ENERGY SPECULATION: IS GREATER REGULATION NECESSARY TO STOP PRICE MANIPULATION?

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

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ENERGY SPECULATION: IS GREATER REGULATION NECESSARY TO STOP PRICE MANIPULATION?

WEDNESDAY, DECEMBER 12, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON ENERGY AND COMMERCE,
Washington, DC.

The subcommittee met, pursuant to call, at 9:35 a.m., in room 2123 of the Rayburn House Office Building, Hon. Bart Stupak (chairman) presiding.

Members present: Representatives Melancon, Green, Barrow, Inslee, Dingell, Whitfield, Walden, Murphy, Burgess, Blackburn, and Barton.

Also present: Representatives Fossella and Shimkus.

Staff present: Richard Miller, Scott Schloegel, John Arlington, John Sopko, Carly Hepola, Alan Slobodin, Dwight Cates, and Kyle Chapman.

OPENING STATEMENT OF HON. BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. STUPAK. The subcommittee will come to order.

Today we have a hearing titled "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?" Before we begin, I would like to make two quick comments. This is the 19th hearing of the Oversight and Investigations Subcommittee in 2007. I want to take a moment to thank all the staff and the members for their hard work throughout the year. This has been a very aggressive schedule, and I know staff on both sides of the dais have logged countless hours of investigations and research, and Members have done the same.

I also want to thank my good friend, Mr. Whitfield, the ranking member, for his work and friendship on this subcommittee. Due to the departure of the former Speaker, Mr. Hastert, the minority redrew their subcommittee assignments, and this will be Mr. Whitfield's last hearing as ranking member. However, you are going to remain on the committee, so your expertise will still be shared with all of us, and we thank you for your time and the courtesy you have shown me, personally, as chairman of the subcommittee this year.

I would now like to recognize members for an opening statement, and I will begin.

Of the 19 hearings this subcommittee has held this year, today's hearing is perhaps the most technical and complex. Americans do not sit around the dinner table and discuss futures markets, swaps, position limits, look-alike contracts, and exempt commercial markets. What families do talk about is the cost of gas, oil, home heating oil, and propane. They talk about how the high energy costs are literally taking food off their table to pay for their basic needs, such as transportation and warmth.

In 1 day, we saw a 45-percent hike in gasoline prices in my district. In another energy spike example, one senior high-rise in my district saw their natural gas bill jump from just over $5,000 in November 2005 to an astonishing $13,000 one month later, in December.

Futures contracts for energy are traded on New York Mercantile Exchange, NYMEX, which is regulated by the Commodity Futures Trading Commission, the CFTC. The unregulated international exchange market was created by the Enron loophole as part of the Commodity Futures Modernization Act of 2000.

Unregulated markets are known as dark markets, because there is very little oversight of the trades. By trading on the dark ICE market, traders can avoid CFTC rules, which are in place to prevent price distortions and supply squeezes. This makes it difficult for regulators to detect excessive large positions, which could lead to price manipulation. Trading volumes on this dark market have skyrocketed in the past 3 years and are now as large, or even larger, in some months as the volumes traded on the regulated futures market.

[Chart shown.]

Chart 3 that is before us shows the quantity of natural gas futures contracts on NYMEX and ICE are almost equal in 2006; 239 trillion cubic feet on NYMEX versus 237 trillion cubic feet on ICE. To put this trading volume in perspective, the total U.S. consumption of natural gas in 2006, represented by the yellow, horizontal line near the bottom, was only 21.6 trillion cubic feet. So why is trading on each market 10 times more than necessary to supply America?

[Chart shown.]

Chart 4 shows that only 600,000 natural gas contracts were traded on the dark ICE market in January 2005, but increased by 433 percent to 3.2 million contracts by October 2007. And why is that? The spiraling growth in commodity trading and dark markets has left regulators with a blind spot and the public without information to track how non-commercial traders could be affecting energy prices.

The CFTC has no control over dark markets, and they lack enough staff to police the regulated markets, let alone the unregulated dark markets. This lack of oversight means that traders who exceed limits or who shun openness of futures markets will merely take their business to the dark markets.

Less than one percent of futures contracts ever result in physical delivery. Thus, most future trades are not interested in delivery of a product. They are interested in profit. The Energy Information Administration recently observed that oil markets have been drawing increased interest and participation from investors and financial entities without direct commercial involvement in physical oil markets. A report from Lehman Brothers entitled “Frenzied Oil Futures Frustrate Fundamentals” states: “The surge in oil markets to $90, the mirror image of last winter’s price fall, seems underpinned more by financial flows and political risk than by fundamental factors.”

Oil and gas trader Steven Schrock, who published the Schrock Report on Energy Markets, wrote “factors other than supply and demand are now impacting the price. We now have to factor in how the speculators are going to affect the market, because they have different priorities in managing their portfolios.” Rather than a market that is serving a price discovery function, we have a market that is more and more driven by profits and excessive prices. Often it is speculation based on fear, which leads to greed.

Because of the Enron loophole, several major energy companies and hedge funds have been charged with price manipulation. In February 2004, British Petroleum acquired 90 percent of all U.S. propane supplies. Once in control of the market, BP intentionally withheld propane from the market and charged buyers artificially inflated prices in a classic supply squeeze. In a recent Court settlement, BP agrees to pay $303 million in penalties and restitution.

In July of this year, FERC and the CFTC brought anti-manipulation cases against Amaranth, a Connecticut-based hedge fund, which dominated natural gas financial markets for most of 2006 until its ultimate collapse in September of 2006. FERC charged that Amaranth manipulated prices paid in the physical natural gas markets by driving down natural gas futures contracts through massive selling during the last 30 minutes of trading for the months of March, April, and May 2006 contracts. This then allowed Amaranth to profit from such larger short positions traded on the dark ICE market that bet on this price decline. FERC has proposed a $291 million in penalties and disgorgement of unjust profits.

A June 2007 staff report by the Senate Permanent Subcommittee on Investigations entitled “Excess Speculation in Natural Gas Market” found Amaranth trading price increased volatility to the point that traders deemed the price “out of whack” with regard to supply and demand fundamentals. These out-of-whack prices may have cost industrial, commercial, and homeowners as much as $9 billion. When the regulated mark at NYMEX directed Amaranth to reduce its excessive positions in the natural gas contracts, Amaranth shifted 80 percent of its gas contracts over to the dark ICE market, allowing them to maintain and even increase their overall speculative position.

[Chart shown.]

Chart No. 6 shows that on August 28, 2006, Amaranth held nearly 100,000 contracts for September on ICE. To put this in perspective, by holding 100,000 contracts, a mere penny increase in price would result in profit to Amaranth of $10 million. Amaranth traders knew this move would be invisible to regulators. In an August 29 instant message about a large price move, Amaranth lead trader wrote, “classic pump and dump. Boy, I bet you see some CFTC inquiries in the last 2 days.”

But another trader reminded him that most of the trades had taken place on the dark ICE market, using swaps. He replied, “only until the monitor swaps, no big deal." No big deal? Tell that to the homeowners across America who are paying record heating costs to heat their homes. Tell that to the domestic manufacturers who are paying exponentially higher energy prices to manufacture their goods. Tell that to the people who have been laid off because the manufacturing plant they worked in closed down and moved their operations offshore, where energy and labor costs are lower. Tell that to Municipal Gas Authority of Georgia, which buys natural gas for public utilities in four States and took $18 million in losses, which they contend was due to Amaranth's trading scheme.

In another case of market manipulation, in July of 2007 FERC and CFTC charged that the Energy Transfer Partners, ETP, manipulated natural gas prices by using its dominant market share in the Houston ship channel to force the price of natural gas down in order to profit from much larger short positions, many of which were held on the dark ICE market. This strategy earned ETP nearly $70 million in unjust profits, according to FERC. Driving down prices might seem to help consumers in the short term. However, in the long run, distorting price signals will drive up costs to consumers.

I would like to now play voice recordings of individuals from the British Petroleum and Energy Transfer Partner cases. Here they are, in their own words.

[Playing TV broadcast.]

Shades of Enron all over again. So what are possible solutions to these problems of manipulation? CFTC recently proposed legislation to regulate dark markets. Witnesses today will explore whether these proposals go far enough to restore integrity to energy markets or will increase oversight of the dark market's drive energy commodity trading overseas to less regulatory jurisdictions. ICE futures already trade oil, gasoline, and heating oil swaps for U.S. delivery in London under the UK's Financial Services Authority, which has weaker market rules.

Another tool in addressing manipulation is ensuring FERC's authority to police price manipulation trades that impact delivery of energy. Legislative intent on the part of this committee is clear. We fully expect the authority granted to FERC through the Energy Policy Act of 2005 will be upheld. We question whether CFTC, in trying to block FERC from enforcing its anti-manipulation authority, is circumventing congressional intent. Consumers could pay dearly if CFTC prevails, and this committee is unlikely to be a bystander, should that unlikely event occur.

A third possible solution which has been proposed by Professor Michael Greenberger, who will testify before us today, is for the CFTC to close the loophole that allows U.S. traders to avoid CFTC regulation by using less regulated foreign markets to trade energy commodities. There are also several pending legislative proposals intended to address this problem: H.R. 3009, The Market Trust Act of 2007, sponsored by Representatives Barrow and Graves, H.R. 4066, Close the Enron Loophole Act, introduced by Representative Welch from Vermont, and H.R. 5942, Preventing Unfair Manipulation of Price Act, which I introduced with Chairman Dingell.

In the end, what we need is less of the greed, of which we just heard from the traders' own voices a few moments ago and more honesty. We need to close the Enron loophole to close the foreign market loophole, and we need additional enforcement by the CFTC and FERC to clamp down on the fear and speculation that lead to greed and market manipulation.

And with that, that is the end of my opening statement. I would next like to yield to Ranking Member, Mr. Whitfield.

OPENING STATEMENT OF HON. ED WHITFIELD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KENTUCKY

Mr. WHITFIELD. Thank you, Chairman Stupak, and I appreciate your comments about our working relationship on Oversight and Investigation, and I have certainly enjoyed working with you and look forward to continuing to do so as we move forward.

I also appreciate this hearing this morning, and today's hearing will cover many diverse and complicated topics regarding how energy markets operate and whether further regulation is necessary. We will hear testimony about the lack of market transparency and excess speculation in the designated contract markets regulated by the Commodity Futures Trading Commission and the Wholesale Energy Markets, regulated by the Federal Energy Regulatory Commission. We will hear about regulatory arbitrage between the regulated futures market managed by the New York Mercantile Exchange and the unregulated over-the-counter market managed by the Intercontinental Exchange, or ICE.

These matters are important and complex. Daily trading volumes in the energy markets have grown significantly over the past few years. In January 2005, only 600,000 natural gas swaps were traded on the ICE Exchange. This number has grown to 3.3 billion in October of 2007. Increased trading activity has had an impact on price volatility, and concerns have been voiced about excess speculation and its potential impact on energy prices. Because of the crucial role energy prices have in our economy, Congress must ensure that regulators have the tools to protect energy consumers. As we consider all of these complex matters, I think we all share one fundamental concern. Do the prices consumers pay for energy represent fundamental supply and demand conditions in the marketplace, or are prices influenced by manipulation or other forces?

According to the testimony of Ms. Laura Campbell, who represents the American Public Gas Association, the public utilities have lost confidence in the natural gas markets. She believes that market prices for natural gas are not an accurate reflection of supply and demand. I look forward to hearing her views, and I am sure that other members of the panel will also have views on this.

However, there is some good news to report today from FERC. In response to provisions we included in the Energy Policy Act of 2005, FERC acted quickly to establish its office of enforcement. As a result, FERC has an enhanced ability to police the electricity and natural gas wholesale markets to prevent market manipulation. We look forward to the testimony of FERC Chairman Joe Kelliher regarding FERC's efforts to protect energy consumers.

In his written testimony, Chairman Kelliher points out that Congress gave FERC all the tools needed 2 years ago. And at this time he testifies he does not believe that FERC needs any additional legal authority to protect consumers from market manipulation. I also look forward to the testimony of the New York Mercantile Exchange and the Intercontinental Exchanges, based in Atlanta. NYMEX is highly regulated by the CFTC, and ICE is not regulated. As Congress considers changes to the Commodity Exchange Act to increase regulation of over-the-counter markets like ICE, we must ensure that FERC's consumer protection authorities are not diminished in this process.

Fundamentally, FERC is a consumer protection agency. With respect to the alleged manipulative trading by the hedge fund Aeromat, FERC was the first to identify the problem and open an investigation. CFTC followed behind FERC with its own investigation, and I think this demonstrates the important and aggressive role that they are playing in protecting the American consumer.

Mr. Chairman, I was going to introduce Marsha Blackburn, who I think has a constituent testifying, but she had to leave for another matter. So I yield back my 32 seconds.

Mr. STUPAK. I thank the gentleman, and hopefully Mrs. Blackburn will be back, because she is a vital member of this subcommittee. Next, I turn to the chairman of the full committee, Mr. Dingell, for an opening statement, please.

OPENING STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. DINGELL. Mr. Chairman, thank you, and good morning. I very much appreciate your holding this important hearing.

