Consumer Federation of America
1620 I Street, N.W., Suite 200 * Washington, DC 20006

STATEMENT OF DR. MARK COOPER

DIRECTOR OF RESEARCH

on

OVERSIGHT OF ENERGY MARKETS AND OIL FUTURES CONTRACTS

Before the

JOINT HEARING OF THE SENATE APPROPRIATIONS SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT AND THE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE

June 17, 2008

SUMMARY

BURSTING THE SPECULATIVE BUBBLE IN COMMODITIES IS THE ONLY WAY TO GIVE CONSUMERS SHORT-TERM RELIEF FROM OUTRAGEOUS ENERGY AND FOOD PRICES

The story has been told many times, but the lessons have still not been learned. The lack of effective prudential regulation of financial and commodity markets leads to excessive speculation that disrupts the economy and costs consumers hundreds of bullions of dollars.

Two years ago the Senate Permanent Subcommittee on Investigations estimated the speculative premium at $20 -$30 per barrel, when the price was $77 a barrel. Today the premium is over $40 per barrel, or about $1 per gallon. An equivalent figure for natural gas would be in the range of $2.50 pr thousand cubic feet.

- Over the past two years this speculative premium has cost the typical American household over $1500 and the economy over $500 billion.
- Sound prudential regulation is the only near-term way to bring down gasoline and food prices because it will burst the speculative bubble that has taken hold of commodity trading.

IRRESPONSIBLE DEREGULATION IS THE PRIMARY CAUSE OF THE SPECULATIVE BUBBLE

The Commodity Futures Modernization Act of 2000 (CFMA), slipped into an omnibus bill with no hearings or debate at the eleventh hour of a lame duck session of congress, created the "Enron loophole," allowing a huge trade in energy commodities and other financial instruments, that is beyond regulatory oversight. The CFTC added insult to injury by issuing "no action letters" to allow contracts designated in U.S. commodities to be traded without exercising oversight and foreign exchanges to trade in U.S. commodities on U.S. soil, subject to foreign, not U.S. regulatory review.

Regulation of commodity exchanges is far too lax with low margin and capital reserve requirement, allowing traders to leverage their assets and multiply their trading in "asset-lite" companies (like Enron) who do not have the equity to ensure soundness. The exchanges also set limits on positions that are far too high, allowing single entities to control large quantities of supply.

Institutional investors and new trading instruments like index funds have poured hundreds of billions of dollars into commodity markets at such a rate that speculation swamps the markets, which no longer provide their proper role to assist commercial traders who actually use the physical commodities to hedge and smooth their physical production and consumption.

REGULATORY REFORM IS THE WAY TO SOLVE THE PROBLEM

With the commodities markets overwhelmed by speculation and the Congress beginning to empower other agencies to do the job that the CFTC has failed to do, the CFTC has belatedly admitted that it did not have sufficient information to perform its primary job of preventing excessive speculation and has asked that the foreign regulators to whom it abdicated its responsibility to impose some order. Begging foreign exchanges for data and foreign regulators to act responsibly is not only embarrassing; it is absurd when the CFTC has not put its own house in order. These proposals are too little too late. The CFTC must be forced to assert regulatory authority over trading within the Untied States and trading in financial instruments designated in U.S. commodities.

Congress must enact broad reforms that close the loopholes, remove the discretion that was given to the CFTC and compel it to do its job. There are five areas in which reform is necessary

Chase out the bad guys

All traders must register and be certified (for honesty and competence, like bankers and brokers).

All trading must be reported across all transactions

Eliminate the funny money

Raise margin requirements
Increase capital reserve requirements

Reduce the ability to push prices up

Lower position limits and tie position limits and margin policies to needs of physical traders
Lengthen settlement windows
Ban conflicts of interest (analyst's reports that enrich analyst's portfolios)

Restore the proper functioning of commodity markets and their regulators

Enforce meaningful speculative limits
Do honest analysis (classify traders correctly)

Close the loopholes (foreign boards of Trade exemptions, the Enron and swaps loopholes)
Create minimum criminal penalties for violation of commodity laws

Redirect investment to productive long-term uses

Put a tax on short-term capital gains
Move pension funds out of speculation
Ban institutional index funds

The speculators will say we this will squeeze the markets, but the malfunctioning markets and abusive practices that afflict commodity trading today were illegal and largely unheard of just a decade ago. The unregulated markets and exotic financial instruments that were allowed by irrational exuberance for deregulation over the past decade have done vastly more harm than good. We were better off without them.

If we do not do more than the half hearted approaches that are on the table, we will continue to lurch from crisis to crisis. It is a big job, but a $500 billion dollar hit on the economy and household budgets that are being devastated by rising prices of basic necessities demand the effort. It is time for thorough reform and re-regulation of the financial commodity markets to put an end to the speculative bubble and restore these markets to their proper function in society.

Mr. Chairman and Members of the Committee,

My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America. I greatly appreciate the opportunity to testify today on the immense burden that the speculative bubble in commodities is placing on American households.

The story has been told many times, but the lessons have still not been learned. The lack of effective prudential regulation of financial and commodity markets leads to excessive speculation, bubbles and bursts that disrupt the economy and cost consumers hundreds of bullions of dollars.

Congressional studies, like that prepared by the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs[1] and industry analyses[2] have become convinced that speculation is contributing to skyrocketing energy prices – by adding as much as $40 per barrel or more. Natural gas prices have been afflicted by a speculative premium of a similar order of magnitude.[3] Since the Senate Permanent Subcommittee on Investigations first flagged this problem two years ago, the speculative bubble in the energy complex has cost the economy more than $500 billion – i.e. half a trillion dollars. Expenditures for household energy have more than doubled in the past six years and speculation has played a significant part in that run up.[4] In the past two years, the speculative bubble has cost consumers over $1500. Speculation in food Commodities is adding billions to the burden.

While this speculative bubble imposes this cost on consumers and the nation, the Commodity Futures Trading Commission (CFTC) did nothing to slow the speculative rampage. On the contrary, it insisted that the markets were functioning properly, that the problem was entirely caused by fundamentals, and that excessive speculation was not a problem. It went so far as to distort its own data to hide the problem, while it continued to irresponsibly deregulate trading.

While market fundamentals have pushed prices up, the evidence is now overwhelming that speculation has made matters much worse. In an analysis of natural gas markets I prepared for four Midwest attorneys general a few months before the Permanent Subcommittee on Investigations issued its first report on speculation, I showed that there is a powerful interaction between physical market problems and financial market problems that creates a vicious, anti-consumer price spiral (see Exhibit 1). There is not doubt that speculation has been a major contributor to recent price increases and consumers are now paying a huge speculative premium.

