax or disallow favorable capital gains tax treatment for energy commodity trading (such as S.1588 from the 111th Congress).
- Disallow index funds and mutual funds from investing directly or indirectly (thru ETFs) from commodity markets.