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# EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET

## HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

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~~The energy markets and the commodity markets in general, given their complexity and rapid transformation, are often vulnerable to market manipulation. Nobody can deny this given our recent experience with the U.S. Western energy markets crisis of a few years ago.~~

~~What is more important is to recognize that the nature of market manipulation evolves and mutates over time as the energy markets become more complex. In the past, market manipulation was typically associated with squeezes, corners, and withholding of physical supplies from the market. Today market manipulation can be accomplished in many different ways by taking advantage of a variety of trading platforms and leverage offered by derivative instruments. A typical scheme evolves around taking positions on different trading platforms, platforms that often receive different levels of regulatory scrutiny.~~

~~Subsequently, a potential manipulator may engage in bursts of rapid fire trading in one market around specific contract expiration time when market liquidity dries up in order to influence the prices used for settlements of outstanding contracts on other platforms and in other markets. The losses incurred through such trading would be typically offset by gains on the positions taken on other platforms and other instruments.~~

~~Also, a potential manipulator can use different platforms to decompose a scheme into different pieces and the regulators, who can see only one part of the bigger scheme, will not detect the manipulation in time.~~

~~I am getting close to my time limit so I shall briefly summarize the recommendations I would like to make. In my view, the efficiency and transparency of the U.S. energy markets can be increased without sacrificing the risk-taking culture and the spirit of innovation. The critical element of the market reform is, in my view, an improved access to information. Such initiatives may be initially opposed by many market participants but in the long run the industry will benefit from them. Less opaque, more transparent markets will grow and flourish in the long run, as evidenced by many other examples.~~

~~My recommendations include regular reports of large transactions executed in the OTC markets; elimination of the Enron exemption; regular reports of trading activity on the ICE exchange available to the trading community.~~

~~Thank you. I will be glad to answer any questions.~~

Senator LEVIN. Thank you very much, Professor Kaminski.

Professor Greenberger.

**TESTIMONY OF MICHAEL GREENBERGER,[1] LAW SCHOOL PROFESSOR, UNIVERSITY OF MARYLAND SCHOOL OF LAW, BALTIMORE, MARYLAND**

Mr. GREENBERGER. Good afternoon and thank you for inviting me to the hearing. I would submit my testimony.

I really wanted to cut to the chase on this. I am more than happy to answer questions. You have asked excellent questions of the prior panel.

[1] The prepared statement of Mr. Greenberger appears in the Appendix on page 137.

Senator Klobuchar, who is on the other side of this?

Senator McCASKILL. McCaskill, but that is OK.

Senator LEVIN. McCaskill.

Mr. GREENBERGER. McCaskill, I am sorry. Senator McCaskill.

Senator McCASKILL. We get mistaken all the time. It is OK.

Mr. GREENBERGER. It is interesting that you are from Missouri because you should be talking to Congressman Graves, who got the Enron loophole largely undone on a floor vote on the House of Representatives when the Republicans controlled the House and natural gas was at $14 per million BTU. It is at $7 today. Why did he do that? Because the farmers of Missouri were dependant on natural gas and were dying on the vine, paying $14.

Who is on the other side of this? Go look at the advisory committees that the CFTC sets up to advise them. You are not going to find the prior panelists on those advisory committees. You are not going to find your constituents who are paying 35 percent of their income from natural gas. Go down the list. It is Goldman Sachs. It is Morgan Stanley.

The CFTC is a captive of the industry it regulates. There is just no doubt about it. And I am under oath and I take that position.

When Mr. Cicio went to the CFTC in June 2005 to talk about the Inter Continental Exchange and the question of whether they should continue to be regulated as a United Kingdom company, which for purposes of crude oil they are, Osama bin Laden could not have been treated any worse by the CFTC because that was a consumer voice coming in to an agency that is dominated by the International Swaps Dealers and Derivatives Association, the Futures Industry Association, the Securities Industry Association, the Bond Market Association, and I could go on.

And Senator McCaskill, you will meet those people believe me, if you want to do away with the Enron loophole. And they will give you every reason under the sun not to do it.

Amaranth. Nobody got burned besides the investors of Amaranth. Well, your prior panel made it clear and your constituents are telling you that they got burned. People locked in to prices that were artificially high in the summer of 2006 and turned around and the spot price was at least one-third lower than what they had to charge their consumers.

If you talk to people like the New England Fuel Institute, these are small businessman. When you ask them what is the global impact that is going to be, that is not what they are dealing with. And I will tell you what the global impact is going to be. But their consumers are furious with them. And they are not controlling this situation. They are trying to hedge.

Yes, you need speculators in this market. The markets could not function without speculation. But these are not casinos. Amaranth turned it into a casino. If you want to have gambling, go to Las Vegas.

This is for a commercial purpose to allow farmers and producers to hedge and the speculators are invited in to create liquidity. And the statute, because of the farmers who were taken to the cleaners by the Chicago Board of Trade at the turn of the 20th Century, the farmers were the ones who insisted there be no excessive speculation.

And by the way, the Enron loophole does not apply to the agricultural interests. If it did, you have wheat producers here complaining about what is happening on these markets. And the farmers are too smart and too vigorous to allow this to happen to them. Agriculture remains completely under the control of the CFTC.

Now with regard to people going over to London, the Inter Continental Exchange bought the British International Petroleum Exchange. And with that fig leaf, they present themselves as a U.K. company. And they want to take advantage of that.

But are they going and buying up London exchanges? No. They have just made a $12 billion bid for the Chicago Board of Trade. They bought the New York Board of Trade. They want to do business in the United States. These kinds of contracts are not—you cannot go to Dubai and hedge for natural gas that is going to be delivered in the United States. The United States is the industry here. ICE is dying. They want to take over the Chicago Board of Trade. They do not want to go to London.

The Enron loophole, if I might just conclude, Alan Greenspan, Secretary Summers, Chairmen Levitt and Rainer, the Chair of the CFTC, each told Congress do not pass the Enron loophole. The market is too much subject to manipulation. The House did not pass it. How did the Enron loophole get here? It was introduced in cover of darkness. It suddenly appeared.

And Senators Feinstein and Cantwell, after seeing the manipulation caused by EnronOnline, raising the price of electricity $40 billion for the consumers of California, ask them about these exchanges and what impact they do. You will hear their answer and you will hear Amaranth's people, they have an economist today who has testified in 83 different proceedings. I counted them. Your constituents do not have an expert who has testified in 83 different proceedings. You are the expert.

Yes, there should be speculation. There should not be excessive speculation. If you are worried about prosecution, cut it off in the beginning the way NYMEX tried. NYMEX told them do not go afar. We do not know what this is going to do, but you are going to cause a dysfunction in the market. Stop. That was not prosecution. That was prescriptive regulation that avoided prosecution.

This can be stopped in a flash.

And finally, with regard to bilateral, that is a very dangerous word, bilateral. Because EnronOnline, which needed the Enron exemption—by the way, Enron predefunctness set up their EnronOnline before they got the Enron exemption, they were so confident they were going to get it. It was grossly illegal and criminal but they had it running.

And by the way, when you look at this report and see who the Amaranth traders were, they were old Enron officials, traders rather. They brought Enron on. And Amaranth may have gone, Brian Hunter took home $75 million the year before the collapse. He does not have to give that back. And the next time we have a crisis like this, you are going to find the Amaranth traders have been hired by somebody else.

Senator LEVIN. Thank you, Professor, very much. Thank you both for your testimony.

Let us get to the point—we have tried very hard, some of us, to close the Enron loophole. We had a vote on it on the floor. We were not able to persuade our colleagues. We limited it at that time to the electronic exchanges, to add the electronic exchanges to NYMEX. We thought we could get that done. We have been unable to get that done.

If that is all we can do this, does that do the job? If we could cover the electronic exchanges, does that do the job?