IRRESPONSIBLE DEREGULATION IS THE PRIMARY CAUSE OF THE SPECULATIVE BUBBLE

The speculators will say we cannot live without these trading practices, but the malfunctioning markets and abusive practices that afflict commodity trading today were illegal and largely unheard of just a decade ago. The unregulated markets and exotic financial instruments that

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[1] Senate Permanent Subcommittee on Investigations, Committee on Homeland Security, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat* (June 27, 2006).

[2] Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices: Analyzing the Effects of Fundamentals and Premium* (Institute of Energy Economics, March 2008; Robert J. Shapiro and Nam D. Pham, *An Analysis of Spot and Futures Prices for Natural Gas: The Roles of Economic Fundamental, Market.*

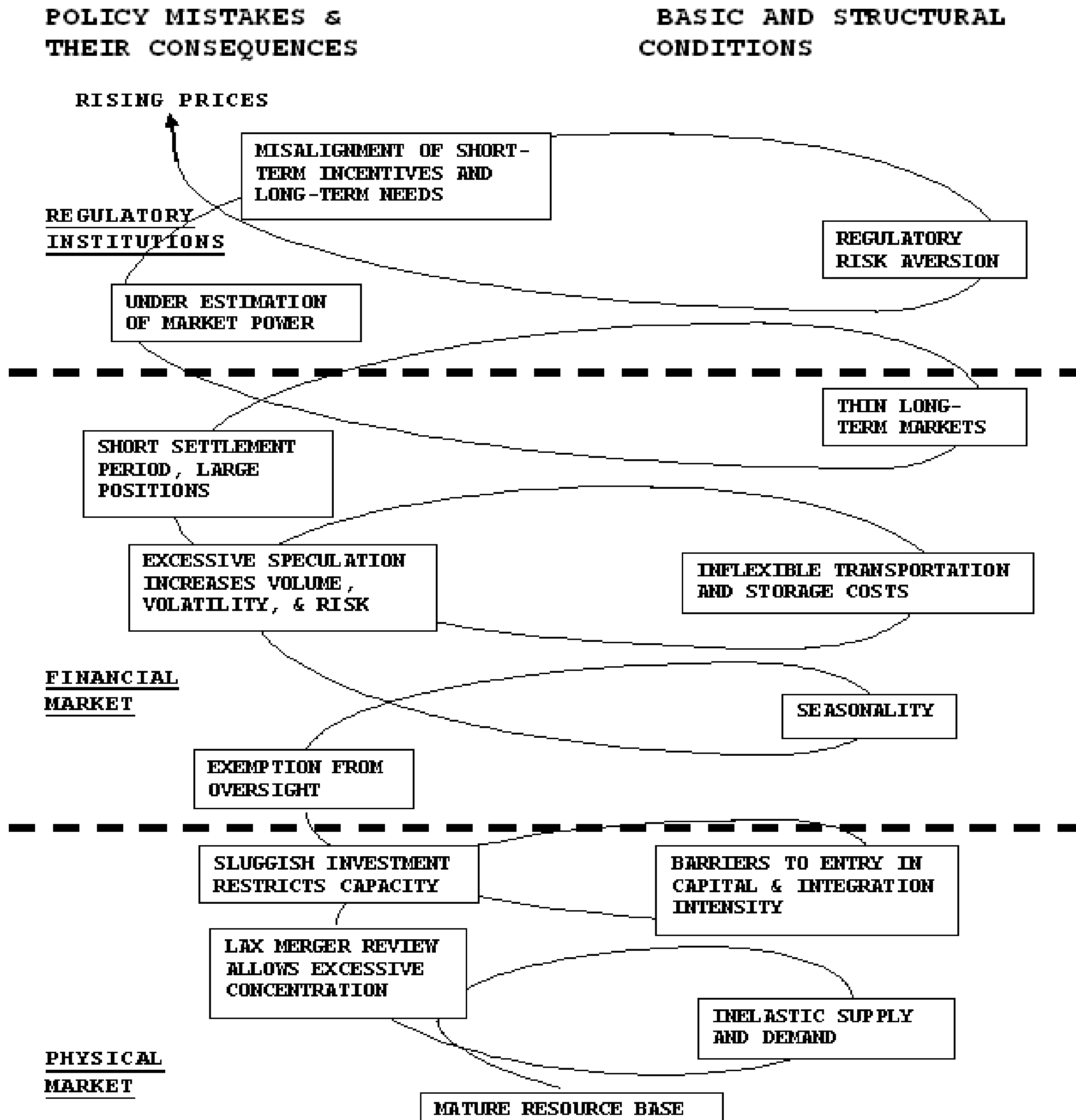
[3] Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral, A report Prepared for the Midwest Attorney General Natural Gas Working Group (Illinois, Iowa, Missouri, and Wisconsin* (March, 2006) *Structure, Speculation and Manipulation* (August, 2006).

[4] Statement of Dr. Mark Cooper, "Consumer Effects of Retail Gas Prices," Judiciary Committee Antitrust Task Force, United States House of Representative, May 7, 2008

were allowed by irrational exuberance for deregulation over the past decade have done vastly more harm than good. We were better off without them.

EXHIBIT 1:

PHYSICAL, FINANCIAL AND REGULATORY FACTORS IN THE ENERGY PRICE SPIRAL



Source: Mark Cooper, "The Failure of Federal Authorities to Protect AmericanEnergy Consumers from Market Power and Other Abusive Practices," *Loyola Consumer Law Review,* 19:4 (2007), p. 318.

If the Congress subjects these markets and practices to effective regulatory oversight, it will restore commodity markets to their proper and useful function in society. More importantly, <u>subjecting these markets to sound prudential regulation is the only way to bring down gasoline and food prices in the short term because it will burst the speculative bubble that has taken hold of commodity trading.</u>

Speculative bubbles have diverse origins and are difficult to analyze and predict, but there is widespread agreement that the underlying cause of the bubble in recent years is a massive influx of money into the commodity markets. "Disappointing" returns on stocks and other investments are frequently cited as a reason that the money has rushed into commodities, but there is also no doubt that lax oversight and easy terms have made these markets magnets for money.

The Commodity Futures Modernization Act of 2000 (CFMA), which was slipped into an omnibus bill with no hearings or debate at the eleventh hour of a lame duck session of congress, created what is known as the "Enron loophole," allowing a huge trade in energy commodities and other financial instruments, that is beyond regulatory oversight. The CFTC has added insult to injury by issuing" no action letters" allowing contracts designated in U.S. commodities to be traded without exercising oversight over those contracts. It has allowed foreign exchanges to trade in U.S. commodities on U.S. soil, subject to foreign, not U.S. regulatory review.