The cost of energy is becoming an ever-enlarging component of the average citizen's household budget for electricity, gasoline, heating, and for all kinds of products and services based on hydrocarbons. Energy costs are rising rapidly for industrial users as well. This in turn raises the price of products and services in virtually every sector of the American economy.

The collapse of Enron in late 2001 confirmed what many had suspected. Not all the increases in energy prices are the result of supply and demand. Much of Enron's business consisted of speculative trading in electronic, over-the-counter market exempt from regulation. It was virtually impossible for anyone, including the government regulators, to know what Enron was doing or how it was affecting the broader market. We now know that Enron engaged in fraud on a massive scale and manipulated California electronic and electric power markets, to the tune of millions of dollars out of the pockets of American consumers. Unfortunately, Enron was and is not alone. Over the past 6 years, the rise in energy prices has been outpaced only by the rise in speculation.

In short, energy speculation is a growth industry, and it has gone global. A case in point is Amaranth. Over recent months in 2006, Amaranth, a $9 billion hedge fund, dominated trading in the U.S. natural gas contracts and intentionally drove down the price of natural gas futures on NYMEX so that it could make tens of millions of dollars on its undisclosed holdings in the so-called dark markets, the unregulated over-the-counter markets. This is not a victimless crime. In the summer of 2006, Amaranth took enormous positions which appeared to have inflated the price of natural gas for delivery in the following winter. Businesses, utilities, schools, and hospitals, as well as individual consumers, wound up paying abnormally high rates as a result, to the benefit of Amaranth.

As a result, and according to a recent Senate report, speculation of this nature may have added $20 to $25 per barrel to the price of crude in 2006. The Industrial Energy Consumers of America estimates that Amaranth's speculation alone cost consumers of natural gas as much as $9 billion from April to August of last year. At a time when people everywhere in this country are paying record prices for gasoline and record prices to heat their homes, government has a responsibility to put an end to this speculative excess.

This raises the interesting question of what the Federal Energy Regulation Commission, FERC, and the Commodity Futures Trading Commission, CFTC, two agencies that share jurisdiction over these matters, have done to address the problem. I understand that FERC has made considerable progress over the past years in providing its market surveillance capabilities to be improved and to be better in exercising its enforcement authorities. On the other hand, there are indications that CFTC may have been more enthusiastic in granting exemptions from regulation than it has been in routing out possible energy market manipulations. I look forward, as do you and the members of this committee, to exploring this matter further with CFTC.

I am also disappointed to see that CFTC has challenged FERC's authority to investigate and pursue the energy market manipulators, despite Congress's explicit granting of authority to FERC in the Energy Policy Act of 2005. We will look forward to explanations of this rather curious behavior. I would hope that by the time we conclude this hearing, CFTC will have rethought its views on this issue, and we will try and help them to achieve that end.

Mr. Chairman, speculative excess in the energy market has cost American consumers billions of dollars in unnecessary energy costs. It is time for us to close the loopholes that have allowed this unscrupulous consumer exploitation and see to it that the Federal agencies do what it is they are supposed to do to protect the American consumers. Thank you, Mr. Chairman.

Mr. STUPAK. Thank you, Mr. Dingell. Mr. Burgess, for an opening statement.

OPENING STATEMENT OF HON. MICHAEL C. BURGESS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. BURGESS. Thank you, Mr. Chairman. And just like everyone else up here on the dais, I am concerned about the manipulation of energy market prices and want to thank you and Ranking Member Whitfield for holding the hearing today. This subcommittee has a long standing in overseeing the health and competitive prosperity of the American public. And although I wasn't able to participate in the Enron hearings held before this committee in 2001 and 2002, I am pleased to be able to participate here today.

Like many members of this body, I hear from constituents on a near-daily basis about the high prices they pay for their energy needs. In fact, in Texas in November, we were paying $3 a gallon for gas. If we are paying $3 a gallon for gas in November, I can promise you it will be at least a dollar higher in May, because that is when our prices typically go up as we have to transition to the summer blends because of regulations under the Clean Air Act. I do find it odd that in November 2006 I was criticized for gas prices that were $2.20. In November 2007, no one is criticizing gas prices of $3 a gallon, but that is a separate matter.

But I am looking forward to hearing from the witnesses on the second panel today, who actually have the authority to properly oversee commodities futures markets and wholesale energy markets.

Manipulation of the natural gas market is especially pertinent in my district, because the exploration of what is known as tight gas reservoirs in a geologic formation known as a Barnett shale in north Texas has become a very successful exercise in drilling for clean, domestic energy and is a key to the recent economic prosperity in the area of Texas that I represent. In 2006, the Barnett shale was responsible for over 50,000 permanent jobs and over $225 million in revenues to local governments in Texas—not to investors, to local governments in Texas. I want to ensure that the price consumers pay for natural gas is fair and that the natural gas is sold in an open and competitive basis.

In economic terms, we need to ensure perfect competition. More competition in the energy markets drives us towards less collusion, and by the definition of perfect competition, no producer, no consumer has the market power to influence or manipulate prices. In true competitive markets, risk has already been calculated, and a technical analyst will tell you that all available information is already incorporated into the market commodity price. Any manipulation of our open, free, and competitive energy markets must be investigated publicly, and that is what we are here about today. And for that, I am grateful.

Now, Mr. Chairman, I just can't help but notice that, because of the issue of global climate change, not so much in this committee, but in other subcommittees, we have been working on how to manage the issue of global climate change. And you hear a lot of people talk about instituting a cap-and-trade system as perhaps a method for regulating carbon in the environment. And today's hearing brings up the question, who is going to regulate this new cap-and-trade market? Will FERC regulate it? Will some other entity be created or crafted to regulate this? How do we guard against manipulation in really what is going to be a new and untested market environment?

And, Mr. Chairman, I would just like to point out that we may go from a situation where we are talking about from dark markets to a dark America, because we are going to be replacing all of America's energy with lethargy. But that is a separate point as well.

From my understanding, through the Energy Policy Act of 2005, it is the intent of this committee and, in fact, the intent of Congress, to provide the Federal Energy Regulatory Commission with the necessary tools to enforce their anti-manipulation authority. I believe this authority was given to the Federal Energy Regulatory Commissions for reasons that will be supported by their testimony here today. And certainly want to welcome Chairman Kelliher back to the Energy and Commerce Committee and thank him for his leadership in the matter.

Mr. Chairman, in the spirit of the holiday season, I am going to yield back the minute of my time.

Mr. STUPAK. You know I don't take carryovers. Mr. Green, for opening statement, please.

OPENING STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. GREEN. Thank you, Mr. Chairman, for holding the hearing today on energy speculation. As a representative from Houston, Texas, where we call ourselves energy capital of the world, including the use and ship channel, I understand the critical need for transparency in the marketplace. The debacle played out by former energy giant Enron Corporation showcased to the world what happens when lax government and private sector oversight collapses under its own weight. Houston is the home of many families who benefited from Enron during the good times and suffered tremendously when it fell apart. Congress must remain vigilant to help prevent similar failures and to ensure American consumers are not being played by any future gaming of the system. Unfortunately, recent allegations brought against a small handful of U.S. companies indicate that gaming may continue to manipulate the price of energy supplies in the marketplace.

Our congressional district manufactures aviation fuel, diesel gas for our trains, planes, cars, and trucks, and our ships. Energy trading is supposed to help move these products efficiently, and it does not add one gallon to our supply. But then it can add substantial amount to the cost to the consumer. Several economists' reports question whether the standard economic principle, supply and demand, are no longer the sole factors affecting energy prices. Current petroleum and natural gas prices are set by a complex mix of factors, including global crude prices, increased world and U.S. demand, gasoline imports, extreme weather conditions, and geopolitical events. Most of these factors are out of our control. What factors are within our control, like the evidence of market manipulation, I believe the appropriate Federal agency should find and prosecute manipulation to the fullest extent of the Law.

To bring this problem home to an energy-producing area, in 2005, the CEO of Shell Western Hemisphere sat in my office and said, we are transferring chemical jobs from the chemical plant in Deer Park, Texas, that is in our district, to the Netherlands because of the high price of natural gas. It just so happens that ETP, the allegations of FERC, includes 2003 to 2005. Now I have to add the full statement. It was also the high cost of healthcare in Deer Park, Texas, compared to the Netherlands, which is also the purview of our full committee, and I hope we would deal with that. But when you have someone like Shell, who probably imports enough of their own, but they use the trading market for either to sell back or maybe to buy what they need for their chemical production, we see what happens.

Both the Commodity Futures Trading Commission and the Federal Energy Regulatory Commission have a complementary role to play in protecting both the integrity in our markets and our consumers. Closer attention should be paid to the largely under-regulated over-the-counter markets which are a rapidly growing segment of the marketplace. If energy supplies are indeed manipulated, the consumer runs the risk of paying distorted prices to drive, fly, heat, and cool our homes. No one in Congress wants to see American families pay distorted energy prices. If we can shine the bright light of accountability on commodity transactions, we can help foster fair and open and transparent markets for American consumers, businesses, industry, and utilities.

Mr. Chairman, I hope today's panels will help flesh out these complex issues, and I look forward to working with you and other members on improving our transparency of our energy markets. And I will actually have a better Christmas spirit. I will yield back more than a minute. Thank you.

Mr. STUPAK. Thank you. Mr. Walden, for an opening statement, please. You are going to waive yours at this point in time? That concludes the opening statements. It should be noted for the record Mr. Barrow, who is from Georgia, was here. He is up in Agriculture. He might be popping back down. Mrs. Blackburn was here. Congressman Welch has entered a statement for the record. I want to recognize you, Mr. Cota, for being here. And on behalf of Mr. Welch, thank you. So it will be entered in record without objection. Any objection, Mr. Whitfield? Hearing none, it will be entered. That concludes the opening statements by members of the subcommittee.

Mr. STUPAK. I now call our first panel of witnesses to come forward. On our first panel, we have Mr. Sean Cota, president and co-owner of Cota & Cota, Incorporated; Ms. Laura Campbell, assistant manager of energy resources at Memphis Light, Gas, and Water; Mr. Tom LaSala, chief regulatory officer at the New York Mercantile Exchange; Mr. Charles Vice, president and chief operating officer at Intercontinental Exchange, ICE; Mr. Michael Greenberger, professor of law and director of Center for Health and Homeland Security at the University of Maryland.

It is the policy of this subcommittee to take all testimony under oath. Please be advised that witnesses have the right under the rules of the House to be advised by counsel during your testimony. Do any of our witnesses wish to be represented by counsel? Everyone is shaking their heads no. OK, then I am going to ask you to please rise and raise your right hand to take the oath. Let the record reflect that all witnesses replied in the affirmative. You are now under oath. We are going to start on my left, your right. Professor Greenberger, if you would like to start, sir, for an opening statement, I appreciate it.

STATEMENT OF MICHAEL GREENBERGER, PROFESSOR OF LAW, AND DIRECTOR, CENTER FOR HEALTH AND HOMELAND SECURITY, UNIVERSITY OF MARYLAND

Mr. GREENBERGER. Thank you, Chairman Stupak. In my statement today, I have in the beginning a one-page summary, which I think encapsulates everything I want to say. I have a detailed statement that follows that is supported with footnotes and academic information.

The agricultural industry founded the concept of futures markets. In the 1960s and 1970s, futures markets were introduced in the energy sector. The futures markets today and historically have served a price discovery function. When somebody goes to sell a commodity in the business world, they most often look to the Wall Street Journal or some other information to see what the futures price is, and that tells them what a fair price is to sell or buy a commodity.

The agriculture industry learned the hard way that the futures market, if unregulated, can be subject to manipulation, excessive speculation, and fraud. And therefore the futures price can be different than what economic fundamentals dictate. The farmers got, in their words, in the late 19th century and the early 20th century, "screwed" by the futures markets. And in 1921, Congress began to introduce regulatory legislation, which now comes to us in the form of the Commodity Exchange Act, which was principally designed to regulate futures markets to prevent excessive speculation, fraud, and manipulation so when someone goes to sell their wheat or their natural gas or their crude oil or their heating oil, and they look to the newspaper or online data to see what the natural gas price is, et cetera, that is an honest price. And that is the job of the CFTC, to ensure it is an honest price.

In a lame duck session in December 2000, a 262-page bill was added to an 11,000-page omnibus appropriation bill on the Senate floor with no substantial consideration. And my view is that nobody but the Wall Street lawyers who drafted that legislation understood what that legislation meant. For today's hearings, the intent of the President's Working Group and the Senate draft, before it was amended late in the night in December 2000, was that agriculture and energy commodities would continue to be regulated fully by the CFTC. Late in the night of December 2000, the word energy was struck from that bill. So the Agriculture Committee made sure that the farmers were still protected by the CFTC, but the energy sector was now allowed to operate outside the confines of the CFTC.

Everybody agrees today that that loophole should be ended. The problem is that people are offering thousands of pages of bills to fix a simple thing. Stick the words "or energy" back in so that energy will be regulated fully by the CFTC. And, for simple purposes, that would mean ICE would be regulated like NYMEX. NYMEX has chosen to be regulated for energy commodities. ICE has chosen not to be regulated for energy commodities.