Mr. KAMINSKI. Probably not. In my view, it is necessary to put in place reporting requirements for the OTC transactions which are typically arranged by the voice brokers. It is a challenging task because, unlike the NYMEX and ICE transactions, many OTC transactions are highly structured and nonstandardized. And also, in many cases, they extend over longer time periods and contain proprietary information.

But at the end of the day any trading corporation has to summarize the positions. They have to know how many MMBtus they sold or bought, what is the position, what is the tenor of the positions. If they do not have this information, they should not be in the business.

And this information can be aggregated, summarized, and reported. I do not see any technical challenges related to it?

Senator LEVIN. There is no technical challenge to getting to the whole over-the-counter market? Is that what you are saying?

Mr. KAMINSKI. Yes.

Senator LEVIN. You agree with that, Professor Greenberger?

Mr. GREENBERGER. My own personal view is, and it is not based on any scientific study, is I think the voice brokers play such a small role in this. If voice brokering was OK, you would not have ICE and you would not have had EnronOnline. I sat in meetings with people when the CFMA was discussed and people from Goldman Sachs and the financial markets said, oh my God, you are going to make us do things by voice brokerage? That takes time. I am one call. I want to go to a computer screen and press a button.

If I could just interrupt, Senator Levin, they call that bilateral trading because it is bilateral. They have entered into an agreement by pressing a button. That is multilateral trading. That must be covered and can be covered and should be and would be covered if the Enron loophole were eliminated.

Senator LEVIN. So that you basically believe we could technically write a law which would cover the trading which you just described if it were described by either electronic or by size?

Mr. GREENBERGER. Yes. The technical word has already been multilateral transaction execution facility. And you must be careful because the industry will come to you and say oh no, what we are doing is bilateral. But you want to look in what they are doing.

Senator LEVIN. I understand. But now if we are able to finally get the regulators into that area, will there be a move to true bilateral trading? Or is that so impractical for the traders that they will not move to a true bilateral trade?

Professor Kaminski.

Mr. KAMINSKI. I agree with my colleague. The days of market based on voice brokers are probably counted. The markets across the world are moving to electronic trading. And even if we have an initial reaction and some migration of trading from the electronic exchanges like ICE back to the broker market, it will not last long.

Senator LEVIN. And you agree with that, Professor Greenberger?

Mr. GREENBERGER. Yes, absolutely. You want to get to the multilateral computerized trading.

Senator LEVIN. And you have no concern that if we cover that, there will be a return to the true bilateral voice brokering? That is not a concern?

Mr. GREENBERGER. That is not a concern and my own view is it would be impractical to try and reach the bilateral voice brokering.

Senator LEVIN. Now who is going to be the enforcer? Who is the regulator here? Is it CFTC through NYMEX and through ICE?

Mr. GREENBERGER. The important point that I think has been lost in all of this is that each exchange, once they are regulated by the CFTC, is a self regulatory organization. They are the front line of protecting the consumer. The CFTC cannot do it all.

Senator LEVIN. Can ICE do it?

Mr. GREENBERGER. Yes, absolutely. But they are not required to right now.

Senator LEVIN. And who is going to do the multilateral trading regulation?

Mr. GREENBERGER. In that case you are quite correct, there would not be a self regulatory organization. But the multilateral transaction execution facility would report directly to the CFTC, as EnronOnline would have had they not achieved this still-of-the-night exemption.

Senator LEVIN. So they would report to the CFTC. Do you agree with that?

Mr. KAMINSKI. Yes, I do.

Senator LEVIN. Now, that then puts at least that part of the trading into the hands of an organization that you say is captured or owned by the people who are being regulated. Is that a problem?

Mr. GREENBERGER. Well, as I understand it—I may have misread things. But on Thursday there is a confirmation hearing for two commissioners. One of them is a former lobbyist for the International Swaps Dealers and Derivatives Association.

I do not know this is a fact, but I would bet that person has written more testimony in opposition to taking down EnronOnline than any person in the United States.

Senator LEVIN. I am not disagreeing or agreeing with you.

Mr. GREENBERGER. And she is being paired with a former aide of Senator Daschle, and that is the way it is done. But there are three vacancies on this commission, including the chair.

Senator LEVIN. I am not agreeing or disagreeing with your point, in terms of controlling CFTC. I am simply saying if that continues, then would there be a problem in relying on CFTC regulating that part of the market which is not self-regulating?

Mr. GREENBERGER. I think with Congressional direction, and I think you are seeing a little bit on that what happened Friday afternoon with this new proposed rule, with Congressional direction, the CFTC would be responsive. And I think in terms of oversight—and I know that is not your function, if the CFTC could be encouraged to welcome the people like who were on the former panel and put them on their advisory committees so they have a voice in the regulatory process, I do believe that eliminating the loophole with good Congressional oversight the CFTC could handle this.

Senator LEVIN. Have you had a chance to read our entire report, either or both of you?

Mr. GREENBERGER. I have.

Senator LEVIN. Have you Mr. Kaminski?

Mr. KAMINSKI. No, I started reading the report last night on the plane. I read about 40 percent of the report and so far I agreed with practically every statement contained in the report.

Senator LEVIN. Thank you. Professor Greenberger, could you give us reaction to the report?

Mr. GREENBERGER. I have worked in this area for 10 years. And what comes a close second to this report is the report that was put out under Senator Coleman's auspices a year ago dealing with the crude oil industry. This report had the advantage of market data.

Leaving aside where it comes out, it is the most full complete report giving you a major understanding of the markets, the need for hedging, the role of speculation, the problem with excessive speculation, and the way the statute works. I think is a first-rate piece of work and the Subcommittee is to be congratulated.

Senator LEVIN. We and our staff thank you both for those comments.

Now, let me go on to the final question that I have, and this has to do with that chart we had up there before.

There was a direct order to Amaranth to reduce its holdings. And the reason for that order was that the NYMEX saw a danger in what was about to happen. It was preventive.

Would you agree that we have got to act in order to prevent harm? And that it is not enough to simply rely on the manipulation provisions of law, which then punish actions that have taken place? Would you agree with that?

Mr. GREENBERGER. Absolutely.

Mr. KAMINSKI. Yes, I fully agree with this. The problem is that one could argue that there is no problem with excessive market manipulation and speculation if the losses are limited to a group of highly sophisticated investors who should know better when they invest in the hedge funds.

The problem is that in a market economy prices have consequences. And if prices are distorted through excessive speculation, this has a systemic impact on the markets. And I worry not so much about this unfortunate incident. I worry more about the systemic impact the excessive speculation will have on the future of the energy markets. This would be a greater concern to me than the specific case of consumers overpaying for natural gas last winter.

Senator LEVIN. I did have an additional question. That is, the CFTC rule last week, and whether or not by requiring traders on regulated exchanges to disclose their holdings on the unregulated markets, whether or not that goes anywhere close to what we are talking about here.

Mr. GREENBERGER. It goes a little bit of the way but not the whole way. For one thing, I am sure what the CFTC is saying to people now is they are getting data that they are required to get from NYMEX. ICE has "voluntarily" agreed to give them data.

What are they going to do with the data? They have got to have some standard. And the standard is excessive speculation. Congress has to tell the CFTC, you can deal with expressive speculation on ICE and multilateral exchanges like ICE, and what is excessive speculation.

Look, bookies even stop taking bets at some point because they are worried about what is going to happen. NYMEX stopped taking bets not because NYMEX was worried about the consumer interest. This was all done on borrowed money. Using a contract, you only put down 10 percent of the funds. Banks are funding the rest. Clearinghouses are guaranteeing the banks.

What NYMEX was worried about was Amaranth was going to fail and their clearing function would collapse.