Where commodities are traded on exchanges that are subject to U.S. regulatory authority, the rules are far too lax. Traders in stocks are required to meet margin requirements of 50%. Traders who buy an energy commodity on an exchange only have to meet a margin requirement of 5%-7%. This low margin requirement allows people to leverage their assets multiply their trading volume. Capital reserves for traders are far too low – creating "asset-lite" companies (like Enron) who do not have adequate equity to ensure soundness. Simply put, low margin and reserve requirements artificially inflate the amount of trading that takes place. The exchanges also set limits on positions that are far too high, allowing single entities to control large quantities of supply, and, in the case of natural gas, have a very short settlement window, which means a small number of trades set the closing price.

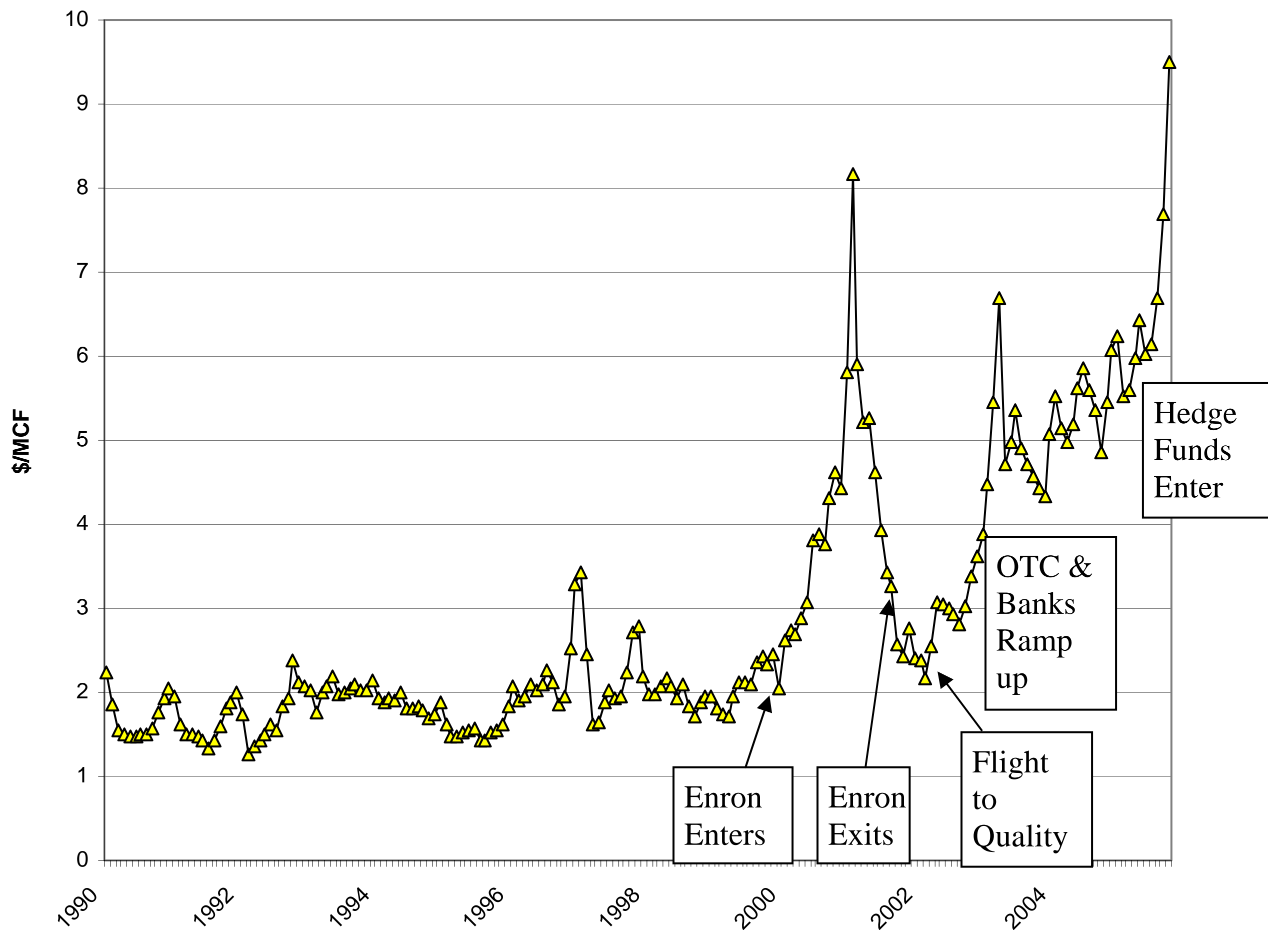
Institutional investors and new trading instruments like index funds have poured hundreds of billions of dollars into commodity markets at such a rate that speculation overwhelms the markets, accounting for the vast majority of trading. The markets no longer provide their proper role to assist commercial traders, buyers and sellers who actually use the physical commodities, to hedge and smooth their physical production and consumption of the commodities. Instead, the contracts have become assets, traded hundreds of times without ever being physically delivered. The volatility and speculation driving price increases have forced smaller commercial traders out of the market. The exchanges have allowed this to happen by failing to impose effective speculation limits or position limits. The CFTC has obscured by problem by misclassifying large speculators (banks like Goldman Sachs and Merrill Lynch) as commercial traders.

THE PROBLEM OF HYPER-SPECULATION AFFLICTS A WIDE RANGE OF MARKETS

Natural Gas

In March of 2006 I published a report for the Attorneys General of Illinois, Iowa, Missouri and Wisconsin that concluded that all was not right in natural gas financial markets. The report showed a close correlation between the escalation of prices and changes in trading policies and practices (See Exhibit 2). The report combined that empirical observation with a detailed explanation of the cause of the problem, which is excerpted below.

Exhibit 2:
Natural Gas Wellhead Prices and Major Changes In Trading Activity



Source: Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 8.

Thus, while there is a spiral of upward pressure on prices radiating from the physical market and filtered through regulation, this analysis shows that the financial commodity markets may be dramatically accentuating the problem of high and volatile prices.

Defenders of the financial markets want to blame the whole problem on the physical markets and even claim that traders will help solve the problem. But the evidence suggests that the financial commodity market bears at least some of the blame for pushing prices up. Today, the evidence that the financial commodity markets are significantly accelerating price increases in natural gas markets is circumstantial, but quite strong.

The overall pattern of prices supports the proposition that they have run up beyond anything that is justified by the problems in the physical market.