Because of the Enron loophole—and believe me, if Christmas had come earlier that year, and that bill had not been passed—we would still have an Enron today. It was Enron's undoing to get that loophole through. That loophole allows ICE to be unregulated, and Mr. LaSala has chosen to be regulated. The CFTC prevents fraud and manipulation and excessive speculation on NYMEX. They can't do it on ICE. It is as simple as that.

Now the Senate Permanent Investigating Committee, in a bipartisan way, once in a Republican Congress, once in a Democratic Congress, in 2006 and 2007, has pinpointed and proven now, I think, beyond all doubt that the price you pay for crude oil and the price you pay for natural gas has been driven up by the kinds of conversations you broadcast there today. And you heard those guys say the CFTC can't touch us because "or energy" was dropped from agriculture or energy in 2000. Energy can now be traded without watching or reporting for fraud, manipulation or excessive speculation.

And as Senator Levin and the Republicans as well in that staff report have said, the economists say that at least $20, maybe as high as $30, added to the price of crude oil is because the futures price is being conducted with those kinds of conversations and manipulated upward without any relation to what supply/demand creates. $20 to $30, what does that mean for gasoline, which is made by crude oil? What does that mean for heating oil, which is made from crude oil? And what does it mean for natural gas, which everybody is dependent on? And in fact, the farmers were so dependent on it that Congressman Graves, Republican, of Missouri, worked through a floor amendment in the Republican-controlled House in December 2005 to do something about the unregulated price of natural gas. At that point, it was $14 per million BTU. Within 6 weeks, it dropped to $9, just because an amendment passed the House.

The day after Amaranth failed, the futures price of natural gas dropped from about $8.50 to $4.50. The manipulator was gone. Economic fundamentals took over. The price dropped about $4 in a day, in half. What does that mean to your consumers? Now, it jumped right back up to $10, and then hearings were held on it. And it is now back at $7.

With a very simple legislative fix, adding "or energy" "and energy" back into the Exchange Act, you can fix this problem.

There is one other point I want to make. ICE not only operates under this exemption—and, by the way, I want to say ICE is not doing the manipulating here. ICE has used this exemption to profit successfully. It is the traders on ICE that are taking advantage of this exemption, not ICE. ICE not only operates under this Enron loophole, but in 2000 they bought the United Kingdom's International Petroleum Exchange. It is now fully owned by ICE, which is a United States company. I understand that while it is not relevant, those exchange platforms are in the United States. And they are now trading West Texas Intermediate Crude in direct competition with NYMEX.

Now, because the International Petroleum Exchange was a foreign exchange, they said we need to get exemptions from the CFTC or you will be discriminating against us on the basis of world trade. We are a foreign company. Want to sell foreign crude oil products, brand oil, on foreign terminals. Exempt us. And the CFTC staff, not the commission, the staff, in a no-action letter, said, fine. ICE, a U.S. company, bought the International Petroleum Exchange. The CFTC staff never changed the no-action letter. ICE decided it was going to trade U.S.-delivered commodities. The CFTC never changed the no-action letter.

All of the legislation that is being offered today does not affect that foreign board of trade exemption, which allows ICE, a U.S. company trading U.S.-delivered products, significantly affecting the price of crude oil in the United States. They are now regulated by the United Kingdom, not the CFTC. This afternoon, the CFTC could go back to its offices and terminate that no-action letter. It has a termination-at-will clause.

Now, if they did, ICE would come back——

Mr. STUPAK. Well, sir, I am going to need you to wrap up your——

Mr. GREENBERGER. OK, if they did, ICE would come back and say, well, now we use the Enron loophole. So you have to close the Enron loophole. You have to end U.S. companies' trading U.S products saying they should be regulated by the United Kingdom.

When I am asked questions, I will tell you why the CFTC's proposal to the Enron loophole is not a regulatory fix. It is regulation in name only, and your consumers in February would be screaming if you passed the CFTC legislation today. Thank you.

[The prepared statement of Mr. Greenberger follows:]

Testimony of

Michael Greenberger
Law School Professor
University of Maryland School of Law
500 West Baltimore Street
Baltimore, MD 21201

Before the Subcommittee on Oversight and Investigations of the United States House Committee on Energy and Commerce

Regarding

Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?

Wednesday, December 12, 2007
9:30 a.m.
2123 Rayburn House Office Building

One Page Summary of Testimony

1. One of the fundamental purposes of futures contracts is to provide price discovery in the "cash" or "spot" markets. Those selling or buying commodities in the "spot" markets rely on futures prices to judge amounts to charge or pay for the delivery of a commodity.
2. Since their creation in the agricultural context decades ago, it has been widely known that, unless properly regulated, futures markets are easily subject to distorting the economic fundamentals of price discovery (*i.e.*, cause the paying of unnecessarily higher or lower prices) through excessive speculation, fraud, or manipulation. The Commodity Exchange Act ("CEA") has long been judged to prevent those abuses.
3. Accordingly, *prior* to the hasty and last minute passage of the Commodity Futures Modernization Act of 2000 ("CFMA"), "all futures activity [was] confined by law (and eventually to criminal activity) to [CFTC regulated] exchanges alone." Johnson & Hazen, *Derivatives Reg.* (2008 Cum. Supp.) at p. 27.
4. At the behest of Enron, the CFMA authorized the "stunning" change to the CEA to allow the option of trading energy commodities on deregulated "exempt commercial markets," *i.e.*, exchanges exempt from CFTC, *or any other* federal or state, oversight, thereby rejecting the contrary 1999 advice of the President's Working Group on Financial Markets. *Id.* This is called "the Enron Loophole."
5. Two prominent and detailed bipartisan studies of the Permanent Subcommittee on Investigations ("SPI") staff represent what is now conventional wisdom: hedge funds, large banks and energy companies, and wealthy individuals have used "exempt commercial energy futures markets" to drive up needlessly the price of energy commodities over what economic fundamentals dictate, adding, for example, what the SPI estimated to be @ $20-$30 per barrel to the price of crude oil.
6. The SPI staff and others have identified the Intercontinental Exchange ("ICE") of Atlanta, Georgia as an unregulated facility upon which considerable exempt energy futures trading is done. For purposes of facilitating exempt natural gas futures, ICE is deemed a U.S. "exempt commercial market" under the Enron Loophole. For purposes of its facilitating U.S. WTI crude oil futures, the CFTC, by informal staff action, deems ICE to be a U.K. entity not subject to direct CFTC regulation even though ICE maintains U.S. headquarters and trading infrastructure, facilitating, *inter alia*, @ 30% of trades in U.S. WTI futures. That staff informal action may be terminated instantly by the CFTC under existing law.
7. Virtually all parties now agree the Enron Loophole must be repealed. The simplest way to repeal it is to add two words to the Act's definition of "exempt commodity" so it reads: an exempt commodity does "not include an agriculture *or energy* commodity;" and two words to 7 U.S.C. § 7 (e) to make clear that "agricultural *and energy* commodities" must trade on regulated markets. An "energy commodity" definition must be then be added to include crude oil, natural gas, heating oil, gasoline, heating oil, metals, etc. In the absence of quick CFTC action permitted by law, the statute should also be amended to forbid an exchange from being deemed an unregulated foreign entity if its trading affiliate *or* trading infrastructure is in the U.S.; *or* if it trades a U.S. delivered contract within the U.S. that significantly affects price discovery.
8. Legislative proposals now seriously under consideration are problematic. They do not address ICE's exemption from U.S. regulation as a "U.K." entity; and they put the burden on the CFTC and the public to prove in complicated contract-by-contract bureaucratic proceedings, that regulation is needed for an individual energy contract, rather for an exempt trading facility. It will also lead to traders using regulatory arbitrage to move to unregulated contracts not found to be subject to regulation. The CFTC will always being trying to catch up to uncovered speculative and harmful trading.

Introduction

My name is Michael Greenberger.

I want to thank the subcommittee 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") energy 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; the now infamous Western electricity market manipulation of 2001-2002 caused by the market manipulation of Enron and others; the collapse of one of the Nation's largest futures commission merchants, Refco, Inc., the then eighth largest futures commission merchant in the 14th largest bankruptcy; the collapse of the hedge fund, Amaranth Trading Advisers, LLC.; and the present subprime mortgage meltdown, which is substantially premised upon OTC derivatives contracts deregulated by statute in 2000 by Congress.

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 United States energy futures trading markets are featured as a case study of the way in which unregulated or poorly regulated futures and derivatives trading cause 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 and fraud within those markets.

The Soaring Price of Energy Commodities Despite Stable Supplies

In examining the questions relating to the high price of energy to American consumers, it is useful to remember that as of January 2002, the cost of crude oil was @ $18 a barrel;[1] by the end of 2005, it had risen to @ $50;[2] and, as of today, the price, which has recently flirted with a record high $100 a barrel, now rests at @ $88 per barrel.[3] In early 2004, the average retail price of gasoline of which crude is a major component was @ $1.50 per gallon.[4] As of today, the average price of gas is slightly below $3 per gallon, with substantial speculation that it will soon soar to over $4.00.[5] Since March 31, 2007, or the "close" of last winter's heating season, the wholesale price of heating oil has risen 32%, from $1.88 per gallon to a record high of $2.77 per gallon.[6] As I show below, these soaring price rises continue despite the fact that supplies of oil both in the U.S. and worldwide remain relatively stable.[7]

Moreover, as recently as January 2002, the spot price of natural gas was approximately $3 MMBtu.[8] By December 2005, the cost of natural gas had "float[ed] to a [record] high near $14 MMBtu."[9] Following a Republican sponsored floor amendment that would have imposed new regulatory restrictions on the deregulated natural gas futures market, the price of natural gas quickly dropped by one third.[10] By late July, 2006, the futures price of natural gas to be delivered in October 2006 had risen to a yearly high of $8.45 MMBtu. After Amaranth collapsed in September 2006, the futures price dropped "to just under $4.80 per MMBtu . . ., the lowest level for that contract in two and

[1] Jad Mouawad & Heather Timmons, *Trading Frenzy Adds to Jump in Price of Oil*, N.Y. TIMES, Apr. 29, 2006, at A1.
[2] *Id.*
[3] Commodities & Futures Overview, Crude Oil Lt Sweet Pit (Nymex) January 2008, WALL STREET J. ONLINE, *available at* http://online.wsj.com/mdc/public/page/mdc_commodities.html.
[4] 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 10 (June 27, 2006) [hereinafter Permanent Subcomm. June 2006 Report].
[5] Clifford Krauss, *Unseasonably Higher, Gas Prices Add to Strain on U.S. Consumers*, N.Y. TIMES, Nov. 8, 2007, *available at* http://www.nytimes.com/2007/11/08/business/08gas.html?fta=y.
[6] *See* U.S. No. 2 Heating Oil Wholesale/Resale Price, Petroleum Navigator, ENERGY INFORMATION ADMINISTRATION, *available at* http://tonto.eia.doe.gov/dnav/pet/hist/whowsus4w.htm.
[7] *See* API Energy Data: Weekly Snapshot, WALL STREET J. ONLINE, Dec. 7, 2007, *available at* http://online.wsj.com/mdc/public/page/2_3020-oilstats.html.
[8] Henry Hub Natural Gas Daily Spot Prices: 2001-2007 (Dec. 7, 2007), *available at* http://www.ferc.gov/market-oversight/mkt-gas/overview/2007/ngas-ovr-hh-pr-rg.pdf [hereinafter Market Overview] (from Federal Energy Regulatory Commission (FERC)).
[9] 151 CONG REC. H11553-01 (daily ed. Dec. 14, 2005) (statement of Rep. Pombo).
[10] *See, e.g.*, AM. PUB. 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.

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."[11] As recently as the end of June, 2007, natural gas rose to over $10 per MMBtu.[12] On June 25, 2007, the Congressional investigations of natural gas futures dysfunction began in earnest with attendant discussions of new regulatory structures, including aggressive FERC investigations.[13] The price therefore spiked at the end of June and today is at the lower, but still relatively high, price of about $7 per MMBtu.[14]

The Two Bipartisan PSI Staff Reports on Distortions in Energy Markets Caused by Unregulated Futures Trading

The 2006 PSI Bipartisan Staff Report on Crude Oil and Natural Gas Speculation. In June 2006, the staff of the Permanent Subcommittee on Investigations ("PSI") of the Senate Homeland Security and Government Affairs Committee issued a bipartisan report making clear that the dramatic increases in commodity prices described above were not attributable (as conventional wisdom insisted at the time) on problems of supply/ demand. Instead, price spikes were caused by dysfunctionality in the recently deregulated energy futures markets and in the maladministration by the CFTC of its no action process pertaining to purported "foreign boards of trade." In that report, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*,[15] the staff showed, for example, that "U.S. oil inventories are at an eight year high and OECD inventories are at a 20 year high,"[16] and that the "last time crude oil inventories were that high in May 1998 – at about 347 million barrels – the price of crude oil was about $15 a barrel."[17]

The staff noted that, in the analysis of one of the Nation's leading energy economists, Philip Verleger, the "reason for this divergence [between adequate supplies and soaring prices] is that purchases of long-term crude oil futures contracts have pushed up the longer-term futures prices by so much that it is more profitable for [speculators] to store the oil and then sell it at a later date than sell it today, even at record spot prices."[18] The 2006 Report concluded that with the then price of oil at @ $70 per barrel (as opposed to @ $90 now), anywhere from $20-30 of that price was caused by excessive speculation or manipulation, rather than by supply/demand.[19]

[11] STAFF OF THE S. PERM. SUBCOMM. ON INVESTIGATIONS, 110TH CONG., REPORT ON EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 1-2 (2007) [hereinafter 2007 Report].
[12] Commodities & Futures Overview: Nat. Gas Henry Hub Pit (Nymex) January 2008, WALL STREET J. ONLINE, *available at* http://online.wsj.com/mdc/public/page/mdc_commodities.html [hereinafter Nat. Gas Henry Hub Pit].
[13] *See generally* 2007 Report, *supra* note 11; Statement of FERC Chairman Joseph T. Kelliher, Subcomm. on Oversight and Investigations of House Comm. On Energy and Commerce, Dec. 12, 2007.
[14] Nat. Gas Henry Hub Pit, *supra* note 12.
[15] Permanent Subcomm. June 2006 Report, *supra* note 4.
[16] *Id.* at 1.
[17] *Id.* at 2.
[18] *Id.* at 25.
[19] *Id.* at 2, 23.