So there is an economic measure here that needs to be followed. Clearly eliminating the Enron loophole would bring ICE into the measure. No prosecution, no enforcement. Just when you get to a certain level, thank you, you have provided liquidity to the market. Now you have to step back. Which is what NYMEX told Amaranth. It would have been in Amaranth's best interest to step back.

Senator LEVIN. It is going to take some direction from Congress. It is not enough that the information simply be available, that it is going to take the removal of the Enron loophole essentially, if we are going to cure this problem. You both agree with that?

Mr. GREENBERGER. Yes.

Mr. KAMINSKI. I do.

Mr. GREENBERGER. One other point about that rule is it does not require—NYMEX can get information about a trader under that rule, what the person is doing on ICE. If the person says hey, like Amaranth said, I do not want to get into this regulatory thing. I am just going to trade on ICE, that rule does not call for the information to be gathered. It only helps NYMEX. It does not help the regulator or the policymaker understand if all of the traders decide to do what Amaranth did and go to ICE. It does not affect that trading.

Senator LEVIN. It is only if they decide to continue on NYMEX that they would be covered.

Mr. GREENBERGER. Exactly.

Senator LEVIN. Senator Coleman.

Senator COLEMAN. Thank you, Mr. Chairman.

Professor Kaminski, I appreciate your reflections on systemic impact. And certainly the first panel's discussion talked about systemic impact. It is not just the traders who are impacted.

We have had a lot of discussion about excessive speculation. To both of you gentlemen, how difficult is it to define that? Is this accepted? And who does that? Is this something that Congress does? Can we leave it to the CFTC? Both of you gentlemen, Professor Kaminski.

Mr. KAMINSKI. Yes. It is very difficult to define excessive speculation and the term itself is a bit fuzzy and ambiguous. I would identify three or four different types of players in the energy markets. We have pure speculators and they are critical to the process because they provide the necessary lubrication to the process.

We have big market makers and the financial institutions which take proprietary positions and in this sense they speculate. But they also offer the risk management tools to the producers and consumers of energy. And they are a critical component of the system because they help to reduce the risk to those participants in the industry who are risk averse.

And finally, we have producers and consumers of energy who are interested in reducing somewhat the returns they get in return for reduction in risk.

My long-term concern is that the natural hedgers, the producers and end-users of energy, will depart this market if they are scared by excessive speculation. And we already have a lot of evidence that this is taking place.

Senator COLEMAN. Professor Greenberger.

Mr. GREENBERGER. I think you do not have to define it. I think you can give guidance. I think the CFTC can do it by rule. And the assurance here is NYMEX had already done it. They had accountability rules. That is what led NYMEX to tell Amaranth to stop. This is not rocket science. This can easily be done.

Do not forget a large trader is someone who trades 200 contracts. Amaranth had 100,000 contracts. As Mr. Cicio said, all of the contracts on NYMEX for the contract month he is talking about, by everybody buying contracts on NYMEX for the month he referred to is 90,000. Somewhere we can come to an agreement where speculation is good but you cross a line.

This is the kind of thing financial regulatory agencies do every day, capital rule requirements, what have you. You pick a figure based on guidance from Congress.

Senator COLEMAN. Professor Greenberger, you raise questions about CFTC that are not just legislative direction issues or regulation issues. It goes to basic structure, mindset.

Mr. GREENBERGER. That is correct. And I think there is a great opportunity for the U.S. Senate to put the right consumer oriented mindset. You have three vacancies coming up. It has been traditional that anybody who supports the industry gets passed on the Senate floor by a voice vote with no discussion. Senator Feinstein went to the floor in the last hours of the 109th Congress to stop the lobbyist from ISDA because she knows what ISDA's concept did to the electricity payers in California.

You have got three vacancies now. This is a great opportunity to reshape that agency.

Are there going to be industrial consumers represented in the Commission? Are there going to be regular consumers in the Commission? Are there going to be academics? Today, if the Financial Industry Association, the International Swaps Dealers Association, and the Bond Market Association give their blessing, the history has been the person goes through.

And even Republican commissioners, Joe Dial being the most famous, a former Texas Ranger, policeman not baseball player, and good friend of Phil Gramm from Texas was held on the floor of the Senate because he dared to question practices in the Chicago Board of Trade.

If you represent the consumer, you get stopped. If you are helping the banks, you sail right through. You have got to put a stop to that. These people who testified in the first panel and your constituents deserve representation. And if not representation, a majority interest in what the CFTC does.

It is no longer a backwater agency. This hearing shows that. Hundreds of millions of dollars are at stake, hundreds of millions and billions out of consumers' pockets.

If you let this sail through thinking it is some backwater agency, your constituents are going to pay through the nose and the Brian Hunter's of this world are going to take home $75 million a year.

Senator COLEMAN. Could you talk a little bit about financing regulation? There was some discussion about user fees a little while ago. I would be interested in your perspective.

Is there a point at which those user fees, in fact, drive folks to other markets? Is this something we should be concerned about?

Mr. GREENBERGER. There are user fees in every market except the futures market. I think user fees, let me tell you, if you try and put user fees in the CFTC, you are going to hear who the other side of the common sense because it will eliminate silk linings in suit jackets if they have to pay those user fees.

But I think user fees should be explored. I have not thought it through very carefully. There is no reason the U.S. public should have to pay to make sure that Brian Hunter keeps his trading limited to speculation as opposed to excessive speculation.

Senator COLEMAN. Do you have any concerns, Professor, about any shifting to opaque markets, any shifting to the bilateral or non-electronic markets? Is your sense that those are either small percentages or not practical questions?

Mr. GREENBERGER. I sat and heard people from Goldman Sachs tell me 10 years ago, voice brokering is a dying art. It is still done but that is not the way you make your silk lining in your suits. I am not worried about that.

And I think ICE is the primary example. They portray themselves, even though they are in Atlanta and even though the investment banks own large portions of it, U.S. investment banks, even though they are trying to buy Chicago Board of Trade, they can say to themselves we are going to go to London. They are not going to London. This is where, these markets are where things are being done.

I remember the Chicago Mercantile Exchange had a contract that paid off depending on what the interest rates that Russian banks paid. You won if you guessed right, you lost money if you guessed wrong. And they called up one day and said guess what, the Russian banks are meeting before the contracts closed and they are lowering their interest rates for a day. So that when the contract has to get paid, the interest rate drops, then the contract expires, they go back and meet and raise it again.

Do you think people are going to trade natural gas contracts in Russia? No.

Senator COLEMAN. Professor Kaminski, you have talked about a globalized market. You have raised concerns about balkanized regulatory infrastructure. Can you talk a little bit about the offshore markets, about the bilaterals and something that we should be concerned about as we move forward?

Mr. KAMINSKI. I do not believe that any responsible corporate entity will move to migrate to trading on an exchange established in a banana republic. The U.S. market is too big and too important and too sophisticated to really lose the business to other trading platforms.

If this happens, the business will go to the countries which have a regulatory infrastructure which is similar to ours if not more complete. The regulatory institutions in those countries, like for example FSA in the U.K. will cooperate with the U.S. Federal agencies.

So I do not see a big danger in U.S. energy trading, energy exchanges losing business in the long run to other platforms. If this happens, it will be more—it will happen on a relative basis and will be just a manifestation of the fact that other markets outside the United States are growing and catching up.

So the U.S. market is not going to shrink in size. It will continue to grow. It may be relatively smaller compared to other markets but it will not go away.

Senator COLEMAN. Thank you. Thank you, Mr. Chairman.

Senator LEVIN. Thank you. Senator McCaskill.

Senator MCCASKILL. Professor Kaminski, in your testimony I looked at your written testimony, and you talked about the various aspects of manipulation. The second one you talked about was the aggressive rapid and large volume trading near the expiration of a contract talking about the excessive speculation, which we have talked about at some length at this hearing today.