- We have a commodity that is vulnerable to abuse, in a new market that has been under-regulated from its birth.
- Public policy adopted in 2000 further reduced regulation and opened the door to counterproductive, if not outright manipulative, behaviors and pushed prices higher.
- We have a clear theory about how consumers could be hurt in this market.
- The problem is that both the structure of the market and the behaviors of market players are biased in favor of higher prices and against consumers.
- We have evidence at the micro levels of a pervasive pattern of past abuses and rumors about suspicious behavior in the current market.[5]

There are several ways in which financial markets may be magnifying the upwardly volatile spiral of prices and contribute to the ratchet:

Financial markets thrive on volatility and volume, but volatility and volume have costs. Producers of gas demand to be paid a higher premium to bring their gas to market sooner rather than later. Traders demand to be rewarded for the risks they incur, risks that are increased by the trading process itself.

The influx of traders fuels volatility and raises concerns about abusive or manipulative trading practices.

Econometric analyses of the natural gas markets in recent years raise important questions as to how well the natural gas markets work. Given the uncertainty about the functioning of these markets, the claim that the market price is always right because it's the market price should be questioned:

The economic analysis does not support the claim that these markets operate efficiently to establish prices.

Risk premiums, which raise the price substantially (10 to 20 percent), are high and rising.

Prices are well above the underlying costs of production.

The operation of financial markets is no accident. Trading reflects the rules that are established – by law and through self-organization. The most troubling part about natural gas trading is that policy makers really have no clue about what goes on:

The majority of transactions take place in markets that are largely unregulated.

[5] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 88.

> These over-the-counter markets, reported in unaudited, unregulated indices, are a major factor in setting the price of natural gas. And these unaudited, unregulated markets have behaved very poorly in recent years, with numerous instances of misreporting of prices.
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> Even where there is light-handed regulation, the rules are inadequate to protect the public:
>
> Players in the natural gas markets can hold very large positions without having to disclose the size of their positions to any regulatory authority, and a small number of large players can influence the price that consumers pay in a very short period of time and under circumstances that place the consumer at risk.
>
> Index prices are often based on a small number of self-reported transactions and there are no mechanisms for determining if such transactions represent an accurate sampling of the natural gas market. When even the hint of accountability was imposed by merely being asked to certify the veracity of reported transactions, traders stopped reporting.[6]
>
> There has been a failure of public policy at every level to build a system that protects the public. The structure of the physical markets induces conduct that has created and is sustaining a tight market. The structure of the financial commodities markets induces conduct that magnifies upward pressures on prices…
>
> The financial markets are not only largely unregulated, they are structured in such a way that there are a large number of small buyers who have weakened incentives and limited ability to resist price increases facing a small number of large sellers who have a strong incentive and a much greater ability to hold out for higher prices. Holding out on the supply side may simply mean buying and holding assets in the ground or positions in the futures market and waiting for buyers who need the commodity to blink.
>
> Most troubling is the fact that many of the impacts of many of the legislative and regulatory policies that have worked to the detriment of consumers were predictable and preventable, given the nature of the commodity and the type of market that Congress and the regulatory agencies in Washington created.[7]

When the Federal Energy Regulatory Commission got wind of the report, without ever talking to us about it, they ridiculed it at an open meeting of the Commission. The Chairman of the FERC, reflecting the party line of the Administration, insisted that all the price gyrations were the result of market fundamentals. He was absolutely certain that the FERC had its finger on the pulse of the commodity markets. He was absolutely wrong.[8] At the very moment he was rejecting our analysis, unbeknownst to him, the Amaranth corner was taking place. Neither the FERC nor the CFTC had a clue about what was going on.

Missing a massive manipulation is embarrassing, but the real damage came when the blind ignorance of the FERC led it to waste the chance to use its newly minted powers under the Energy Policy Act of 2005 to follow our recommendations to adopt a broad view of abusive behaviors that afflict energy commodity markets.[9] As I wrote in the natural gas report:

> The FERC has also issued rules implementing the Energy Policy Act of 2005 that change its market monitoring procedures and implement new powers granted in the Act. It has

[6] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 9.

[7] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 89.

[8] A point-by-point response to the FERC's misguided comments on the report was provided to but never acknowledged by the Commission (Letter Appendix to Cooper, The Role of Supply, Demand and Financial).

[9] Federal Energy Regulatory Commission, Order No. 670, Prohibition of Energy Market Manipulation, Docket No. RM06-3-000, January 19, 2006; Memorandum of Understanding Between The Federal Energy Regulatory Commission and the Commodity Futures Trading in Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information, October 12, 2005.

> entered into a vague memorandum of understanding about sharing information. The foregoing analysis demonstrates that a lot more than manipulation is at issue in the natural gas price spiral and suggests that much more needs to be done. Both the FERC and the CFTC are looking for a very narrow range of manipulative behaviors with a very narrow telescope. Unlike other physical commodities, a vast amount of trading of natural gas goes on in the over-the-counter markets that are hidden from the view and beyond the authority of these agencies. The indices that are based on this unregulated market activity have been unreliable and remain subject to doubt.
>
> In the case of regulated activities the changes at the FERC replicate the weaknesses of the CFTC approach by adopting its definitions and case law. It may be illegal to contrive to manipulate markets and there are new fines if you are caught doing so, but the FERC is going to have great difficulty proving manipulation, when prices are "moved." It is precisely for this reason that the CFTC and the exchanges subject to its jurisdiction do more than rely on narrowly defined manipulation statutes to prevent abuse.[10]

The FERC and the CFTC have failed to adopt a broad view of abuses in financial markets. They cannot see the abuse because they are not looking for it. My earlier analysis of natural gas markets identified the numerous ways that prices can be moved by actions that are well below the radar of the FERC and the CFTC.

> There are strands in this literature that identify potential and actual abusive practices…
>
> manipulation facilitated by large positions,
>
> lack of transparency,
>
> structural advantages enjoyed by large traders or the exercise of market power,
>
> insider trading and self-dealing,
>
> trading practices that accelerate market trends, perhaps causing them to overshoot.[11]

Instead of taking a hard look at the broad pattern of abuse, the FERC adopted a very narrow view of manipulation, taking on the existing CFTC case law and definitions. Instead of providing new and vigorous oversight over the natural gas market, we have a second cop walking the same beat with it eyes half shut.

Unfortunately, the Federal Trade Commission has started down the same useless path. The lengthy discussion of intension (scienter) in the advanced notice of proposed rule making points the FTC down the same dead end path that the FERC took. The FTC needs to break out of the narrow "scienter" manipulation view to identify and attack the broad range of practices and structural conditions that can and have been moving prices in the markets.[12]

Policymakers must recognize that certain commodities are fundamentally different. Energy is at the top of the list of commodities that have special vulnerabilities, but energy commodities are not alone. The transformation of commodity markets into speculative engines is hurting food commodities as well. The description I wrote of natural gas applies to greater or lesser degree to the entire energy complex and many food commodities.

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[10]Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 93

[11] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 68.