In this vein, Abdalla al-Badri, OPEC's secretary general announced early this month that OPEC will not lift oil production to reduce prices charged to consumers out of the futility such an action, saying: "The market is not controlled by supply and demand . . . It is totally controlled by speculators who consider oil as a financial asset."[20]

The June 2006 bipartisan staff report recommended ending the deregulation of energy futures contracts brought about by the so-called Enron Loophole passed in December 2000[21] and having the CFTC alter staff no action letters that now allow U.S.-owned exchanges trading U.S. crude oil futures in the U.S. to remain regulated by British regulators under a regulatory scheme that fails to protect the American consumers from excessive speculation and manipulation of "spot" crude oil, gasoline, and heating oil prices.[22]

The 2007 PSI Bipartisan Staff Report on Excessive Natural Gas Speculation. The authors of that June 2006 Report were quick to recognize, that that report was based only on publicly available information and that the staff therefore had "gaps in available market data."[23] Those gaps were eliminated with regard to natural gas futures trading in the bipartisan report released by the PSI staff on June 25, 2007: "*Excessive Speculation in the Natural Gas Market*."[24] That 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 transactions from trading records" and "numerous interviews of natural gas market participants."[25]

That bipartisan 2007 Report is not only 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 2007 Report on natural gas speculation 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.[26]

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[20] Robin Pagnamenta, *OPEC rejects rise in output but prepares for review*, TIMESONLINE, Dec. 6, 2007, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article3007105.
[21] *See* 2007 Report, *supra* note 11, at 8, 119-20.
[22] Permanent Subcomm. June 2006 Report, *supra* note 4, at 49.
[23] *Id.* at 6.
[24] 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].
[25] *Id.* at 2.
[26] Today's report is also fully corroborated by a sophisticated economic study conducted during the 2006 natural gas futures market destabilization period. *See* ROBERT J. SHAPIRO & NAM D. PHAM, AN ANALYSIS OF SPOT AND FUTURES PRICES FOR NATURAL GAS: THE ROLES OF ECONOMIC FUNDAMENTALS, MARKET

The 2007 PSI Report's Basic Findings. The basic findings of the SPI 2007 Report on natural gas speculation are:

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."[27]

Second, Amaranth's dominance of this market caused extensive price volatility. As recently as January 2002, the spot price of natural gas was approximately $3 MMBtu.[28] 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 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."[29]

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.'"[30]

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."[31]

STRUCTURE, SPECULATION, AND MANIPULATION (August 2006), *available at* http://www.pulp.tc/Nat_Legal_Policy_Center_Gas_Manip_August_29_2006.pdf.
[27] June 25 Report, *supra* note 25, at 2.
[28] Market Overview, *supra* note 8.
[29] 2007 Report, *supra* note 11, at 1-2 (citations omitted).
[30] *Id.* at 11 (internal citations omitted).
[31] *Id.* at 114.

Fifth, as reflected in substantial commentary presented to the PSI 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]."[32]

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.[33] However, the PSI 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."[34] 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"].[35] Because of the infamous "Enron loophole"[36] 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."[37] "As a result, NYMEX's instructions to Amaranth did nothing to reduce Amaranth's size, but simply caused Amaranth's trading to move from a regulated market to an unregulated one."[38] 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"[39] even though "NYMEX and ICE are functionally equivalent markets."[40]

Seventh, the bipartisan 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.[41]

Observations on the 2007 PSI Staff Report. I would add only the following few comments to the comprehensive 2007 Report:

[32] *Id.* (internal citation omitted).
[33] 7 U.S.C.A. § 6a(a) (2006).
[34] 2007 Report, *supra* note 11, at 120.
[35] *Id.*
[36] *Id.* at p. 119; *see* 7 U.S.C.A. § 2(g), (h)(3) (2006).
[37] 2007 Report, *supra* note 11, at 119.
[38] *Id.* at 3.
[39] *Id.* at 40.
[40] *Id.* at 3.
[41] *Id.* at 119-32.

Poorly Considered Enron Loophole. First, it should be emphasized that the "Enron loophole" – which allows energy futures trading facilities to choose 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 Senate 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.[42] 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),[43] the Enron loophole exempted OTC energy derivative markets (even though functionally equivalent to the regulated exchanges) from CFTC and all other federal regulation.[44]

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.[45] While this legislation retained CFTC authority to investigate fraud and manipulation (but not excessive speculation) in OTC energy markets,[46] the CFTC, as a practical matter, read this legislation as generally 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. As the leading commentators on derivatives regulation have stated:

> "[The CFMA] moved fitfully through the Congress, having been declared dead on several occasions only to be resurrected at the last minute and enacted by members of Congress prepared to recess for the Christmas holidays. The most stunning procedural feature of the CFMA was its lack of legislative history [to] help resolves ambiguities in legislative drafting. . . ." [47]

The Enron Loophole and Western States Electricity Crisis. 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

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[42] *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 (3d ed. Supp. 2002).

[43] *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 16 (1999), *available at* http://www.ustreas.gov/press/releases/reports/otcact.pdf.

[44] Edward J. Rosen & Geoffrey B. and Goldman, *SWAPs & Other Derivatives in 2001*, *in* THE COMMODITY FUTURES MODERNIZATION ACT OF 2000, 581-88 (2001).

[45] *See* Jeff Gosmano, *Electronic Trading Could Change; Enron Situation Rolls Markets*, NATURAL GAS WEEK, Nov. 12, 2001 (noting Enron Online's launch in November 1999).

[46] Rosen & Goldman, *supra* note 44, at 585.

[47] PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION (2008 Cum. Supp.) at 1.17, p. 27.

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.[48] 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.[49] 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: *e.g.*, long term supply contracts costing $700 million during the electricity crisis would only cost $350 million by March 2002.[50]

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.[51]

The Enron Loophole's Premium Price. In addition to malpractices in the Western United States electricity markets, the 2006 bipartisan 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 $20-30 per barrel increase in the cost of crude oil at the time crude oil was @ $70 a barrel.[52] One can only guess as to what speculation has added to the price of crude oil now that it is within striking range of $100. That speculation is enough to prevent OPEC from increasing production only to sell their product into a market where that increased production only leads to higher prices because of excessive speculation.[53]

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[48] *See* Press Release, 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.
[49] Peter Navarro & Michael Shames, *Aftershocks—And Essential Lessons—From the California Electricity Debacle*, 24 ELECTRICITY J. 2003, at 24.
[50] 148 CONG. REC. S2018-03 (daily ed. Mar. 19, 2002) (statement of Sen. Cantwell); Senators Propose Bill Regulating OTC Markets, ENERGY COMPASS, Feb. 14, 2002; *see also, e.g.*, Navarro & Shames, *supra* note 49, 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 supra* text accompanying notes 8-9.
[51] 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.
[52] *See supra* notes 2-3 and accompanying text.
[53] *See* Pagnamenta, *supra* note 20.

The overwhelming influence of Enron on these unregulated markets is evidenced by the 2007 PSI 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."[54] 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 indication 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 PSI staff has recommended, the Enron loophole should be repealed.

House Republican Efforts to Reregulate Natural Gas Futures Markets

The bipartisan nature of the 2007 PSI 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, on December 14, 2005, the then Republican-controlled House led by 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,[55] 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."[56] 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 Graves' December 2005 action and there was considerable analysis at that time that the mere threat of aggressive regulation of natural gas futures markets by a Republican controlled House may have been responsible for that price decline.[57]

"Foreign Boards of Trade" Run by U.S. Companies Facilitating Unregulated Trading in U.S. Crude Oil Contracts

Besides the deregulatory effect of the CFMA and that statute's contribution to the opaqueness of the deregulated energy futures transactions, there is an informal CFTC staff process that has evolved into a further obstacle to controlling excessive speculation and manipulation in energy futures markets: that is, the CFTC staff no action letter process permitting Foreign Boards of Trade ("FBOT's") the right to trade energy futures products on computer terminals located in the U.S., but be exempt from direct U.S. regulation.

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[54] 2007 Report, *supra* note 11, at 57.
[55] 151 CONG. REC. H11554 (daily ed. Dec. 14, 2005).
[56] 151 CONG. REC. H11553-01 (daily ed. Dec. 14, 2005) (statement of Rep. Pombo).
[57] *See, e.g.*, AM. PUB. 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.

The 1996 German Exemption. In February 1996, the CFTC Division of Trading and Markets ("T&M"), in what appeared at the time to be an action of little consequence, authorized the German futures exchange, then called the Deutsche Terminborse (DTB), to allow trading of DTB foreign delivered contracts on computer terminals within the U.S.[58] In what was a surprise to almost everyone, the privilege granted to DTB for U.S. terminals resulted in a substantial upsurge in that exchange's business. Shortly thereafter, virtually all the world's major FBOT's desired exemptions from U.S. regulation for the U.S. trading of foreign delivered futures contracts.

Recognizing the substantial trading that would be done under this kind of exemption, the CFTC first tried to establish a Commission rule that would govern regulatory exemptions for these foreign exchanges.[59] When the Commissioners could not promptly agree on such a rule and because of the need quickly to level the playing field in terms of giving other foreign exchanges the rights given to DTB, it was decided that T&M would oversee these approvals through a no action letter process.[60]

The Original Limited Staff No Action Process for FBOT's. As a result, on July 23, 1999, I signed a no action letter that permitted the principal U.K. futures exchange, LIFFE, the same rights that had earlier been afforded to DTB.[61] There followed a series of similar no action letters (almost all signed after I left the Commission in September 1999) for other foreign exchanges, including the exchange most relevant to the present enquiry: the U.K.'s International Petroleum Exchange ("IPE"),[62] subsequently purchased by the U.S.-based Intercontinental Exchange ("ICE") in 2001.[63]

These no action letters were filled with uniform standard conditions carefully confining the regulatory right afforded. Each of the FBOT's had to be regulated by a foreign governmental entity whose regulatory format was akin to that of the CFTC.[64] Assurances had to be received from the FBOT that meaningful information about trades would be provided the CFTC, especially in situations where there was a concern about market manipulation. Information sharing arrangements had to be in place assuring the CFTC that the foreign regulatory authority overseeing the FBOT would provide relevant information to the CFTC promptly upon request.[65] Even more important, a condition was written into these no action letters that the FBOT itself would "provide, upon the request of the [CFTC], the . . . Department of Justice, . . . , prompt access to original books and records maintained at their United States offices . . ."[66] Moreover, in these no action

[58] Access to Automated Boards of Trade, 64 Fed. Reg. 14,159 (Mar. 24, 1999) (to be codified at 17 C.F.R. pts. 1, 30).
[59] *Id.*
[60] *Id.*; *see also* Access to Automated Boards of Trade, 64 Fed. Reg. 32,829 (June 18, 1999) (withdrawing March 24, 1999, proposed rules).
[61] LIFFE Administration & Management, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 38, 59-60 (July 23, 1999).
[62] IPE, CFTC No-Action Letter, 1999 CFTC Ltr. LEXIS 152, 53 (Nov. 12, 1999).
[63] *See* IPE, CFTC No-Action Letter, 2002 CFTC Ltr. LEXIS 90, 3 fn.3 (July 26, 2002).
[64] *See* LIFFE Administration & Management, CFTC No-Action Letter, *supra* note 61, at 65-66.
[65] *Id.* at 68-71.
[66] *Id.* at 68-69.

letters, "the [CFTC's] ability to bring appropriate action for fraud or manipulation" was retained.[67] Finally, the CFTC authority was ***"retain[ed] to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in [the agency's] discretion***."[68]

FBOT U.S.-Delivered Contracts Exempt from Prior CFTC Staff Approval. The no action letters also specified the precise contracts that could be traded under the approval.[69] Until quite recently, those contracts were always **foreign** based and not in direct conflict with U.S. futures contracts traded on U.S. exchanges. Under the original "no action" template, the FBOT had to seek affirmative approval of T&M before it could list new contracts.[70] In July 2000, that policy was changed to allow FBOT's to list new contracts simply by giving notice to the CFTC.[71] On the basis of that action, FBOT's no longer needed prior CFTC staff approval to list new contracts.