The first one that you talked about, however, was the exploitation of market power control by the control of physical assets or physical supply. I would like both of you to address what, if anything, can be done in that area by Congress?

It is interesting to me because most businesses there is an incentive to invest in the capital infrastructure. There is a bottom-line business incentive to keep the infrastructure strong, to keep the capital investment at peak performance.

The irony is in this area there is a disincentive because if you can fig leaf a lack of supply because of a problem with the delivery in terms of the capital infrastructure, then it is a way that you can, in fact, manipulate the market to your advantage.

What, if anything, can we do in terms of that manipulation issue as it relates to market control of the physical assets and then therefore of the physical supply?

Mr. KAMINSKI. Well, one fact to be recognized is that the energy market is global integrated. But at the same time there are local pockets of market power which have been due to the rigidities and imperfections of the physical infrastructure.

And often at the specific trading location, far away from NYMEX and ICE, is a company which is relatively small in size can establish a dominating position because it controls the transmission lines or it controls the pipelines in a given region and takes advantage of the fact that it dominates a local market. And then it may engage in very similar strategies, taking positions in the derivatives and trading high volumes in the physical markets to influence the benchmarks which are used for settlement, cash settlement of derivative transactions.

Senator MCCASKILL. What can we do in Congress to address that kind of manipulation?

Mr. KAMINSKI. Information and information again. Just reporting the positions taken in the OTC markets and on ICE will preclude it, because this form of manipulation happens typically outside NYMEX, happens through the OTC markets, and happens through the ICE.

Senator MCCASKILL. So the prescription for the second kind of manipulation will also cure the first kind?

Mr. KAMINSKI. In my view it will go a long way to address this problem.

Senator MCCASKILL. You both have kind of addressed this, and that is that the attractiveness of our market, in fact, is due to the regulation, which is not what you hear from people who are working against regulation. You hear oh, if we regulate, they are going to run off someplace else.

But essentially what both of you are saying with your expertise in this area is that it is the certainty that regulation provides that is the magnet for the investment in this regard because people know it is not going to be a fixed house. Is that a fair way of summarizing your position on that issue?

Mr. GREENBERGER. Certainly in the financial area that is absolutely true. The proof in the pudding is after this report came out today, NYMEX started putting out press releases saying you want to invest securely, invest in a regulated exchange. Yes, that is the answer.

When Long Term Capital Management failed, the Chicago exchanges put out a full-page ad in all of the financial newspapers saying this would have never happened if this trading had happened on the Chicago Board of Trade or the Chicago Merc.

And yes, you do not want having indices arbitraged in advance of payments on these contracts like it happened in Russia with their bank thing. That would not happen in the United States, even with the most minimal regulation. Good regulation does attract interest.

I would also say, with regard to the IPOs going over to Europe, I would look at the percentage U.S. investment banks take to put out an IPO. I think it is 7 percent versus 4 percent in Europe. That may have a big explanation why IPOs are being done in Europe.

Senator MCCASKILL. As opposed to it is a less stringent regulatory environment?

Mr. GREENBERGER. Absolutely. And the other point is, about this arbitrage, potentially Congress passes a law, does things strictly. There is something called the International Organization of Security Commissions. And by and large, I remember when Long Term Capital failed, they put out a report about what needed to be done to control hedge funds. Many of the securities commissions want to look to the United States for how to regulate effectively, and on their own adopt procedures to try and stop these malpractices from happening.

Now they do not have somebody buying 100,000 contracts over there. They have not been exposed to this kind of massive excessive speculation, if not manipulation. But they would be very sympathetic to the kind of discussion that you are having here today.

Senator MCCASKILL. Let me finally address the comments you made, Professor Greenberger, about the CFTC and the oversight function that it has or has not based on the compilation of the board. I will tell you that it was fascinating to me maybe last week or the week before when we had a hearing in the Commerce Committee with the FCC. The commissioner from the FCC said well, the reason that they have not acted on this, if we can just talk the next panel into all agreeing, they would probably move forward. Of course, the next panel were all the industry players.

It was an absolute confession in a Senate hearing that the FCC was not capable of acting unless all of the people making money could, in fact, join hands and agree.

Are you saying that the CFTC has that same kind of dynamic, that they are dependent upon agreement of the big financial players in this area in order for them to do what they need to be doing right now?

Mr. GREENBERGER. I am going to be very candid with you, it is worse than that. It is a very small agency. It started out as an agricultural agency. And all of a sudden Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Bank of America, and all of these prominent people walked in the door and essentially unless you watch what happens, they take over.

If you look at the *Wall Street Journal*, I think it was December 13, 2001, there is a story there which I believe the protagonist agreed to where a lawyer from Sullivan and Cromwell called the commissioner over to the Washington, DC office of Sullivan and Cromwell and instructed that commissioner on how he should vote.

Now that would not happen at the FCC. It would not happen at the SEC. By the way, the commissioner came back and reported it immediately, and so maybe it did not happen at the CFTC either. But the fact that they thought that they could do that——

Senator MCCASKILL. They could.

Mr. GREENBERGER [continuing]. And by and large if somebody from Goldman Sachs or the Managed Funds Association, which is the industry association for hedge funds, needs an appointment with a commissioner my experience was, in the 2 years I was there, the appointment happens that day.

By the way, there is a lot of talk about the fact that the CFTC should be part of the SEC because a lot of these instruments it is hard to tell whether they are futures, derivatives, or securities. So why have a fight over it? Let us put them all in one——

Senator MCCASKILL. Put them all one place.

Mr. GREENBERGER. But I will tell you something, the people I am talking about do not want that to happen because they know that even with the present SEC that some people may think is more laissez-faire than traditional, they are not going to be able to say jump and hear the question back how high.

Senator MCCASKILL. Professor Kaminski, do you think it would be a good idea to move the CFTC under the SEC?

Mr. KAMINSKI. I did not think about it. Given the growing integration of the U.S. financial markets, it definitely makes sense to improve coordination between different agencies, including FERC, SEC, and CFTC. Whether it makes sense to create one big institution, regulatory institution, regulating all the markets, looking at all the markets, I have not been thinking about it so I cannot give you an informed opinion.

Senator MCCASKILL. I would welcome both of your comments about both a user fee structure so that we are getting the vig that we need to run the place.

And second, whatever thoughts you have about if, in fact, due to the changing and evolving financial transactions as it relates to these kinds of products, particularly in light of the global nature and electronic transactions, if it does make sense for all of this to be under the umbrella of one regulatory realization as opposed to being split up the way it is. I would appreciate your input on that.

Finally, I will just say that the biggest enemy we have here is complexity. Invariably the public can be the best lobbyist in the world, if they are aware, informed and understand. Unfortunately in this area this is so complex that most people do not understand the relationship between what they are paying on their gas bill and hedge funds and the speculative market. And frankly, until 2 days ago, I had no idea what ICE even was. I did not even understand ICE.

To the extent that you all can present the view of consumers from a very educated position is invaluable to this Subcommittee. I only wish that you could, in fact, multiply and fan out throughout the capitol and begin to do one-on-one visits with all the senators that have votes because I can assure you the other side will do exactly that. Thank you very much.

Senator LEVIN. Thank you, Senator McCaskill. Just a couple more questions to get this on the record.

The size of the Amaranth position on the market and the significance for the market when the traders get to be that large, is that a significant matter?

Mr. KAMINSKI. It is a very significant matter and Amaranth's position were known to the market. The market knew about it. And when I was watching the situation last year it was like watching a train wreck in slow motion. It was obvious that it would end up in a crash.

Senator LEVIN. Does it also affect future prices when someone can dominate the market to that extent?

Mr. KAMINSKI. Absolutely.

Senator LEVIN. Professor Greenberger.