[12] Federal Trade Commission, *Prohibition on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007,* 16 CFR 317.

> Because natural gas is a physical commodity that is actually consumed (unlike a pure financial instrument), difficult to store, and expensive to transport, natural gas markets are challenging… The key elements identified are the supply-side difficulties of production, transportation and storage, and the demand-side challenges of providing for a continuous flow of energy to meet inflexible demand, which is subject to seasonal consumption patterns.
>
> "[T]he deliverables in money markets consist of a "piece of paper" or its electronic equivalent, which are easily stored and transferred and are insensitive to weather conditions. Energy markets paint a more complicated picture. Energies respond to the dynamic interplay between producing and using; transferring and storing; buying and selling – and ultimately "burning" actual physical products. Issues of storage, transport, weather and technological advances play a major role here. In energy markets, the supply side concerns not only the storage and transfer of the actual commodity, but also how to get the actual commodity out of the ground. The end user truly consumes the asset. Residential users need energy for heating in the winter and cooling in the summer, and industrial users' own products continually depend on energy to keep the plants running and to avoid the high cost of stopping and restarting them. Each of these energy participants – be they producers or end users – deals with a different set of fundamental drivers, which in turn affect the behavior of energy markets…
>
> What makes energies so different is the excessive number of fundamental price drivers, which cause extremely complex price behavior."
>
> Complexity of physical characteristics translates into a highly vulnerable product in this commodity market.
>
> "Although the formal analysis examines transportation costs as the source of friction, the consumption distortion results suggest that any friction that makes it costly to return a commodity to its original owners (such as storage costs or search costs) may facilitate manipulation.
>
> The extent of market power depends on supply and demand conditions, seasonal factors, and transport costs. These transport cost related frictions are likely to be important in many markets, including grains, non-precious metals, and petroleum products.
>
> Transportation costs are an example of an economic friction that isolates geographically dispersed consumers. The results therefore suggest that any form of transactions cost that impedes the transfer of a commodity among consumers can make manipulation possible.[13]

These characteristics demand much more vigorous oversight of energy and food commodity markets than other commodities, especially financial instruments and precious metals that have few physical uses. Unfortunately, for about a decade we have had much less oversight of energy markets. More broadly, the transformation of commodity markets generally has created problems for physical markets. When commodity markets lose touch with the underlying physical market fundamentals, they do more harm than good.

Physical traders get frozen out. I found this in my study of the natural gas market. The utilities that actually sell the gas to the consumer could not play in the hyper-inflated commodity markets. They simply tied their purchases to the indexes, hoped for the best and let the consumer suffer the consequences.

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[13] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, pp. 28-29

There is a general consensus that utilities are not in the markets as hedgers, although a small number are. Moreover, there is a belief that hedging has declined, as volatility and large financial players have moved into the market.

"Most utilities have stopped hedging and instead rely on the fuel-adjustment clause that allows them to pass on to consumers… Many utilities exited trading, Duke being the last one. The point is they are not really in the game except for Constellation, Sempra, Dominion and a few others. That more customers are exposed to price risk because they are passing on the higher costs to customers."

Cooper said many utilities probably have stopped hedging in such a risky environment because they have to eat their losses if they miscalculate. "Utilities are not in the business of predicting prices," he said. "They don't care what the price it. They pass it on to customers."

While the institutional context in which utilities function certainly restricts their inclination to play in the financial market, as volatility and prices mount, it becomes more burdensome for all users. The cost of hedging becomes higher and higher.

But with gas above $10/mmBtu and futures market direction unpredictable, even hedging and other risk management tools are becoming more and more expensive – raising the question of whether the benefit is worth the cost…

For example, Invista uses financial derivatives, collars and similar tools to hedge against current market conditions. But gas at $10/mmbut or higher and unprecedented volatility "makes all of these actions a little more costly," Poole noted. "It raises the question: is the elimination of price volatility worth the cost?"

And while Invista has the money and in-house expertise to handle risk management activities internally rather than farming them out to marketers or energy service companies, "unfortunately, for smaller-volume companies that may not be a feasible option."

Tying prices to indices is the ultimate short-term strategy. This institutional view raises concerns because the capital-intensive infrastructure of the industry has historically been financed by long term contracts. The deregulation and unbundling of the industry inevitably shortened the time horizon of the participant. Flexibility and choice loosens commitments and makes "bypass" possible. Pipelines cannot count on shippers as much as in the past. Utilities cannot count on load as much as in the past. Merchants demand faster recovery of costs.

In fact, a major impetus for restructuring of the natural gas industry was the high social cost associated with rigid long-term contractual arrangements…

With the natural-gas sector restructuring… trading arrangements have become much more short term and flexible in both price and in terms and conditions. We have observed this phenomenon throughout the natural-gas sector, from gas procurement, gas storage, and retail transactions, to capacity contracting for pipeline services.

Long term commitments to transportation and storage facilities, exposes the contracting parties to greater risk in this environment, especially where long term commitments to supply cannot be secured. The mismatch between the incentive structure and the necessary time horizon results in missed opportunities. For example,

Jack Flautt, Managing Director of March & McLean, suggested there is an anomaly in the storage investment area. It is strange, in his view, that investors are not trampling one another to participate in the storage development market. "The value of storage today is

greater than at any time in my lifetime," but Flautt reported he gets only blank stares from bankers at the suggestion.

The hesitance of public utility commissions to push utilities to jump back in to long-term commitments is understandable and the task of realigning risks is challenging.[14]

Petroleum

The problems that have afflicted natural gas have afflicted other energy commodities as I explained in my natural gas analysis...

Natural gas markets share this pattern of abuse with other energy markets. Unilateral actions by any of a number of individuals in any of a number of circumstances provide a landscape in which upward price movements are probable. "There are regular squeezes in the Brent [oil] market… The whole trick is to collect more money in CFDs [contract for differences] than you lose on the physical squeeze… People seem to do it in turn. It depends on who's smart enough to move in a way nobody notices until it happens."

In a case brought by a private party in late 2001, the practical reality was revealed.

Tosco won a settlement claiming that Arcadia Petroleum (a British subsidiary of the Japanese firm Mitsui) engineered an elaborate scheme to manipulate oil prices in September of 2001 through the use of OTC derivatives and a large cash market position to corner the market in Brent crude oil. As a result, the price of Brent crude soared between August 21st and September 5th and pushed its price to a premium over West Texas Intermediate crude oil (WTI)…

Dated Brent, which acts as a price marker for many international grades, is physical crude traded on an informal market, rather than a regulated futures exchange. This lack of regulation poses problems for oil producers and consumers seeking a fair price… A typical Brent squeeze involves a company quietly building a strong position in short-term swaps called contracts for difference, or CFD's, for a differential not reflected in current prices. The company then buys enough cargoes in the dated Brent market to drive the physical price higher, which boosts the CFD differential…

The Company may lose money on the physical side, but it's more than compensated for by profits on its offsetting paper position in the short-term swaps market."[15]

The problem in oil markets has continued to mount, as I explained in a law review article written in 2007.