FBOT Approval Was Not for U.S. Controlled Exchanges or U.S. Contracts. When the no action approval process was instituted in July 1999, there was an intent not to undercut U.S. exchanges that were fully compliant with, and under the regulatory control of, the CFTC. By requiring the foreign exchange to list the contracts it would market under the no action letter and by further requiring the exchange to receive the express approval of the CFTC if it wanted to add contracts, it was fully understood that the T&M would not allow a foreign exchange to market contracts that were U.S. denominated or delivered and directly competitive to those offered by U.S. exchanges. Second, ***it was well understood that the FBOT no action process was for exchanges that were organized in foreign countries.*** It was ***never*** contemplated that the no action process would apply where a foreign exchange was owned by a U.S. entity.

Therefore, under the original FBOT no action process, both the introduction of products that were in direct competition with U.S. exchanges or the purchase of an exempt foreign exchanges by U.S. entities ***were understood to trigger the immediate revocation of the no action approval and the requirement that those previously exchanges register as a U.S. regulated market under the direct auspices of the CFTC***.

CFTC Staff Continues FBOT Exemption Even After a U.S. Company Purchases IPE. Unfortunately, when the IPE was purchased by the Atlanta-based ICE in 2001, CFTC staff, despite considering four post-acquisition ICE no action letter amendments, never required that exchange after the acquisition to become a U.S. regulated contract market. Indeed, this is so even though it is my understanding that ICE has transferred the

[67] *Id.* at 64.
[68] *Id.* at 73.
[69] *Id.* at 60-62.
[70] *Id.* at 62.
[71] 65 Fed. Reg. 41,641, Notice of Statement of Commission Policy Regarding the Listing of New Futures and Option Contracts by Foreign Boards of Trade that Have Received Staff No-Action Relief to Place Electronic Trading Devices in the United States (July 6, 2000); *see also supra* note 58, describing the CFTC's recent repeal of this regulation and assertion of a more aggressive stance toward the review of new contract designations by a FBOT.

bulk of its oil trading platform from the U.K. to computerized trading infrastructure now located in Atlanta.[72]

CFTC Staff Continues FBOT Exemption Even After FBOT Facilitates U.S. WTI Trading. Moreover, in February 2006 by merely serving notice on CFTC staff, ICE began trading U.S. based futures contracts in direct competition with what had theretofore been Nymex's signature and exclusive oil futures contract: the United States West Texas Intermediate crude oil contract ("WTI"). As of October 2007, ICE had garnered over 33% market share of WTI volume, a futures contract based on crude oil delivery in the United States.[73] ICE now also trades U.S. gasoline and home heating oil contracts.[74]

Regulatory Arbitrage Caused by U.S. Owned FBOT's. As the 2006 PSI staff report so aptly concluded: "This type of unregulated trading of [] U.S. commodit[ies] from within the United States undermines the very purpose of the Commodity Exchange Act and the central mission of the CFTC – to prevent manipulation or excessive speculation of commodity prices 'to the detriment of the producer or the consumer and the persons handling the commodities.'"[75] According to the most recent public report that could be obtained, while the CFTC has entered into new (and duplicative) information sharing arrangements with the U.K. and ICE to conduct surveillance on ICE's influence on U.S. commodity markets, "[s]o far, the CFTC has sought only data that are tied to the [Nymex] natural gas contract" – not to possibly excessively speculative trading taking place with regard to the U.S. WTI contracts.[76]

Simple Proposal to End the Enron Loophole

1. The Simplest Enron Loophole Fix. The quickest, most effective way to end the Enron Loophole is to simply go back to the *status quo ante* before the Loophole was passed in December 2000, *i.e.*, treat "energy commodities" the way the CFMA treats "agricultural commodities," 7 U.S.C. § 7 (e), and explicitly exclude "energy commodity" (as the CFMA does for an "agricultural" commodity) from the definition of an "exempt commodity,"[77] 7 U.S. C. § 1a (14), thereby removing energy commodities from the umbrella of 7 U.S.C.§ 2(h)'s deregulatory ambit and make such trading subject to Designated Contract Markets ("DCMs") regulation (as the PWG unanimously recommended in November 1999).[78] This calls for a two word change to two sections of

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[72] *See* Gerelyn Terzo, *A Battle Royal: A Sleek Upstart and an Entrenched Giant Are Waging All-Out War for the Soul of the Energy Trading Market*, INVESTMENT DEALERS DIGEST, May 1, 2006, *available at* www.iddmagazine.com; Kevin Morrison, *Nymex 'Disadvantaged' by Future Rules*, FINANCIAL TIMES, Apr. 18, 2006, at 35.
[73] *Id.*; CFTC, WTI Crude Oil: Futures Volume & ICE Market Share, chart (2007).
[74] Permanent Subcomm. June 2006 Report, *supra* note 4, at 49.
[75] *Id.*
[76] Greenberg Traurig, Private Funds Weekly Roundup, Feb. 5, 2007, *available at* http://www.gtlaw.com/pub/alerts/2007/0205a.pdf.
[77] 7 U.S.C. § 1a(14) would be changed to say: "The term 'exempt commodity' means a commodity that is . . . not an agricultural *or energy* commodity." A new definitional term of "energy commodity" would then be added to the definitional section of the statute to include crude oil, natural gas, metals, heating oil, gasoline, construction materials, propane gas, and other fuel oils.
[78] *See* PRESIDENT'S WORKING GROUP, *supra* note 43.

the Act, i.e., an "exempt commodity" in § 1a (14) of the Act would exclude "an agriculture *or energy* commodity"[79]; and "agricultural *and energy*" commodities must be traded on regulated markets. 7 U.S.C. § 7 (d).

2. The "Safety Valve" of Statutory Exemptive Authority. Under § 4(c) of the Act, the CFTC may create exemptions from Nymex-like or DCM regulation if it finds any proposed exemption by a contract market consistent with the public interest and purposes of the act and the exemption will not have a materially adverse effect on the ability of the CFTC to discharge regulatory or self regulatory responsibilities. This statutory safety valve will allow the CFTC to alter Nymex-like regulation in transparent and public agency proceedings where appropriate.

3. Statutory Regulatory Requirements of a DCM. To the extent trading in OTC energy commodities becomes part of the Designated Contract Markets ("DCMs") process, as is true of agricultural products defined in §1a (14), under the existing Commodity Exchange Act, those DCMs will adhere, as does Nymex, to the CFMA's Core Principles,[80] designed to prevent, *inter alia*, excessive speculation, manipulation or fraud. Alternatively, the contract market can apply for the lesser (but still protective) regulation applied to a Derivatives Transaction Execution Facility ("DTEF") (7 U.S.C. § 7a) if it chooses to only permit trading by sophisticated investors and institutions. Again, general exemptions from any regulation may be allowed by the CFTC under § 4 (c) of the Act.

4. FBOT's Should Neither Be Affiliated with A U.S. Entity Nor Trade U.S. Delivered Contracts Significantly Affecting Price Discovery. Finally, a new § 2 (j) should be added to provide expressly:

> "No entity or subsidiary of an entity that: (i) is incorporated or has its principal place of business in the United States; or (ii)) facilitates agreements, contracts, or transactions that serve a significant price discovery function within the United States shall be eligible for status as an approved Foreign Board of Trade."

5. Grace Period. Finally, the bill's effective date should provide a grace period of 180 days to existing trading facilities that must apply for status as Contract Designated Market under the new legislation, or for those trading facilities that have applied and are awaiting approval for that status or a statutory exemption from DCM status.

ANALYSIS OF EXISTING LEGISLATION TO CLOSE THE ENRON LOOPHOLE

1. No Pending Legislation Designed to End the Enron Loophole Addresses ICE's and Its Subsidiary's Status as a U.K. Regulated Entity for Purpose of West Texas Intermediate Crude Oil Trading. As the June 2006 SPI report makes clear that are at present only two major contract markets trading the all important WTI futures contracts:

[79] *See supra* note 77.
[80] 7 U.S.C.A. § 7(a)-(d) (West 2006 & Supp. 2007).

Nymex, which is fully regulated by the CFTC, and ICE's subsidiary which is regulated by the U.K. even though its corporate parent is located within the U.S.; its trading infrastructure is within the U.S.; and it has @ 30% of the contract market in a contract that indisputably affects the price of, *inter alia*, crude oil. If "ending the Enron Loophole" does not impact ICE for purpose of its facilitating WTI crude oil trades, a major component of the excessive price paid by U.S. citizens and businesses will be totally unaffected by newly enacted legislation.

2. <u>The ICE WTI Loophole Could Be Ended Immediately by the CFTC without Any Legislation.</u> Since the FBOT exemption under which ICE evades U.S. regulation is the product of a CFTC staff no action letter, and since that no action letter includes absolute rights of termination by the CFTC, the CFTC needs no legislative authority to fix this loophole, but could immediately ask ICE to show cause why it should not register as a fully regulated DCM, as is true of Nymex, in order to keep trading the U.S. WTI contract. Again, because ICE is a U.S. company, with a *U.S. trading infrastructure, and because the WTI contract significantly affects price discovery in a U.S. market, the CFTC would be fully within *existing* statutory authority to insist that ICE register either as a DCM (or a DTEF) or seek an appropriate exemption from such regulation under the public and transparent procedures of § 4 (c) of the Act.

3. <u>The Legislation Proposed by the CFTC (and the PWG) to End the Enron Loophole Puts the Burden on that Agency and the Public through Highly Bureaucratic Procedures to Stop Soaring Commodity Prices.</u> The CTFC and the President's Working Group has only recommended regulating otherwise deregulated futures contracts if an individual contract "serve[s] a significant price discovery function in order to detect and prevent manipulation."[81] The proposed definition of a "significant price discovery function" is narrow and it has been widely reported that, under the CFTC and PWG analysis, it would only cover a single natural gas contract presently traded by ICE.

4. <u>The CFTC Proposes Lengthy Administrative Proceedings in Which It and the Public Would Bear the Burden of Proof.</u> Whether its proposed definition of "significant price discovery function" is broad or narrow, the CFTC under that proposal would have to engage in a lengthy administrative procedure in which the burden would be on it or other government or private parties to prove a "significant price discovery function," thereby causing self evident agency and litigation-related delays before any anti-manipulation controls could be put in place. This regulatory approach differs from the template underlying the Commodity Exchange Act, *i..e.*, that all futures contracts are automatically covered by the Act's protections (*i.e.*, the very nature a publishing the prices of futures contract is to provide price discovery) unless (1) the proponent of the contract demonstrates to the CFTC that lesser or no regulation is required under § 4 (c) of the Act; or (2) the proponent is able to obtain a full statutory exemption, *e.g.*, the Enron Loophole.[82] Of course, virtually everyone agrees that the absolute statutory exemption afforded by the Enron Loophole must be ended. In short, it is far preferable to just end that exemption, rather than to play contract-by-contract gamesmanship, and to have those

[81] Letter of the President's Working Group on Financial Markets to Sen. Michael D. Crapo, at 1.
[82] *See* JOHNSON & HAZEN, *supra* note 47, at 26-34.

who believe that they are entitled to regulatory relief bear the burden of proving that entitlement to the CFTC in a § 4 (c) proceeding.

5. The CFTC Proposal Will Lead to Further Regulatory Arbitrage. Of course, under the CFTC's proposed statutory structure, it will not be just the CFTC that will bear the burden of proving a "significant price discovery function," but it will be other federal and state consumer protection agencies and U.S. consumers of the commodity that will have to join with it (or perhaps even fight it) to prove that point. The CFTC's structure of imposing on itself and the public the burden of proving "significant price discovery," will be tantamount to a lawyers' relief act for those who can afford the lawyers to prove this arcane point. Finally, once lengthy administrative proceedings and related litigation are ended proving that an individual contract has a "significant price discovery function," traders will then employ regulatory arbitrage and they will simply move their trading to those contracts that remain exempt from regulation as Amaranth did when Nymex imposed position limits and that hedge fund just moved its trading ICE.

6. The Original Levin Legislation Comes Closest to Effectively Ending the Enron Loophole. On September 17, 2007, Senator Levin introduced S. 2058,[83] the "Close the Enron Loophole Act." It does not purport to resolve the CFTC's dealing with U.S.-based ICE as an entity regulated by the U.K. when trading U.S. WTI contracts. S. 2058 does offer a considerable improvement over the CFTC legislative proposal, because it calls for regulating the entire contract market (not just the contract itself) if the market facilitates contracts performing a "significant price discovery function."[84] S. 2058 also has a more developed definition of the "term significant price discovery function;" creates a self regulatory process for the electronic trading facility on a regulated contract market; and expressly empowers the CFTC to enforce the closing of the Enron Loophole.[85] Finally, S. 2058 also puts the burden on the contract market to apply for regulated status, rather than relying upon the CFTC to prove that that market or the any contracts on it should be regulated.[86] In other words, a contract market would run the risk of violating Senator Levin's proposed statute and of suffering substantial sanctions if it was found not to have properly registered with the CFTC. This regulatory approach relieves the CFTC and U.S. commodity consumers from having to bear the expensive burden of proving that there should be regulation.