Mr. GREENBERGER. Absolutely. The futures markets, to the extent they are transparent, are used for price discovery. If you are affecting them, these kind of trading affects the market. The collapse of Amaranth and the drop in natural gas, you do not have to be a rocket scientist or have an algorithm to figure out why that happened.

Senator LEVIN. To get a direct answer for the record, then the size of the Amaranth trades affected future prices?

Mr. GREENBERGER. Absolutely.

Mr. KAMINSKI. Yes, it did.

Senator LEVIN. In terms of CFTC, does it pay to—end the Enron loophole—close it, even with the current CFTC? Even if we cannot do these kind of changes, we are not the people who appoint them and whether or not they are confirmed is kind of a different issue, and an important one. But is it worth pursuing and following the road that we are on, even if we cannot impact the makeup of the CFTC?

Mr. GREENBERGER. I think it definitely is. I think that as captive as it sometimes is, that the direction from Congress will have an influence.

And also, the Commodity Exchange Act has a private right of action point in it. I say that hesitantly. I do not want to look to private lawsuits to protect these things. But if you put down these mandates and all these malpractices are happening, Amaranth's lawyer was quick to point out there was no intent here, trying to stay one step ahead of manipulation. I am not so sure that they are one step ahead.

But yes, you definitely should do this. It is an easy fix. Alan Greenspan would agree with you on it. He did not want this to happen in 1999–2000. It should be fixed immediately.

Senator LEVIN. Do you agree with that Professor Kaminski?

Mr. KAMINSKI. I agree that removing the Enron exemption will be very helpful. But at the same time, CFTC should be given more firepower. It may be underfunded and understaffed currently.

I have been watching the energy markets not only in the United States but also in other markets. And the common denominator is complexity. This is what was mentioned a moment ago.

There were many cases of manipulation in other countries. The regulators came. They looked at the complexity of the trades and volume of the data and they threw their hands up in the air and left. They did not have resources to investigate the issues.

Senator LEVIN. Senator Coleman.

Senator COLEMAN. Nothing. Thank you.

Senator LEVIN. Thank you both. You have been a tremendous panel and we are very appreciative.

Let us now welcome our final witness for today's hearing, Shane Lee, who is a former natural gas trader at Amaranth, appearing here today at Amaranth's request, to answer questions about its trading.

Let me just clarify what I just said, that even though Amaranth is the one that selected Mr. Lee to represent them and to answer questions today, we obviously are the ones that asked Amaranth to identify a witness who could answer questions about its trading, and Mr. Lee was identified by Amaranth as that person. Mr. Lee worked at the Calgary office of Amaranth where the energy trading was carried out.

Mr. Lee, we appreciate your being with us this morning. We welcome you to the Subcommittee. As you have heard, all witnesses who testify before the Subcommittee are required to be sworn so we would ask that you stand at this time and please raise your right hand.

Do you swear that the testimony you will give before this Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. LEE. I do.

Senator LEVIN. We have that system there where that light will go on a minute before the 5-minute mark, where we would hope that you could keep your oral testimony to. And we, again, appreciate your coming here. We know that you are coming here volun-

Testimony of

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Before the U.S. Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs

Regarding

**Excessive Speculation in the Natural Gas Futures Market**

Monday, June 25, 2007
11:00 a.m.
106 Dirksen Senate Office Building

My name is Michael Greenberger.

I want to thank the committee for inviting me to testify on the important issue that is the subject of today's hearings.

After nearly 24 years in private legal practice, I served as the Director of the Division of Trading and Markets ("T&M") at the Commodity Futures Trading Commission ("CFTC") from September 1997 to September 1999. In that capacity, I supervised approximately 135 CFTC personnel in CFTC offices in DC, New York, Chicago, and Minneapolis, including lawyers and accountants who were engaged in overseeing the Nation's futures exchanges. During my tenure at the CFTC, I worked extensively on regulatory issues concerning exchange traded energy derivatives, the legal status of over-the-counter ("OTC") derivatives, and the CFTC authorization of computerized trading of foreign exchange derivative products on computer terminals in the United States.

While at the CFTC, I also served on the Steering Committee of the President's Working Group on Financial Markets ("PWG"). In that capacity, I drafted, and oversaw the drafting of, portions of the April 1999 PWG Report entitled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," which recommended to Congress regulatory actions to be taken in the wake of the near collapse of the Long Term Capital Management ("LTCM") hedge fund, including Appendix C to that report which outlined the CFTC's role in responding to that near collapse. As a member of the International Organization of Securities Commissions' ("IOSCO") Hedge Fund Task Force, I also participated in the drafting of the November 1999 IOSCO Report of its Technical

Committee relating to the LTCM episode: "Hedge Funds and Other Highly Leveraged Institutions."

After a two year stint between 1999 and 2001 as the Principal Deputy Associate Attorney General in the U.S. Department of Justice, I began service as a Professor at the University of Maryland School of Law. At the law school, I have, *inter alia*, focused my attention on futures and OTC derivatives trading, including academic writing and speaking on these subjects. I have also served as a media commentator on the role of unregulated financial derivatives in recent major financial scandals, including the failure of Enron and the now infamous Western electricity market manipulation of 2001-2002 caused by market manipulation of Enron and others. Besides addressing these issues in a variety of commercial and financial regulatory law courses, I have designed and now teach a course entitled "Futures, Options, and Derivatives," in which the collapse of the hedge fund Amaranth Advisors LLC ("Amaranth") is featured as a case study of the way in which unregulated or poorly regulated futures and derivatives trading causes dysfunctions within those markets and within the U.S. economy as a whole, including causing the needlessly high prices which energy consumers now pay because of excessive speculation and illegal manipulation within unregulated OTC energy derivatives markets.

The Permanent Subcommittee on Investigations ("PSI") is to be congratulated on its excellent work in shedding light on these opaque markets and on the substantial economic damage that the lack of regulation has caused America's energy consumers. The bipartisan June 2006 PSI staff report, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*, [1] is the most complete analysis of the manner in which excessive speculation in the oil and gasoline futures and derivatives markets is, by the estimation of many prominent analysts, almost certainly adding approximately 20% to the prevailing price of crude oil, which was in June 2006 (and which is again today) hovering in the \$70 per barrel range – a price that far exceeds the approximately \$18 a barrel price as recently as January 2002.[2]

The authors of that June 2006 report were quick to recognize, however, that that it was based only on publicly available information and that the staff therefore had "gaps in available market data."[3] Those kinds of gaps were eliminated in the bipartisan report released by the PSI staff today: "*Excessive Speculation in the Natural Gas Market.*"[4] Today's report is the result of accessing all encompassing data pertaining to the natural gas futures and derivatives markets, including the analysis of "millions of natural gas

[1] Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT (June 27, 2006) [hereinafter Permanent Subcomm. June 2006 Report].
[2] Jad Mouawad & Heather Timmon, *Trading Frenzy Adds to Jump in Price of Oil*, N.Y. TIMES, Apr. 29, 2006, at A1.
[3] Permanent Subcomm. June 2006 Report, *supra* note 1, at p. 6.
[4] Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET, (June 25, 2007) [hereinafter June 25 Report].

transactions from trading records" and "numerous interviews of natural gas market participants."[5]

Not only is today's report a thorough analysis of the destabilization in the natural gas markets caused by a lack of adequate regulation; it is the most complete and scholarly description of the way in which futures and derivatives markets operate as a whole and the critical role appropriate regulation plays in allowing those markets to operate consistent with basic free market principles.

The report makes clear that the failure to regulate these markets properly has distorted and sabotaged free market principles. It has cut those markets off from the moorings of economic fundamentals. It has turned them into nothing more than casinos serving neither those who need them to hedge for commercial purposes nor those who wish to speculate based on honest fundamentals.[6]

Today's report is so complete that it is difficult to find anything to add. It may be worth restating, however, its basic findings.