On April 29, 2006, the *New York Times* ran a front-page article under the headline "Trading Frenzy Adds to Jump in Price of Oil."[16] The *Times* article opens with a brief paragraph on the conditions in the physical market but then devotes about 36 column inches to the proposition that financial markets are adding to the price increase.

"A global economic boom, sharply higher demand, extraordinarily tight supplies and domestic instability in many of the world's top oil-producing countries – in that environment higher oil prices were inevitable.

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[14] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 83.
[15] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 64.
[16] Jad Mouawad & Heather Timmons, *Trading Frenzy Adds to Jump in Price of Oil,* N.Y. TIMES, Apr. 29, 2006, at A-1.

But crude oil is not merely a physical commodity . . . It has also become a valuable financial asset, bought and sold in electronic exchanges by traders around the world. And they, too, have helped push prices higher...

"Gold prices do not go up because jewelers need more gold, they go up because gold is an investment," said Roger Diwan, a partner with PFC Energy, a Washington-based consultant. "The same has happened to oil…"

"It is the case," complained BP's chief executive, Lord Browne, "that the price of oil has gone up while nothing has changed physically."[17]

Three key factors serve to drive the price spiral higher: volume, volatility and risk…

The structure and availability of markets plays a role in allowing the volumes to increase.

Changes in the way oil is traded have contributed their part as well. On Nymex, oil contracts held mostly by hedge funds – essentially private investment vehicles for the wealthy and institutions, run by traders who share risk and reward with their partners – rose above one billion barrels this month, twice the amount held five years ago.

Beyond that, trading has also increased outside official exchanges, including swaps or over-the-counter trades conducted directly between, say, a bank and an airline…

Such trading is a 24-hour business. And more sophisticated electronic technology allows more money to pour into oil, quicker than ever before, from anywhere in the world.

The influx of new money is sustained by movements of different institutions and individuals into the market. "Everybody is jumping into commodities and there is a log of cash chasing oil," said Philip K. Verleger Jr., a consultant and former senior advisor on energy policy at the Treasury Department."

This fundamental observation had been offered a couple of years earlier in a front page *Wall Street Journal* article entitled, "Oil Brings Surge in Speculators Betting on Prices: Large Investors Playing Ongoing Rise is Increasing Demand and Price Itself:"

Oil has become a speculator's paradise. Surging energy prices have attracted a horde of investors – and their feverish betting on rising prices has itself contributed to the climb.

These investors have driven up volume on commodities' exchanges and prompted a large push among Wall Street banks and brokerage firms . . . to beef up energy-trading capabilities. As the action has picked up in the past year, those profiting include large, well-known hedge funds, an emerging group of high-rollers, as well as descendants of once-highflying energy-trading shops such as Enron Corp.[18]

A recent paper from the Japanese Ministry of Economy Trade and Industry (METI) has echoed my conclusion and the conclusion of the Senate Permanent Subcommittee on Investigations.

According to the METI paper, during the second half of 2007, when the physical price of Wet Texas Intermediate crude averaged $US90 a barrel, market speculation, geopolitical risk and currency factors were responsible for $US30-$US40 of the price.

The average WTI "fundamental price," consistent with the underlying supply/demand situation, was around $US60/barrel during the December half-year, according to the paper, citing research for the Institute of Energy Economics in Japan.

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[17] *Id.*

[18] *Id.*

> Last week the benchmark WTI futures contract touched $US135/bbl, more than double the level of a year previously.
>
> "We cannot say exactly what the fundamental price is at the moment," a METI official said yesterday. "But we believe the increases this year in the market price have much to do with the influx of speculative money.[19]

The study from the Institute on Energy Economics mentioned above draws a direct link between the growth in speculation and the rising price.

> In the futures market, oil-futures trading at New York Mercantile Exchange (NYMEX) are expanding faster than actual spots. While the futures markets are designed to hedge price fluctuations risks, oil is becoming a commodity, making the futures market something like an alternative investment target. As a result, long position by speculators ("non-commercial" and "non-reportable") conspicuously leads to a rise in the oil prices in more cases.[20]

Exhibit 3 presents an updated version of the analysis that linked prices to changes in trading policy and practices base on spot prices for both natural gas and oil. It shows the close correlation of price movements and major institutional/structural changes in trading. The sharp increase in spot prices for West Texas Intermediate crude since early 2007 stands out. This actually links directly to one of the key policy issues that we have identified.

The Intercontinental Exchange, located in Atlanta, was granted a "no action letter" to trade contracts for West Texas Intermediate crude, exempt from U.S., regulation. There has been a rapid increase in trading Exhibit 4 shows this by contrasting the growth of open positions in West Texas Intermediate and Brent crude, another major marker crude. Starting in 2006 and accelerating in 2007 and 2008, the open positions in West Texas Intermediate left Brent crude behind. The extraordinary increase in the volume of trading puts upward pre