7. The Levin/Feinstein Compromise. On October 31, 2007, Senator Feinstein circulated a draft of legislation entitled the "Prevention of Fraud and Manipulation in Energy Markets Act." That legislation included many "reporting" requirements pertaining to deregulated energy futures contracts, and further provided that an "exempt commercial market upon which any price determining [energy] contract is presently executed" shall "be designated as a qualified electronic trading facility" ("QETF").[87] That proposal does not make clear what entity does that designating or the consequences of

[83] S. 2058, 110th Cong. 2007.
[84] *Id.* at § 2(a)(14) (defining a new "energy trading facility").
[85] *Id.* at § 2(a)-(c).
[86] *Id.* at § 2(j)(1)-(4).
[87] Prevention of Fraud and Manipulation in Energy Markets Act (unintroduced draft 2007), § 2(b).

failing to be designated as a QETF. Once designated, a QETF would have to comply with certain core principals, but far fewer than those required of a designated contract market under the existing statute, such as those with which Nymex complies.

In any event, in order to ready legislation of this nature as an amendment to Senate consideration of the Farm Bill, Senators Levin and Feinstein circulated a compromise version of their legislation on November 14, 2007.[88] That compromise adopts the CFTC's process of making contract-by-contract determinations of whether an unregulated contract is a "significant price discovery contract."[89] There is no provision for regulation of an entire contract market. That tact once again puts the burden back on the CFTC and the public to prove that there should be regulation with all the attendant bureaucratic delay and litigation. The contact-by-contract designation would be lengthy and would encourage regulatory arbitrage. The Levin/Feinstein compromise does give the CFTC powers to enforce the proposed statute's provisions.

8. The Easiest Course to End the Enron Loophole Has Not Been Chosen. None of the pending legislation takes the easiest tact: *i.e.*, return to the *status quo ante* prior to passage of the Enron Loophole. First, simply redefine an "exempt" commodity, as the PWG in 1999 would have done, as not including an energy commodity. With a simple two word change in two sections of the Act to join "energy" with "agricultural" commodities, all energy futures trading (as is now true of all agricultural futures trading) would be done on regulated exchanges unless the contract market demonstrates the need for a legitimate regulatory exemption to CFTC under § 4 (c) of the Act. Second, provide that no contract market would be eligible to trade U.S. energy futures contracts as a foreign board of trade if it is affiliated with a U.S. entity; has its trading engines within the U.S.; *or* trades U.S. futures contracts in the United States that have a significant effect on U.S. energy prices.

[88] Leg. Proposal for Significant Price Discovery Contracts on ECMs (unintroduced draft to amend 7 U.S.C.A. §§ 1-27), Nov. 14, 2007.
[89] *Id.* at § 1(a).

Mr. STUPAK. Thank you, Professor. And Ms. Campbell, please, for an opening statement.

STATEMENT OF LAURA CAMPBELL, ASSISTANT MANAGER, ENERGY RESOURCES, MEMPHIS LIGHT, GAS AND WATER

Ms. CAMPBELL. Chairman Stupak and members of the subcommittee, I appreciate the opportunity to testify before you today, and I thank you for calling this hearing to examine the critically important issue of the need for greater transparency in the energy markets.

My name is Laura Campbell, and I am the assistant manager of energy resources for Memphis Light, Gas and Water, or MLGW. MLGW is the Nation's largest three-service municipal utility, and we currently provide services to over 420,000 customers. I am testifying today on behalf of the American Public Gas Association, or APGA.

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 States, and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by and accountable to the citizens they serve. APGA's top priority is the safe and reliable delivery of affordable natural gas.

To bring gas prices back to affordable level, we ultimately need to increase the supply of natural gas. However, also critical is to restore public confidence in the natural gas pricing. This requires the natural gas market to be fair, orderly, and transparent so that the price consumers pay reflects the fundamental supply-and-demand forces and not the result of manipulation or abusive conduct. An appropriate level of transparency does not currently exist, and that has led to a growing lack of confidence by our members in the natural gas market.

Without question, natural gas futures contracts traded on NYMEX and financial contracts for natural gas traded on the over-the-counter or OTC markets are economically linked. The market for financial and natural gas contracts is composed of a number of segments, which include futures contracts traded on NYMEX, the financial contracts for natural gas traded on the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities known as exempt commercial markets, or ECMs. They also may be traded bilaterally on electronic platforms through voice brokers and in direct bilateral transactions between counter parties.

The impact of last year's activities by the Amaranth advisors' hedge fund exemplifies both the linkage and the harm caused by the lack of transparency in these markets. When the positions accumulated by Amaranth began to unwind, gas prices decreased. Unfortunately, many of APGA's members had already locked in prices prior to that period at levels that did not reflect the current supply-and-demand conditions.

As a result, the elevated prices during that period when Amaranth held these exceedingly large positions, many of APGA's members were forced to pay a premium, which was passed through to their customers on their gas bill.

Today the Commodity Futures Trading Commission has effective oversight of NYMEX, and the CFTC and the NYMEX provide a significant level of transparency. But the simple fact is that the CFTC's large trader reporting system, its chief tool in detecting and deterring manipulative market conduct, generally does not apply with respect to transactions in the OTC markets. This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection by the CFTC until after the damage is done to the market.

It simply makes no sense to have transparency with respect to one small segment of the market and none with respect to a larger and growing segment. Accordingly, APGA believes that transparency in all segments of the market is critical to ensure that the CFTC has a complete picture of the market. We believe that the CFTC does not currently have the tools necessary to police its beat. The CFTC has done a good job in catching market abuses after the fact. However, by the time these cases are discovered using the tools currently available to government regulators, our members and their customers have already been injured by the higher natural gas prices that result from these abusive activities.

It is beyond dispute that the CFTC did not have a complete picture of the full extent of Amaranth's trading position until after Amaranth's collapse and that Amaranth was able to use the current gaps in transparency to obscure their abusive activities from the regulatory authorities while Amaranth was engaging in those abuses. Greater transparency with respect to the traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas, will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

One additional issue I would like to briefly address relates to the enforcement response to Amaranth. Both the CFTC and FERC have brought enforcement actions against Amaranth. FERC's enforcement action was the first brought under its anti-manipulation authority contained in the Energy Policy Act of 2005. APGA supported congressional action to provide FERC with this new anti-manipulation authority, and we support FERC's use of this authority through its recent enforcement action.

APGA's view was then and remains that FERC's new anti-manipulation authority affords consumers an important additional measure of protection. We support having multiple cops on the beat and urge the CFTC and FERC to work closely together to provide consumers with the full measure of protection that Congress intended.

The current situation is not irreversible. Congress can provide American consumers with the protection they deserve by passing legislation that would turn the lights on in these currently dark markets. APGA looks forward to working with you to accomplish this goal, and I will be happy to answer any questions that you may have.

[The prepared statement of Ms. Campbell follows:]

TESTIMONY OF LAURA CAMPBELL

Chairman Stupak and Members of the Subcommittee, I appreciate this opportunity to testify before you today and I thank you for calling this hearing to examine the critically important issue of the need for greater transparency in our energy markets. My name is Laura Campbell and I am the Assistant Manager of Energy Resources for Memphis Light Gas & Water (MLGW). MLGW is the nation's largest three-service municipal utility and currently provides service to more than 420,000 customers. Since 1939, MLGW has met the utility needs of Memphis, Tennessee and Shelby County residents by delivering reliable and affordable electricity, natural gas and water service. Natural gas is the most popular means of residential heating in the MLGW service area and we currently provide natural gas to more than 313,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's members have lost confidence that the prices for natural gas in the futures and the economically linked over-the-counter ("OTC") markets are an accurate reflection of supply and demand conditions for natural gas. This lack of confidence has increased over the past several years as volatility in the natural gas market has drawn hedge funds and others to the market. Restoring our trust in the validity of the pricing in these markets requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct. APGA strongly believes that this level of transparency currently does not exist, and this has directly led to the current lack of confidence in the natural gas marketplace. Although APGA's number one priority is the safe and reliable delivery of affordable natural gas, which ultimately will require an increase in the supply of natural gas, it is equally critical that public confidence in the pricing of natural gas be restored through increased transparency.

APGA believes that statutory changes are necessary to remedy the lack of market transparency which undermines the public's confidence in the pricing integrity of these markets. Accordingly, APGA has called upon Congress to move quickly to pass legislation that would increase transparency in the natural gas markets.

THE MARKET IN NATURAL GAS CONTRACTS

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on the New York Mercantile Exchange ("NYMEX"), a designated contract market regulated by the Commodity Futures Trading Commission (CFTC). Contracts for natural gas are also traded in the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities which are exempt from regulation as exchanges ("exempt commercial markets" or "ECMs"). They may also be traded in direct, bi-lateral transactions between counterparties, through voice brokers or on electronic platforms. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus economically linking the various financial natural gas market segments, including regulated futures markets, ECMs and bilateral trading, whether conducted on an electronic trading platform or otherwise.

The exemption under Section 2(h)(3) of the Act providing for ECMs was added as part of the Commodity Futures Modernization Act of 2000 ("CFMA"). In general, the greater flexibility of a principles-based regulatory framework provided for by the CFMA has worked exceedingly well with respect to the regulated markets, as has the CFMA's overall concept of tiered regulation based upon the characteristics of the trader and of the commodity traded. However, since enactment of the CFMA, changes in the nature of trading and the composition of traders on ECMs warrant reconsideration of the provisions relating to ECMs. More broadly, as discussed in greater detail below, issues surrounding the lack of transparency are particularly acute with respect to trading in contracts for natural gas and the lack of transparency with respect to the market for natural gas should be reconsidered. In this regard, differentiating the appropriate regulatory response based upon the characteristics of the particular commodity traded is consistent with the overarching framework and philosophy of the CFMA.

Specifically, with respect to ECMs, there is scant legislative or regulatory history with respect to the intent behind the Section 2(h)(3) exemption. Nevertheless, the trading platforms that have qualified for exemption under this provision have evolved since enactment of the CFMA in a number of ways. Initially, such markets tended to be an electronic substitute for voice brokers with respect to the trading of OTC contracts. Their participants were generally limited to those in the trade and trading likely carried with it counterparty credit exposure. Since then, however, ECMs have introduced cleared transactions, effectively removing the counterparty risk of such transactions which initially distinguished their trading from trading on futures exchanges. In addition, ECMs over the years have attracted greater numbers of non-trade market participants, such as hedge funds. The introduction of clearing of contracts that are financially settled based upon the settlement prices of regulated futures contracts along with this broader and deeper non-trade customer base has, over time, rendered trading on some ECMs to be largely indistinguishable from trading on regulated futures markets. These markets are economically linked through arbitrage and the prices on one affect prices on the other.

The economic links between the natural gas futures contracts traded on NYMEX and those contracts, agreements and transactions in natural gas traded in the OTC markets (which include but are not limited only to trading on ECMs) are beyond dispute. Without question, a participant's trading conduct in one venue can affect, and has affected, the price of natural gas contracts in the other. [1]

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies ("LDC"), including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts. Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[2] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and which do not reflect its true value. This has a direct affect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that reflects bona fide demand and supply conditions. If the futures price is manipulated or distorted, then the price a consumer pays for the fuel needed to heat their home and cook their meals will be similarly manipulated or distorted.

Today, the CFTC has effective oversight of NYMEX, and the CFTC and NYMEX provide a significant level of transparency with respect to NYMEX's price discovery function. But, the OTC markets, which include but are not limited to ECMs, lack such price transparency. The lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market. It simply makes no sense to have transparency over one segment of the market and none over a much larger segment, especially when the OTC markets are the fastest growing sectors of the natural gas marketplace. APGA strongly believes that it is in the best interest of consumers for Congress to rectify this situation by passing legislation that would ensure an adequate level of transparency with respect to OTC contracts, agreements and transactions in natural gas.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[3]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform has determined to voluntarily provide information on traders' large positions,[4] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions.[5] Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected until after the damage has been done to the market, ultimately harming the consumers or producers of natural gas.

AMARANTH ADVISORS LLC

Last year's implosion of Amaranth Advisors LLC ("Amaranth") and the impact it had upon prices exemplifies these linkages and the impact they can have on natural gas supply contracts for LDCs. Amaranth was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund-MotherRock- further contributed to the extreme volatility in the price of natural gas. The Report by the Senate Permanent Subcommittee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility. [6]

The lack of OTC transparency and extreme price swings surrounding the collapse of Amaranth have caused bona fide hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

GREATER TRANSPARENCY NEEDED

APGA members, and the customers served by them, do not believe there is an adequate level of market transparency under the current system. This lack of transparency leads to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one segment of the total market. Without comprehensive large trader position reporting, the government is currently handicapped in its ability to detect and deter market misconduct. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on NYMEX, on an OTC multi-lateral electronic trading facility which is exempt from regulation or through bi-lateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms. The passage of legislation is necessary to achieve this needed level of transparency.