First, even though these markets were established principally to afford commercial hedging, the natural gas futures markets from sometime in 2004 through at least mid-September 2006 were overwhelmingly dominated by a single institution, which had no commercial stake in natural gas. The staff dramatically describes the dominance of a single hedge fund, Amaranth, as follows:

> "[T]he CFTC defines a 'large trader' . . . in the natural gas market as a trader who holds at least 200 contracts; . . . Amaranth held as many as 100,000 natural gas contracts in a single month, representing 1 trillion cubic feet of natural gas, or 5 % of the natural gas used in the entire United States in a year. At times Amaranth controlled 40% of all of the outstanding contracts on NYMEX [(one of the two major exchanges on which natural gas is traded in the U.S.)] for the winter season (October 2006 through March 2007), including as much as 75% of the outstanding contracts to deliver natural gas in November 2006."[7]

Second, Amaranth's dominance of this market caused extensive price volatility. As recently January 2002, the spot price of natural gas was approximately $3 MMBtu.[8] By late July, 2006, the futures price of the October 2006 natural gas contract was at a yearly high of $8.45 MMBtu. After Amaranth collapsed in September 2006, the futures

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[5] June 25 Report at p. 2.

[6] Today's report is also fully corroborated by a sophisticated economic study conducted during the 2006 natural gas futures market destabilization period. See AN ANALYSIS OF SPOT AND FUTURES PRICES FOR NATURAL GAS: THE ROLES OF ECONOMIC FUNDAMENTALS, MARKET STRUCTURE, SPECULATION, AND MANIPULATION (August 2006), *available at* http://www.pulp.tc/Nat_Legal_Policy_Center_Gas_Manip_August_29_2006.pdf.

[7] June 25 Report at p. 2.

[8] FEDERAL ENERGY REGULATORY COMMISSION (FERC), NATURAL GAS MARKET OVERVIEW (2007) [hereinafter MARKET OVERVIEW], *available at* www.ferc.gov ("Market Oversight" to "Natural Gas Markets, National Overview," then "Henry Hub Spot Prices").

price dropped "to just under $4.80 per MMBtu . . ., the lowest level for that contract in two and one-half years. . . The Electric Power Research Institute described this price collapse as 'stunning . . . one of the steepest declines ever.' . . . Throughout this period, the market fundamentals of supply and demand were largely unchanged."[9]

Third, the staff makes clear that "[t]he price of natural gas directly affects every segment of the U.S. economy, from individual households to small businesses to large industries. 'Natural gas is used in over sixty million homes. Additionally, natural gas is used in 78% of restaurants, 73% of lodging facilities, 51% of hospitals, 59% of offices, and 58% of retail buildings.'"[10]

Fourth, because of the heavy correlation between futures and spot prices (i.e., the prices actually paid for natural gas), "end users were forced to purchase natural gas at inflated prices," i.e., "they were forced to purchase contracts to deliver natural gas in the [2006] winter months at prices that were disproportionately high when compared to the plentiful supplies in the market."[11]

Fifth, as reflected in substantial commentary presented to the staff by end users of natural gas, including, *inter alia*, the Minnesota Municipal Utilities Association, the staff concluded that "'the lack of transparency in the over-the-counter (OTC) market for natural gas and the extreme price swings surrounding the fallout of Amaranth have, in their wake, left bona fide hedgers reluctant to participate in the markets for fear of locking in prices that may be artificial[ly high].'"[12]

Sixth, the Commodity Exchange Act ("CEA") bars excessive market speculation or the "sudden or unreasonable fluctuations or unwarranted changes" in the price of commodities traded on a regulated exchange.[13] However, the staff aptly concluded that there are two critical problems in enforcing that prohibition. First, the PSI staff found that the CFTC's enforcement of that prohibition has been very limited in its focus and "the CFTC and energy exchanges need to reinvigorate the CEA's prohibition against excessive speculation."[14] Second, even to the extent that the limited enforcement of the excessive speculation ban was applied to Amaranth in August 2006 by the NYMEX exchange, "Amaranth moved those [NYMEX] positions to [the Intercontinental Exchange or "ICE"].[15] Because of the infamous "Enron loophole"[16] enacted in December 2000 as part of the Commodity Futures Modernization Act, "ICE, [unlike NYMEX,] operates with no regulatory oversight, no obligation to ensure its products are traded in a fair and orderly manner, and no obligation to prevent excessive speculation."[17] "As a result, NYMEX's instructions to Amaranth did nothing to reduce Amaranth's size,

[9] June 25 Report at pp. 1-2 (internal citations omitted).
[10] *Id.* at 11 (internal citations omitted).
[11] *Id.* at 114.
[12] *Id.* (inside citations omitted).
[13] 7 U.S.C. §6a(a) (2006).
[14] June 25 Report at p. 120.
[15] *Id.* at p. 120.
[16] *Id.* at p. 119. *See* 7 U.S.C. §2(h)(3), (g) (2006).
[17] June 25 Report at p. 119.

but simply caused Amaranth's trading to move from a regulated market to an unregulated one."[18] Thus, "[a]lthough both NYMEX and ICE play an integral role in natural gas price formation, the two exchanges are subject to vastly different regulatory restrictions and government oversight under current federal law"[19] even though "NYMEX and ICE are functionally equivalent markets."[20]

Seventh, the bipartisan June 25, 2007 staff report recommends that: (1) the "Enron loophole" be abolished and that the similarly situated NYMEX and ICE exchanges both be subject to the protections afforded hedgers and other traders under the CEA; (2) the excessive speculation ban within the CEA be upgraded and be applied vigorously to both NYMEX and ICE; and (3) CFTC staffing and technological resources be upgraded to meaningfully apply the protections of the CEA.[21]

Again, the June 25, 2007 bipartisan report submitted by the PSI staff is thorough and complete. I would add only the following few comments:

First, it should be emphasized that the "Enron loophole" adopted in December 2000 – which allows energy futures trading facilities to be unregulated even though they are functionally equivalent to those exchanges which are regulated – was far from a carefully considered legislative measure. The loophole was added at the last minute to a 262 page bill, which was itself belatedly and quite suddenly attached in a lame duck session on the Senate floor by then Senate Finance Chairman Gramm to an 11,000 page consolidated appropriation bill for FY 2001.[22] Over the express and emphatic opposition of the President's Working Group on Financial Markets (including Fed Chairman Alan Greenspan, Treasury Secretary Lawrence Summers, and SEC Chairman Arthur Levitt),[23] the Enron loophole exempted OTC energy derivative markets (even though functionally equivalent to the regulated exchanges) from CFTC and all other federal regulation.[24] This exemption was called the "Enron loophole" because Enron (upon whose board, Wendy Gramm, Senator Gramm's wife, then sat) at that time was seeking to authorize retroactively its now defunct Enron Online energy trading facility, which began operation even in advance of the passage of the CFMA.[25] While this legislation retained CFTC authority to investigate fraud and manipulation (but not excessive speculation) in OTC energy markets,[26] the CFTC, as a practical matter, read this legislation as generally

[18] *Id.* at p. 3.
[19] *Id.* at p. 40.
[20] *Id.* at p. 3.
[21] *Id.* at pp. 119-132.
[22] *See* Sean Gonsalves, Opinion, *Enron Exemplifies 'Genius of Capitalism'*, SEATTLE POST-INTELLIGENCER, Jan. 22, 2002, at B5; PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, COMMODITIES REGULATION § 1.01, at 3 (3d ed. Supp. 2002).
[23] *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 16 (1999).
[24] Edward J. Rosen & Geoffrey B. and Goldman, *SWAPs & Other Derivatives in 2001*, *in* THE COMMODITY FUTURES MODERNIZATION ACT OF 2000, PLI article at 581-88 (PLI Corporate Law and Practice, Course Handbook Series No. B0-0168, 2001).
[25] *See* Jeff Gosmano, *Electronic Trading Could Change; Enron Situation Rolls Markets*, NATURAL GAS WEEK, Nov. 12, 2001, *available at* WLNR 8879099 (noting Enron Online's launch in November 1999).
[26] Rosen & Goldman, *supra* note 24, at 585.

constricting its authority to call for regular OTC energy reporting in the absence of pre-existing demonstrative evidence of fraud or manipulation. Needless to say, given the last minute nature of this amendment, there were no hearings, committee reports, or floor debates justifying this legislation or the reason it should have been passed over the contrary guidance of Messrs. Greenspan, Summers, and Levitt.