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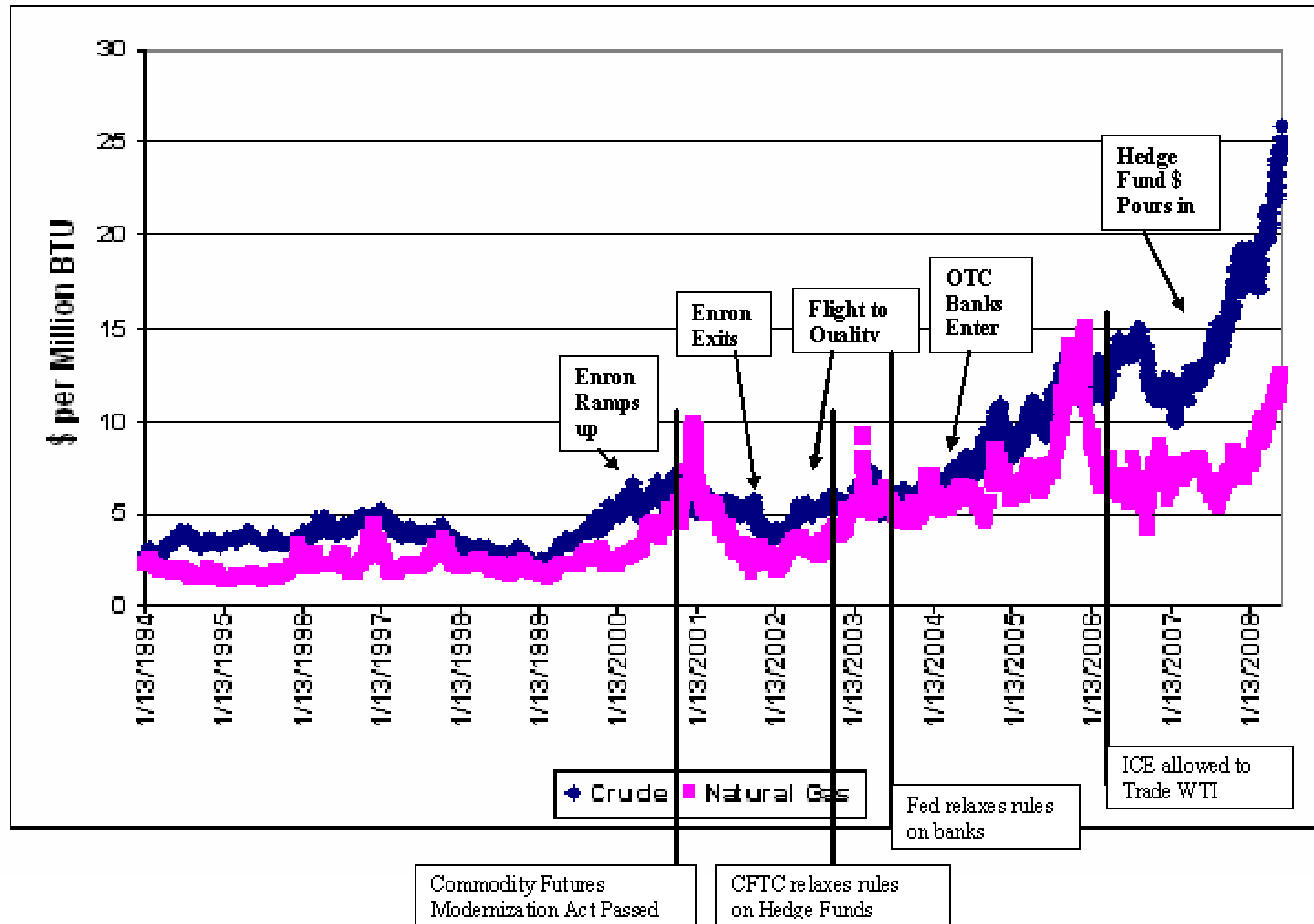
[19] Peter Alford, "Japan Blames Speculators for Oil Hike," May 28, 2008.

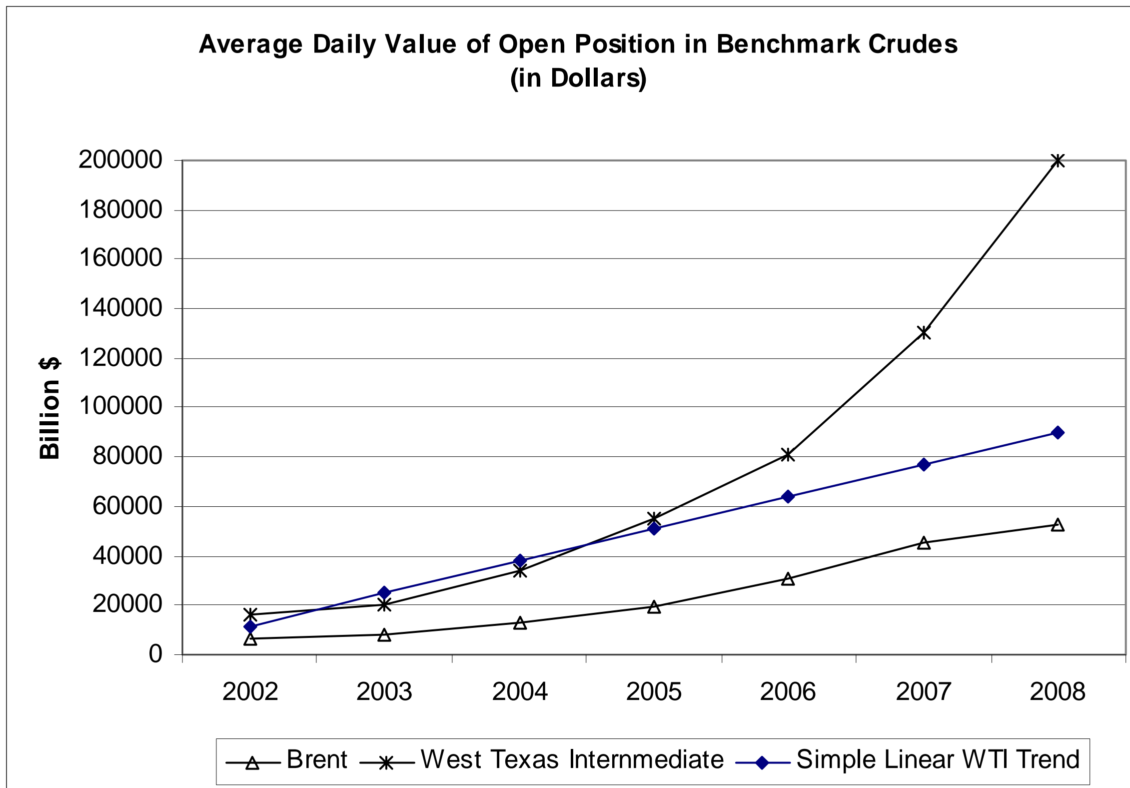
[20] Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices: Analyzing the Effects of Fundamentals and Premium* (Institute of Energy Economics, March 2008), p. 5.

Exhibit 3:
Energy Spot Prices, Deregulation and Changes in Trading Activity



Source: Energy Information Administration, Database and Source: Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 8.

Exhibit 4:



Source: Testimony of Michael Masters, Managing Member/ Portfolio Manager, Masters Capital Management, LLC, Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008, Note 16.

Food

The plague of the "influx of speculative money" has now spread to food commodities. For instance, the evidence is mounting that speculation is contributing to the run up in food commodity prices that we have experienced over the past year. Speculation can be seen as contributing to price increases and volatility, as a study from the University of Wisconsin recently noted.

> One unique aspect of the market the last year has been the size of the non-commercial position in the futures market for corn. Speculative traders have significantly increased their net long position over the last year, while non-commercial traders have tended to be net short. Note that corn prices have been highly correlated with the net positions of non-commercial traders since the first quarter of 2006/2007, and the speculators have had large net long positions most of the year. It is important to note that this does not imply

causality, only correlation. However, there does appear to be reason to study more carefully the impact of speculative activity on both price levels and volatility.[21]

The disutility of hyper-inflated commodity markets was recently underscored by a study of food commodities conducted by Texas A&M University.