BI-LATERAL TRADING

Because Amaranth's trading was largely conducted on both a regulated futures exchange and on an unregulated electronic trading facility, the immediate focus has been confined to the relative inequality of transparency between those two multi-lateral trading venues. Moreover, because the volume of transactions in bi-lateral markets may not be as apparent as the volume of transactions on exchanges or electronic trading facilities there may be a tendency to discount the impact that the bi-lateral markets have upon the price discovery process. APGA believes that, to be comprehensive, a large trader reporting system must include large positions amassed through the OTC bi-lateral markets in addition to those accumulated on futures exchanges or on OTC electronic trading facilities.

Bi-lateral trading can also take place on an electronic trading venue that may be as attractive to traders as multi-lateral trading facilities. Enron On-line, for example, was an all-electronic, bi-lateral trading platform. Using this platform, Enron offered to buy or sell contracts as the universal counterparty to all other traders. On the Enron On-line trading platform, only one participant--Enron--had the ability to accept bids and offers of the multiple participants--its customers-- on the trading platform. This one-to-many model constitutes a dealer's market and is a form of bi-lateral trading.[7]

Section1a(33) of the Act further defines bi-lateral trading by providing that, "the term 'trading facility' does not include (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bi-lateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, non-discretionary automated trade matching and execution algorithm. . . . ." This means that it is also possible to design an electronic platform for bi-lateral trading whereby multiple parties display their bids and offers which are open to acceptance by multiple parties, so long as the consummation of the transaction is not made automatically by a matching engine.

Both of these examples of bi-lateral electronic trading platforms might very well qualify for exemption under the current language of sections 2(g) and 2(h)(1) of the Commodity Exchange Act. It is entirely foreseeable that if a CFTC large-trader reporting regime were expanded to require the reporting of positions entered into only on multi-lateral electronic trading facilities and does not include bi-lateral electronic trading platforms too, traders who wish to evade the new reporting requirement would simply be able to move their trading activities from an electronic trading facility to a bi-lateral electronic trading platform, just as Amaranth moved its trading from NYMEX to ICE.

Moreover, even in the absence of electronic trading, the ability of traders to affect prices in the natural gas markets through direct or voice-brokered bi-lateral trading should not be underestimated. For example, a large hedge fund may trade bi-laterally with a number of counterparty/dealers using standard ISDA documentation. By using multiple counterparties over an extended period of time, it would be possible for the hedge fund to establish very large positions with each of the dealer/counterparties. Each dealer in turn would enter into transactions on NYMEX to offset the risk arising from the bi-lateral transactions into which it has entered with the hedge fund. In this way, the hedge fund's total position would come to be reflected in the futures market.

Thus, a prolonged wave of buying by a hedge fund, even through bi-lateral direct or voice-brokered OTC transactions, can be translated into upward price pressure on the futures exchange. As futures settlement approaches, the hedge fund's bi-lateral purchases with multiple dealer/counterparties would maintain or increase upward pressure on prices. By spreading its trading through multiple counterparties, the hedge fund's purchases would attract little attention and escape detection by either NYMEX or the CFTC. In the absence of routine large-trader reporting of bi-lateral transactions, the CFTC will only see the various dealers' exchange positions and have no way of tying them back to purchases by a single trader.

NEED FOR LEGISLATION

As previously stated in this testimony, establishing the level of transparency that APGA maintains is warranted will require the passage of legislation. There have been a number of bills introduced in the House that directly address market transparency. Those bills include the PUMP Act introduced by Chairman Stupak, the

Market TRUST Act introduced by Congressmen Barrow (D-GA) and Graves (R-MO) and the Close the Enron Loophole Act introduced by Congressman Welch (D-VT). The CFTC has also recommended changes to the Act that would extend its large trading reporting system and other regulatory requirements to contracts traded on an ECM that are significant price discovery contracts.[8]

APGA believes that the legislation that Congress enacts to enhance transparency in these markets should require that large traders report their positions regardless of whether they are entered into on designated contract markets, on electronic trading facilities, on OTC bi-lateral electronic trading platforms, in the voice-brokered OTC markets or in direct bilateral OTC markets. This would treat all trading positions in financial natural gas contracts equally in terms of reporting requirements. Extending large trader reporting to OTC natural gas positions and to positions entered into on electronic trading facilities will provide the CFTC with a complete picture of the natural gas marketplace and ensure that the cop on the beat has the tools necessary to be effective.

Although some have raised concerns about the costs of expanding the large trader reporting system, APGA believes the costs would be reasonable. Insofar as the CFTC's large trader reporting system is already operational, there would be no need to create an entirely new program to collect this information. In addition, large traders, such as those which would be required to report to the CFTC, will likely have automated recordkeeping systems for their own internal risk management purposes that could be adapted for the purpose of reporting positions to the CFTC. APGA believes that the costs of a comprehensive large trader reporting system for natural gas would be reasonable and are far outweighed by the benefits in terms of helping assure consumers that the market price is a reflection of appropriate market forces.

Even if Congress determines to extend the CFTC's routine large trader reporting system only to contracts traded on ECMs, it should take care that the enhanced level of transparency is not drawn too narrowly. In this regard, unlike some of the legislative proposals such as the Market TRUST Act and the Close the Enron Loophole Act which apply broadly to ECMs, the CFTC's legislative recommendations apply only to those specific contracts traded on an ECM that have been found to be a significant price discovery contract. Where some contracts on an ECM are found to be a significant price discovery contract but other, related contracts are not, there is the danger that in response to regulatory inquiries or disciplinary action, a trader would move his positions to the less transparent, less regulated contracts trading on the same trading platform. This is the very course of action that Amaranth followed when, in order to avoid regulatory scrutiny, it liquidated its positions on NYMEX and opened similar positions on ICE. In order to avoid this possibility, APGA urges Congress to extend the CFTC's large trader reporting system to all contracts traded on an ECM for a commodity the prices of which are discovered to a material degree by trading on the ECM. In this way, a trader will not be able to obscure its positions by moving them between contracts, some regulated and others not, which are traded on the same ECM.[9]

CFTC Enforcement Authority

The need to provide the CFTC with additional surveillance tools through legislation does not imply that the CFTC has not been vigilant in pursuing wrongdoers using its current statutory enforcement authorities. In this regard, we note that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets. These actions affirm the CFTC's vigor in pursuing misconduct in these markets. However, while APGA applauds the CFTC's vigorous enforcement efforts to address misconduct with respect to trading in the energy markets, it notes that increased coordination between Federal regulators is necessary to provide U.S. consumers with the full measure of protection that Congress has provided.

In this regard, both the CFTC and the Federal Energy Regulatory Commission (FERC) initiated enforcement actions against Amaranth in connection with Amaranth's trading activities in natural gas, alleging that Amaranth had engaged in price manipulation. The CFTC brought a civil enforcement action against Amaranth in the United States District Court for the Southern District of New York. [10] The FERC brought an administrative action, issuing an Order to Show Cause and Notice of Proposed Penalties with respect to Amaranth's trading activities.[11] Significantly, FERC's enforcement action was the first brought by it under the anti-manipulation authority granted to FERC by the Energy Policy Act of 2005, Pub. L. No. 109-58 (2005).

In response to FERC's commencement of its enforcement action, Amaranth argued to the U.S. District Court that its futures trading activities are subject to the exclusive jurisdiction of the CFTC and beyond the jurisdiction of FERC. FERC maintains that its authority to impose penalties upon those who manipulate markets in natural gas applies not only to direct participants in the physical gas markets, but also to entities whose manipulative conduct in the financial markets directly or indirectly impacts the price of FERC-jurisdictional transactions. On September 28, 2007 the American Public Gas Association, American Public Power Association (APPA) and National Rural Electric Cooperative Association (NRECA) jointly filed an amicus memorandum of law with the court in support of FERC's authority to bring an enforcement action against Amaranth in connection with Amaranth's futures-related trading activities.

As a group that represents consumers, APGA supported Congress' action in providing FERC with its new anti-manipulation authority in the Energy Policy Act of 2005. APGA's view was then, and remains, that the anti-manipulation authority granted to FERC affords consumers an important additional measure of protection. Accordingly, APGA urges the CFTC and FERC to work closely together towards exercising their respective authorities in a way that increases the protection of energy consumers from market abuses, as we believe, Congress intended.

In any event, it must be borne in mind that although these efforts to punish those that manipulate or otherwise abuse markets are important, catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

Finally, APGA believes that greater public involvement would assist the CFTC as its policies necessarily evolve to meet the challenge of these new conditions in the energy markets. In this regard, APGA strongly commends the CFTC for its recent announcement of its intention to establish an Advisory Panel on Energy Markets composed of industry experts, including representatives of consumer organizations, to offer technical advice on issues relating to reporting and surveillance of the markets. APGA believes this group will play a valuable role in providing technical advice to the CFTC on issues relating to reporting and surveillance of the markets.

* * * * *

Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves.

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[1] See "Excessive Speculation in the Natural Gas Market," Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report"). The PSI Report on page 3 concluded that "Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap. . . . The data show that prices on one exchange affect the prices on the other."

[2] See the Congressional findings in Section 3 of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

[3] See letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

[4] Id, at 7. The CFTC presumably issued this call for information under Section 2(h) (5) of the Act.

[5] As explained in greater detail below, special calls are generally considered to be extraordinary, rather than routine, requirements. Although special calls may be an important complement to routine reporting requirements in conducting market surveillance, they are not a substitute for a comprehensive large trader reporting system.

[6] See PSI Report at p. 119

[7] This stands in contrast to a many-to-many model which is recognized as a multilateral trading venue. This understanding is reflected in section 1a (33) of the Act, which defines "Trading Facility" as a "group of persons that . . . provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system."

[8] "Report on the Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets," Report of the Commodity Futures Trading Commission, http://www.cftc.gov/stellent/groups/public/@newsroom/documents/file/pr5403-07—ecmreport.pdf (October 2007).

[9] As part of this authority, the CFTC could determine that particular contracts with de minimus levels of trading would be exempt from the reporting requirement. This would enable the CFTC to exempt particular contracts traded on the ECM that are inactive or too illiquid to be used in this way by a trader with large positions.

[10] See, U.S. Commodity Futures Trading Commission v. Amaranth Advisors, L.L.C., Amaranth Advisors (Calgary) ULC and Brian Hunter, No. 07CIV 6682 (SDNY filed July 25, 2007).

[11] Amaranth Advisors, LLC et al, Federal Energy Regulatory Commission Docket No. IN07-26-001.

Mr. STUPAK. Thank you, Ms. Campbell. Mr. Cota, please, opening statement.

STATEMENT OF SEAN COTA, PRESIDENT AND CO-OWNER, COTA & COTA INC.

Mr. COTA. Honorable Chairman Stupak, Ranking Member Whitfield, and distinguished members of the committee, thank you for this invitation to testify before you today. I currently serve as the regional chair of Petroleum Marketers Association of America, a national federation of 46 States in regional associations representing over 8,000 independent fuel marketers that account for about half the gasoline sold and nearly all of the distillate sold to American consumers in the United States. I am also the president of New England Fuel Institute, which represents over 1,000 heating oil fuel dealers in related service companies throughout the Northeast. NEFI members' companies deliver approximately 40 percent of the nation's heating oil, and many market diesel fuel, heating oil, propane, kerosene, jet fuel, and off-road diesel and motor vehicle fuels.

Finally, I provide insight today as a co-owner and President of Cota & Cota of Bellows Falls, Vermont, a third-generation family-owned and operated heating fuel provider in southern Vermont and western New Hampshire. Unlike larger energy companies, most retailer dealers are small, family-run businesses. Also unlike larger energy companies, heating oil and propane dealers deliver product directly to the doorstep of American homes and businesses.

With the winter weather once again settling across the country, American families are facing a new and cold reality. In the Northeast, where consumers use over 80 percent of the nation's heating oil, the increase in heating oil costs has left them not only wondering how to fit the heating bill into the family budget but also wondering—and this is the billion-dollar question—why energy prices have skyrocketed so abruptly.

Excessive speculation in the market is driving this runaway train. Even the general secretary of OPEC said this week, "the market is not controlled by supply and demand. It is totally controlled by speculators who consider oil as a financial asset." The rise in heating oil prices and crude prices in recent months has dragged with it nearly every single refined product, especially heating oil. Since March 2007, when the industry recognized the end of the peak heating season demand, the wholesale price of heating oil had risen a remarkable 32 percent from $1.88 per gallon to $2.77 per gallon, despite reports by the EIA that heating inventories remain well above the 5-year average.

Home heating fuel dealers do not benefit from inflated prices now set by activity in the energy commodities market. For us, volatility and skyrocketing prices mean strained credit lines with terminals, suppliers, and their banks, increased cash demands. A load of heating oil to me now costs $27,000, where just a few years ago it was less than $10,000. Struggling families find it harder to pay their bills, further straining the dealers' credit obligations with their banks and suppliers. Consumers are more likely to use credit cards for their purchases, due to hidden credit card company interchange fees, and consumers ultimately pay more for their fuel. Federal and State LIHEAP dollars, already at severely insufficient levels, become diluted by rising prices, and each dollar invested in the energy assistance program is only able to help fewer families in need.