The "Enron loophole" almost immediately caused havoc in energy markets. It is now beyond doubt that manipulation of futures and derivatives contracts pursuant to that loophole dramatically increased the market price of electricity in the Western United States during 2001-2002. This resulted in needless widespread and rolling blackouts, along with a surge in corporate bankruptcies during that time period.[27] Enron and others, using such unregulated trading facilities as Enron Online, "gamed" the energy derivatives markets to drive up the cost of electricity in a manner that bore no relationship to underlying economic fundamentals.

Between 1999 and 2001, California's electricity bill rose by more than $40 billion.[28] Because the explanation at that time – as it often is today with the price of oil and natural gas – was that this sudden and highly disruptive price spike was caused by economic fundamentals, California and other Western states, as well as energy dependent public authorities and industries within those states, entered into long term supply contracts. These contract prices vastly exceeded what history would prove was the market's fundamental equilibrium: long term supply contracts costing $700 million during the electricity crisis would only cost $350 million by March 2002.[29]

Only after internal Enron memos that outlined manipulation strategies were uncovered in unrelated proceedings did the CFTC begin serious investigations into the then recently deregulated OTC energy derivatives market. The CFTC ultimately assessed hundreds of millions of dollars in damages and fines for what it found to be widespread, devastating, and costly futures and derivatives market manipulation in this otherwise unregulated market.[30]

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[27] *See* Press Release, Sen. Dianne Feinstein, Sens. Feinstein, Cantwell Press for Public Release of Enron Evidence, Citing Implications for Oil Markets (May 2, 2006), *available at* http://feinstein.senate.gov/06releases/r-enron-evidence.pdf.

[28] Peter Navarro & Michael Shames, *Aftershocks—And Essential Lessons—From the California Electricity Debacle*, 24 ELECTRICITY J. 2003, at 24.

[29] 148 CONG. REC. March 7, 2002, p. S1653 (daily ed. Mar. 7, 2002) (statement of Sen. Cantwell); Senators Propose Bill Regulating OTC Markets, ENERGY COMPASS, Feb. 14, 2002; *see also e.g.* Navarro *supra* note 28, at 24 ("[T]he state remains saddled with almost $40 billion of long-term contracts that are roughly twice the actual market value of the electricity and that will institutionalize high electricity rates in the state for years to come."). Similarly, the rising cost of natural gas in the summer of 2006 caused utility companies to hedge at inflated costs; these costs were then passed on to consumers. *See* text accompanying notes 8-9 *supra*.

[30] U.S. GENERAL ACCOUNTING OFFICE, REPORTS & TESTIMONY NO. GAO-04-420T, NATURAL GAS: FACTORS AFFECTING PRICES AND POTENTIAL IMPACTS ON CONSUMERS 21 (2006), *available at* http://www.gao.gov/new.items/d06420t.pdf.

http://www.bloomberg.com/apps/news?pid=20670001&refer=&sid=aHAgHb.3Gdzg.

In addition to malpractices in the Western United States electricity markets, last year's PSI staff report corroborated independent economic analysis demonstrating that excessive speculation on unregulated OTC energy trading facilities has caused (and almost certainly is causing) an estimated unnecessary 20% increase in the cost of crude oil.[31]

Finally, the overwhelming influence of Enron on these unregulated markets is evidenced by the June 25, 2007 staff report's finding that when Amaranth in 2002 "added energy trading to its slate of strategies" to boost its earnings, "it hired several former Enron traders to its staff."[32] Doubtless those former Enron traders were well educated in the school for scandal that constituted the Western United States electricity manipulation.

In short, there is every evidence that the hastily enacted and poorly examined Enron loophole has done nothing but add billions of dollars to prices charged the American consumers for such important everyday commodities as electricity, heating oil, natural gas, and gasoline. As the staff has recommended, the Enron loophole should be repealed.

Second, there is an additional chapter that might be added to this subcommittee's June 25, 2007 bipartisan staff report. As mentioned above, today's report notes that Amaranth drove October 2006 natural gas contract up to the 2006 high of $8.45 per MMBtu and then down to a $4.80 per MMBtu – a two and one half year low – upon that hedge fund's failure.[33] Yet, the spot price of natural gas now hovers around $7.00 per MMBtu. One might well ask about the reason for this increase. Again, market fundamentals have not changed. Of course, the staff investigation leading to today's exhaustive report stopped in October 2006 shortly after the Amaranth failure. It does not require a great leap of logic to wonder if that investigation had examined trading data well into 2007, one might have found that other large financial institutions with deep pockets have picked up Amaranth's "torch" and that the natural gas market is still being driven by excessive speculation – but on exempt or unregulated OTC markets. In the absence of regulation and in the presence of opaque markets, we are left to speculate why the price of natural gas has almost returned to the highs seen when Amaranth dominated these markets.

In this regard, and as the June 25, 2007 staff report points out, those who oppose further regulation in this area are quick to contend that there was no systemic risk associated with the Amaranth failure. As the staff report so rightly demonstrates,[34] however, this argument overlooks the billions of dollars American consumers (including industrial consumers) had to pay trying to lock in prices based on the "price discovery" function NYMEX and ICE were purportedly playing in the summer of 2006. Moreover, the contentment over the lack of systemic problems does not take into account that just as the collapsed Enron provided a template for Amaranth, a collapsed Amaranth may be

[31] *See supra* note 2 and accompanying text.
[32] June 25 Report at p. 57.
[33] *See supra* p. 3-4.
[34] June 25 Report at p. 21.

providing a template for one or more large financial institutions in today's natural gas markets. This complacency also overlooks those investors who were badly hurt by the Amaranth fiasco. The San Diego County Employees Retirement Association is suing Amaranth for over $150 million in lost retirement savings invested with the hedge fund.[35] Finally, and perhaps most importantly, it takes great optimism to conclude that repetition of these kinds of exorbitant losses incurred by Amaranth in just a few days in September 2006 will not, especially if several funds were to implode at the same time, cause systemic risk to the economy. It is now undisputed that the near failure of Long Term Capital Management, which lost less money than Amaranth, raised the prospect of systemic financial collapse.[36] Within the last few weeks, the Bank of Montreal (certainly not a commercial hedger in these markets) experienced "trading losses of between $313 million and $403 million as a result of natural gas trading strategies that went awry."[37] Policy makers have to ask themselves whether they are prepared to allow this kind of excessive speculation fueled in large part by borrowed funds continue to go unmonitored merely because Amaranth's failure did not cause the collapse of the American economy. No less a free marketeer than Alan Greenspan counseled against allowing this kind of opaque and unregulated energy futures trading which is the result of the Enron loophole.