> The increased activity in futures markets has had the unexpected consequence of reducing producer's ability to manage price risk using futures markets. The large influx of money into the markets, typically long positions, has pushed commodities to extremely high levels. But, these funds also quickly move large amounts of money in and out of positions. This has generated much more price volatility in the futures markets. In response, the exchanges have increased the daily move limits for most of the agricultural commodities over the past six months….
>
> The up and down volatility in the market and expanded trading price limits mean that more margin calls occur. Small elevators and even large grain companies and cotton merchants, who are trading even larger volumes, not to mention farmers doing their own price risk management, have been unable to make the margin calls.
>
> Producers, elevators, and companies use bank financing to finance their businesses and the price risk management. As the margin calls have increased, they have exhausted their ability to finance their normal hedging activities and have therefore been forced out of the market.[22]

Simply put, commercial entities that need the physical commodities to run their enterprises are priced out of the market. If you do not have deep pockets, are tied to the physical schedule of production and consumption, and live in the real world of bank finance, hyper-inflated commodity markets are a big part of the problem, not the solution.

REGULATORY REFORM IS THE WAY TO SOLVE THE PROBLEM

It would be reassuring if we could blame the current speculative bubble on the arrogance, ignorance and ineptitude of the regulatory agencies with oversight responsibilities. If that were the case, we could just fire the commissioners and secretaries and clean up the problem. Unfortunately, there is a more fundamental problem that must be addressed. Federal authorities must look broadly at the conditions in modern financial markets that feed volatility, amp up volume, and increase risk and policymakers must impose new structural oversight on these markets to return them to their proper role, as institutions that help smooth the functioning of physical markets. They have become centers of idle speculation that do vastly more harm than good.

With the commodities markets finally overwhelmed by speculation and the Congress empowering other agencies to do the job that the CFTC has failed to do, the CFTC has belatedly admitted that it did not have sufficient information to perform its primary function of preventing excessive speculation. The administration has formed a task force to look into the problem. The CFTC has finally asked that the foreign regulators to whom it abdicated its responsibility, to impose some order. Begging foreign exchanges for data and foreign regulators to act responsibly is not only embarrassing; it is absurd when the CFTC has not put its own house in

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[21] T. Randall Fortenbery and Hwanil Park, *The Effect of Ethanol Production on the U.S. National Corn Price,* University of Wisconsin-Madison, Department of Agricultural Economics, Staff Paper 523, April 2008, p. 16.

[22] David P Anderson, et al. *The Effects of Ethanol on Texas Food and Feed,* Agricultural and Food Policy Center, Texas A&M University, April 10, 2008, p.32.

order. These proposals are too little too late. The CFTC must be forced to assert regulatory authority over trading within the Untied States and trading in financial instruments designated in U.S. commodities.

Too much money chasing too few goods in the commodity markets has created the upward spiral, amping up volume, increasing volatility and adding to risk. We must turn down the volume in commodity markets. Sound prudential regulation is the key to restoring order.

The failure of the CFTC to act responsibly and in the past and the weak-kneed reaction to the dire crisis in commodity markets in the present ensure that Americans will continue to the victims of excessive speculation. Congress must enact broad reforms that close the loopholes, remove the discretion that was given to the CFTC and compel it to do its job. There are five areas in which reform is necessary, with a variety of policy making institutions needing to take action. It is a big job, but a $500 billion dollar hit on the economy and household budgets that are being devastated by rising prices of basic necessities demand the effort.

Chase out the bad guys

All traders must register and be certified (for honesty and competence, like bankers and brokers).
All trading must be reported across all transactions

The CFMA created a market in over the counter trading that is beyond regulatory scrutiny. These dark markets have played a prominent role in major manipulations. Without comprehensive registration and reporting, there will always be room for mischief that is out of sight to the regulator. Large traders should be required to register and report their entire positions in those commodities across all markets. Registration and reporting should trigger scrutiny to ensure the good character, integrity and competence of traders.

Eliminate the funny money

Raise margin requirements
Increase capital reserve requirements

We need to restore the balance between speculation and productive investment. Margin requirements on organized exchanges are a fraction of the margin requirements on stocks. If it is cheaper to put your money into speculation, why bother with real investment. The margin requirement for commodity trading among non-commercial traders should be fifty percent higher than the margin requirement for investment in stocks, but more lenient terms should apply to physical traders. Capital requirements should be increased to further reduce the amount of leverage in these markets and dampen excessive risk taking.

Reduce the ability to push prices up

Lower position limits and tie position limits and margin policies to needs of physical traders
Lengthen settlement windows
Ban conflicts of interest (analyst's reports that enrich analyst's portfolios)

Large position limits and short settlement periods invite efforts to influence prices. They should be reformed to reduce the risk. The practice of hyping prices by firms that stand to profit from the predictions should be should be banned.

Restore the proper functioning of commodity markets and their regulators

Enforce meaningful speculative limits
Do honest analysis (classify traders correctly)
Close the loopholes (foreign boards of Trade exemptions, the Enron and swaps loopholes)
Create minimum criminal penalties for violation of commodity laws

Public policy must return the futures markets to their function of supporting the operation of physical markets. Speculation should not be allowed to dominate these markets, and limits should ensure that genuine commercial traders are a substantial majority of the market by imposing strict speculative limits. Traders must e properly classified to ensure this outcome.

We must not only close the Enron-loophole, which allowed vast swathes of trading to take place with no oversight, but also ensure vigorous enforcement of registration and reporting requirements. We must take back the authority we have given to foreign exchanges and stop abandoning authority to private actors.

Failure to comply should result in mandatory jail terms. Fines are not enough to dissuade abuse in these commodity markets because there is just too much money to be made.

Redirect investment to productive long-term uses

Put a tax on short-term capital gains
Move pension funds out of speculation
Ban institutional index funds

We must level the playing field between long-term productive investment and short-term speculative gains, with a tax on short term capital gains between 33 and 50 percent to make holding productive investments for long periods as attractive as flipping short term financial paper.

Speculators will insist that they will just go abroad, but the Congress need not fear such an outcome. If the U.S. is determined to assert jurisdiction over trading in the U.S. and for U.S. commodities, foreign exchanges will comply. To survive they desperately need to have access to legal instruments for U. S. traded commodities. Individuals may chose to become expatriates and move to countries that chose not to comply, or they may break the law, but vigorous enforcement will put a stop to it. I suspect that the vast majority of traders do not want to live in places like Zimbabwe or Leavenworth, Bangladesh or Sing Sing.

If we do not do more than the half hearted approaches that are on the table, we will continue to lurch from crisis to crisis. American consumers are suffering needlessly from this speculative bubble in vital necessities. It is time for thorough reform and re-regulation of the financial commodity markets.