Third, the bipartisan nature of the June 25, 2007 staff report is reflective of the widespread adverse impact the high price of natural gas has had on all sectors of the economy all over the Nation. In this regard, it should be remembered that on December 14, 2005, the then Republican-controlled House led by conservative Republican Congressman Sam Graves of Missouri, passed, at the behest of the farming community then suffering from all time record high natural gas prices, a version of the CFTC Reauthorization Act of 2005 (H.R. 4473), which included a Title II,[38] mandating an aggressive regulatory posture by the CFTC in overseeing "any contract market" engaged in the trading of natural gas futures and derivatives. At that time, the cost of natural gas had "float[ed] at a high near $14 MMBtu."[39] Even though the CFTC reauthorization has yet to make it through Congress, the spot price of natural gas dropped by roughly one third after Congressman Grave's December 2005 action and there was considerable analysis at that time that the mere threat of aggressive regulation by a Republican controlled House markets may have been responsible for that price decline.[40] Similarly, adoption of the recommendations of the staff report at issue will almost certainly cause a similar decline, because the markets will then be controlled by commercial interests rather than by excessive speculation.

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[35] SDCERA v. Maounis, No. 07-CV-2618 (S.D.N.Y., complaint filed March 29, 2007).
[36] U.S. GENERAL ACCOUNTING OFFICE, REPORTS & TESTIMONY NO. GAO/GGD-00-3, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK (1999), *available at* http://www.gao.gov/archive/2000/gg00003.pdf.
[37] *U.S. CFTC Wants to Adopt New Market Rules*, HOUSTON CHRONICLE, June 22, 2007, *available at* http://www.chron.com/disp/story.mpl./ap/fn/4912831.html.
[38] 151 CONG. REC. H11554 (daily ed. Dec. 14, 2005).
[39] 151 CONG. REC. H11561 (daily ed. Dec. 14, 2005) (statement of Rep. Pombo).
[40] *See, e.g.*, AMERICAN PUBLIC POWER ASS'N, LONG TERM STRATEGIES ARE KEY IN ACHIEVING STABLE NATURAL GAS PRICES 6 (2006 ), *available at* http://www.appanet.org/files/PDFs/NaturalGasPriceOutlook306.pdf.

Fourth, the bipartisan June 25, 2007 staff report lays to rest another argument often advanced by CFTC commissioners, as well as banking and hedge fund speculators, when fighting the regulation of the OTC energy markets. They contend that it will be impossible for either the regulated exchanges or CFTC staff to make sense out of the flood of market data that would result from re-regulating those markets.[41] However, the subcommittee staff, which has far fewer resources than even the now depleted CFTC, has been able to digest and cogently explain a multi-year trading period that is now widely recognized as one of the most volatile in natural gas market history. They have done so with a coherent narrative aided by the creation of numerous highly instructive charts. They have included a helpful history of these markets, a complete description of the relevant exchanges and traders, and a full explanation of the relevant statute, rules, and regulations. They have presented a report that far exceeds the investigative materials that would have been needed by CFTC staff to commence an enforcement action in these circumstances. Moreover, if the PSI staff's recommendations were adopted, the exchanges, in their capacity as self regulatory institutions, could put a stop to excessive speculation with far less data than has been collected for the instant report. The report adduced today gives a global multi-year history of a volatile trading period. A regulated exchange or the CFTC itself could put a stop to excessive regulation with information collected over a period of days, as evidenced by the actions NYMEX took in August 2006 in its attempt to limit Amaranth's excessive speculation.[42]

Finally, and perhaps most importantly, I have one concern about what might be a mistaken impression left by the report that was doubtless unintended by its authors. One could very well be left with the impression after reading the June 25, 2007 report that the CFTC, as presently constituted, is fully supportive of receiving the new statutory authority that the authors' recommendations would provide it. However, it must be remembered that two successive Chairmen of the CFTC, Messrs. Newsome and Jeffery, as well as (and perhaps most especially) the intervening Acting Chair, Ms. Brown-Hruska, have strongly resisted undoing the Enron loophole. Moreover, Mr. Newsome and Ms. Hruska, and until recently Mr. Jeffery, have proudly pointed to reduced Commission staffing as a worthy dividend of the CFMA[43], i.e., of deregulating both the OTC markets and substantially reducing regulation of the established exchanges, which now adhere to governing principles rather than a rule-based regime.[44] One has every

[41] *CFTC Member Says Her Agency Can Provide Necessary Oversight of OTC Markets, Dismisses Claims About Excessive Market Speculation*, FOSTER ELECTRIC REP., Apr. 5, 2006, at 13.
[42] June 25 Report at p. 53.
[43] *See*, e.g., Peter A. McKay, *CFTC Chairman Opposes Plan to Broaden Regulators' Power*, WALL STREET JOURNAL, July 25, 2002 ("The futures industry's top government watchdog [, Chairman James E. Newsome,] said his agency has adequate authority and staff to regulate the nation's commodity markets, despite the Enron Corp. and Dynegy Inc. scandals. He warned against a proposal in Congress to broaden regulators' power.").
[44] PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION § 1.18 [2], at 323 (2004) ("The CFMA decreased significantly the degree of market regulation over designated contract markets. Rather than affirmative day-to-day regulation that was imposed under the former regulatory regime, under the . . . CFMA, the [CFTC] is charged with an oversight role with respect to contract markets."). Indeed, the House regulatory measure concerning the natural gas futures markets, *see* text at n. 38 *supra*, was driven in considerable part because of widespread complaints that NYMEX's daily trading "limits" rules (as well as the CFTC's oversight of them) were deemed to be unusually weak and, according to many

reason to worry that the CFTC would welcome that part of today's report that increases staffing and funding while resisting the bipartisan staff recommendation pertaining to additional regulatory responsibility concerning the OTC energy markets and more rigorous enforcement of the excessive speculation bar.

I should add that I do not draw complete comfort from the proposed rule issued by the CFTC late this last Friday afternoon making it clear, as I read it, that NYMEX should now have the authority to request from a trader all of its "other positions" in particular commodity, including positions in "over-the-counter" markets.[45] Under this proposal, Amaranth would have had to report to NYMEX its ICE natural gas positions. However, this proposed rule does not require anyone trading exclusively on an exempt OTC trading facility to report positions, i.e., a trader executing contracts almost exclusively on ICE would not have to report positions to the CFTC. Thus, even if adopted as a permanent rule after completion of the proposed rule's comment period, this suggested regulation does not address the heart of the problems caused by the Enron loophole (regulating exempt exchanges); nor does it reinvigorate the CEA's bar against excessive speculation.

In this regard, it is important to note that the CFTC now only has three of its full complement of five commissioners. After Chairman Jeffery is confirmed to become Undersecretary Secretary of State for Economic, Energy, and Agricultural Affairs, only two commissioners will remain. One proposed commissioner is a former high ranking lobbying employed by the International Swaps and Derivatives Association ("ISDA"). On the long list of financial industry associations which strongly oppose regulation of the OTC energy markets, ISDA is undoubtedly, at the very least, first among equals. If the Senate truly wants to protect the American consumer and to reduce the prices those consumers are paying for gasoline, heating oil, natural gas, and crude oil, it must exercise with care its advice and consent role with regard to the three new commissioners. The CFTC is in desperate need of new commissioners who represent the consumer interest. Congress can pass all of the laws it wants to ensure that the energy derivatives markets are not overrun and made dysfunctional by excessive speculation. If the CFTC commissioners do not believe in those laws, the American consumer will continue to take a back (and highly uncomfortable) seat to the large banks, hedge funds, and other market speculators.

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traders' and end users' complaints, encouraged extraordinary volatility in NYMEX's natural gas futures contracts. *See, e.g.*, Alistair Barr, *Bill Limiting Natural Gas Speculation to be Introduced*, MARKETWATCH, (Apr. 13, 2005). Because the CFMA encourages the most passive CFTC oversight of the even the most regulated contract markets, and the December 14, 2005 House amendment as passed affirmatively addresses that problem insofar as natural gas trading is concerned.

[45] Maintenance of Books, Records and Reports by Traders, 72 Fed. Reg. 120 (proposed June 22, 2007).