Additionally, many heating fuel companies like mine hedge in an effort to protect consumers against roller-coaster-like price volatility in energy commodity markets. Because of this we strongly support open, transparent exchanges subject to the rule of Law. In fact, it is essential to a business like me, which began to offer fixed pricing to our consumers 20 years ago. We enter into NYMEX-based futures contracts with our suppliers, who purchase contracts for future delivery and then resell these contracts to me for profit. In this way, companies like mine are able to financially hedge heating fuels to the benefit of the consumer and help protect them against uncertainty and volatility.

However, the ability of commodities markets to set the price based upon economic fundamentals has become less and less reliable, and, as a result, so do our hedging programs. As the influence of price setting functions under the under-regulated markets continue to grow, American consumers are forced to ride the same speculative roller coaster as the energy trader. My Congressman, Peter Welch, from Vermont, has helped to bring this important question for my State and for all American consumers nationwide to these halls.

For far too long, insufficient oversight in transparency has encouraged excessive speculation in creating a trading environment that rewards misdeeds like the recent allegations against Amaranth Hedge Funds in British Petroleum. Loopholes in Federal Law have created what I call "dark markets", energy trading environments that operate without adequate Federal oversight or regulation. Today, the vast majority of trading occurs in these markets.

We strongly urge that Congress make and take swift action to bring these dark markets to light. We would recommend that, one, closing the notorious Enron loophole ripped open by the Commodities Futures Modernization Act, through which billions of dollars have poured since it was created in 2001. Virtually overnight, this loophole freed electronic trading from the Federal oversight. Congress needs to close the loophole and enclose it for all energy commodities, thereby returning the CFTC to the statutory authority that it lost 7 years ago.

Two, investigate the CFTC's use of no-action letters, which Professor Greenberger alluded to earlier, which I call the no-action loophole. In this area, the CFTC could provide regulatory exemptions to applicable foreign boards of trade that offer contracts for delivery within the United States. The current process may fail to provide sufficient public notice and consultation and may not take into account the impact that these letters have had on the market. Moreover, in order to obtain such exemptions, the CFTC requires that a comparable regulatory authority be presented in a country where these exchanges operate. Congress should examine whether or not it determined such regulatory authorities be comparable. And finally, we are concerned that no-action letters may have been approved for exchanges that sought to establish electronic platforms overseas in order to circumvent U.S. regulatory authority.

And three, provide adequate funding to the CFTC, which currently receives approximately one tenth of the funding of its sister regulator, the Securities and Exchange Commission. We make these recommendations while acknowledging that there are several different policy recommendations floating around on Capitol Hill from an array of sources, including legislators, the Commission, Administration officials, futures groups, and commodity exchanges themselves. We ask that your deliberations take into account all trading environments in all energy commodities, not just the regulation of one commodity to the exclusion of others.

Moreover, we urge lawmakers and Administration officials take into account the impact of these reforms in rulemaking on the American consumer and small businesses like mine. Again, thank you, Mr. Chairman, and to your colleagues for this opportunity to present my insight on this issue. And I am open to any questions later.

[The prepared statement of Mr. Cota follows:]

Mr. Sean Cota
Co-Owner and President, Cota & Cota, Inc.
Northeast Chair, Petroleum Marketers Association of America
President, New England Fuel Institute

Testimony before the
United States House of Representatives
Committee on Energy & Commerce
Subcommittee for Oversight & Investigations

Washington, DC
December 12, 2007

Honorable Chairman Stupak, Ranking Member Whitfield and distinguished members of the committee, thank you for the invitation to testify before you today. I appreciate the opportunity to provide you with insight as both a petroleum marketer and as a representative of two respected trade groups that together represent our nation's independent motor vehicle and heating fuel dealers.

I currently serve the Petroleum Marketers Association of America (PMAA)[1] as its Northeast Regional Chair. PMAA is a national federation of 46 states and regional associations representing over 8,000 independent fuel marketers that collectively account for approximately half of the gasoline and nearly all of the distillate fuel consumed by motor vehicles and heating equipment in the United States.

I am also President of the New England Fuel Institute (NEFI)[2], a 60-year-old trade association representing well over 1,000 heating fuel dealers and related services companies in the Northeastern United States. NEFI member companies deliver over 40

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[1] Official website www.pmaa.org.
[2] Official website www.nefi.com.

percent of the nation's home heating oil, and many market biodiesel, bioheat, propane, kerosene, jet fuel, off-road diesel and motor vehicle fuels.

And finally, I provide you insight today as co-owner and President of Cota &Cota, Inc. of Bellows Falls, Vermont, a third generation family-owned and operated heating fuel provider in southeastern Vermont and western New Hampshire. Unlike larger energy companies, most retail fuel dealers are small, family-run businesses. Also unlike larger energy companies, heating oil and propane dealers deliver product *directly* to the doorstep of American homes and businesses. Because of this we often develop close relationships, often lasting for decades, with our customers, their families, and our local communities.

It is in light of this important relationship that I appear before you today. With winter weather once again setting in across the country, American families are facing a new and cold reality. In the Northeast, where consumers use over eighty percent of the nation's home heating oil,[3] the increase in heating costs has left them not only wondering how to fit the heating bill into their family budget, but also wondering – and this is the billion dollar question – why energy prices have skyrocketed so abruptly.

I urge Congress to investigate the recent climb of crude oil prices to record shattering levels, despite what many consider to be reasonably grounded economic fundamentals. It has become apparent that excessive speculation is the fuel that is driving this runaway train. Even the Secretary General of the Organization of the Petroleum Exporting

[3] Energy Information Administration, "Annual No. 2 Fuel Oil and Kerosene Sales," 2005.

Countries (OPEC) said this week, "The market is not controlled by supply and demand... It is totally controlled by speculators who consider oil as a financial asset."[4] And the rise in crude oil prices in recent months has dragged with it every single refined petroleum product, especially heating oil. Since March, 2007, the industry-recognized "end" of peak demand for the heating season, the wholesale price of heating oil has risen a remarkable 32 percent, from $1.88 per gallon to a record $2.77 per gallon.[5] The spike comes despite reports by the Energy Information Administration (EIA) that heating oil inventories remain well above the five-year average.[6]

Many heating fuel customers falsely assume that their fuel dealer is the source of this increase, in the same way that many motorists falsely assume that their local gas station is "gouging" them when it is in fact speculative trading on the commodity markets that is driving up the cost of petroleum products. Fuel dealers do not benefit from the inflated prices now being set by activity on the energy commodity markets. For the heating fuel dealer, volatility and skyrocketing prices mean:

- Strained lines of credit with their terminal suppliers and their banks;
- Increased cash demands (a load of heating oil to me can now cost $27,000 dollars, where just a few years ago it averaged under $10,000);

[4] Robin Pagnamenta, "OPEC rejects rise in output but prepares for review" *The Times Online*, December 9, 2007. Accessed December 9, 2007, 6:00PM EST. <http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article3007105.ece>

[5] Energy Information Administration, "U.S. No. 2 Heating Oil Wholesale/Resale Prices," March 5-November 25, 2007

[6] At the start of the 2007-2008 heating season, the EIA reported that U.S. heating oil inventories were 6 million barrels above the 5-year average. *See Ibid*, "Short Term Energy Outlook," November 6, 2007.

- Struggling families find it harder to pay their bills and collections become more difficult, further straining a dealer's credit obligations with banks and suppliers;
- Customers will be more likely to use credit cards for their purchases and due to hidden credit card company interchange fees, customers ultimately pay more for their fuel; and
- Funding for the federal Low Income Home Energy Assistance Program (LIHEAP), already at severely insufficient levels, becomes diluted by rising prices and each government dollar invested in energy assistance is able to help fewer families in need.

Additionally, many heating fuel companies like mine hedge in an effort to protect their customers against roller-coaster-like price volatility on the energy commodity markets. Because of our industry's hedging activities, we strongly support open, transparent and well-managed exchanges subject to the rule of law. In fact, it is essential to businesses like mine. My company began offering fixed price programs to our customers twenty years ago. We enter into New York Mercantile Exchange (NYMEX) based futures contracts with our suppliers, who purchase contracts for future delivery and resell these contracts to me for a profit. In this way, companies like mine are able to financially hedge heating fuels for the benefit of the consumer, and help protect them against uncertainty and volatility.

However, the ability of the commodities markets to set a price based on economic fundamentals has become less and less reliable, and as a result, so do our hedging programs. As the influence of price-setting functions on unregulated or under-regulated markets continues to grow, and as trading on over-the-counter and foreign-based exchanges continues to become the norm, American consumers are forced to ride the same speculative roller coaster as the energy trader.

It is time that Congress put some breaks on this roller coaster. The principle question being asked by this committee today is whether or not greater regulation is needed at the federal level in order to bring about greater transparency and reliability in the energy commodity markets, thereby creating renewed stability and closing the doors to manipulative and abusive trading practices. On behalf of independent petroleum marketers and retail heating fuel dealers, the answer is "yes." For far too long, insufficient oversight and transparency has encouraged excessive speculation and created a trading environment that rewards trading misdeeds, like that of Amaranth Hedge Funds and British Petroleum. "Loopholes" in federal law have created what I call "dark markets," or energy commodity markets engaging in futures or futures like contracts, swaps and derivatives trades without adequate federal oversight and regulation. Today, a vast majority of trading occurs on these markets.[7]

More specifically, we strongly urge Congress to take swift action to bring light to the "dark markets" by:

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[7] **Nearly all experts agree that a majority of trading now occurs off of traditional exchanges like the NYMEX, and some estimate that number to be 75 percent or more.**

1. **Closing the notorious "Enron Loophole"** ripped open by the Commodity Futures Modernization Act (CFMA)[8] and through which billions of dollars have poured since it was created in 2001. Virtually overnight, the "Enron Loophole" freed all electronic markets from oversight. Congress needs to close the loophole, and close it for all energy commodities, thereby returning to the Commodity Futures Trading Commission (CFTC) the statutory authority that it lost in 2001. NEFI and PMAA are part of a broad coalition of consumer and trade groups that have begun a major grassroots effort to educate the public about the loophole. They have established closetheenronloophole.com, a website loaded with latest news, reports on abuse in the commodity markets, and even providing the general public with the opportunity to contact you, their representatives in Washington, on the subject.

2. **Investigating the CFTC's use of "no-action letters" which I call the "no-action loophole,"** whereby in certain conditions, the CFTC may provide regulatory exemptions to an applicable foreign board of trade (FBOT) offering contracts for delivery within the United States.[9] Last year, NEFI and PMAA called on the CFTC to conduct a comprehensive review of all existing no-action letters, urged commissioners to withdraw letters where appropriate, and questioned whether or not the no-action letter process is adequate.[10] The current process may fail to provide sufficient public notice and consultation, and may not

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[8] *See* 7 U.S.C. §2(h)(3), (g) (2006)
[9] *See* 17 CFR 140.99
[10] NEFI and PMAA Comment Letter to the CFTC regarding the regulation of FBOTs, July 11, 2006, Docket ID No. CFTC-2006-0039-0001.

take into account of the full impact that these letters may have on the market. Moreover, in order to obtain such an exemption, the CFTC requires that a "comparable" regulatory authority be present in the country where the exchange operates. Congress should examine whether or not it determines such regulatory authorities to be "comparable." And finally, we are concerned that no-action letters may be requested and approved for exchanges seeking to establish electronic platforms overseas with the intent to circumventing U.S. regulatory authority.

3. **Provide adequate funding to the CFTC**, which currently receives approximately one-tenth of the funding of its sister-regulator, the Securities and Exchange Commission (SEC). Greater funding will be needed in order to provide the futures regulator with adequate personnel, IT infrastructure and resources to adequately regulate energy commodity exchanges and to fully implement existing and future regulatory authority.

Additionally, while we applaud the CFTC for its recent announcement of intent to establish an Advisory Committee on Energy,[11] we hope that Acting Chairman Lukken and the Commissioners will work to insure that all interests and perspectives are represented, including those of small businesses like mine, as well as that of consumers, energy distributors, storage companies, and noteworthy academics.

[11] *See* "CFTC Seeks Legislative Change to Regulation of Exempt Commercial Markets," CFTC Press Release 5403-07, October 24, 2007.

We make these recommendations all the while acknowledging that there are several different policy recommendations floating around Capitol Hill from an array of sources, including legislators, commission and administration officials, futures trade groups and the commodity exchanges themselves. Each proposal claims to have the solution for well regulated and balanced energy commodity markets. No doubt some of my fellow panelists will be making alternative recommendations to you today. As members of Congress weigh each these recommendations, we urge you to always be mindful that the well-being of American small businesses, struggling families and the economy at-large must come before an exchange, energy trader, hedge fund or other market player. We also ask that your deliberations take in to account all trading environments and all energy commodities, not just the regulation of one commodity at the exclusion of all others.

We – those that provide fuels to American motorists, contractors, farmers, homes and businesses – are hopeful that Congress will vigorously investigate regulatory inadequacies and their role in excessive speculation and allegations of manipulation, and that it will provide the resources necessary to police and monitor all markets and commodities vital to U.S. interests. To do so will minimize market volatility, prevent market manipulation *before it occurs*, and close the door to individuals and trading practices that artificially inflate prices for personal gain.

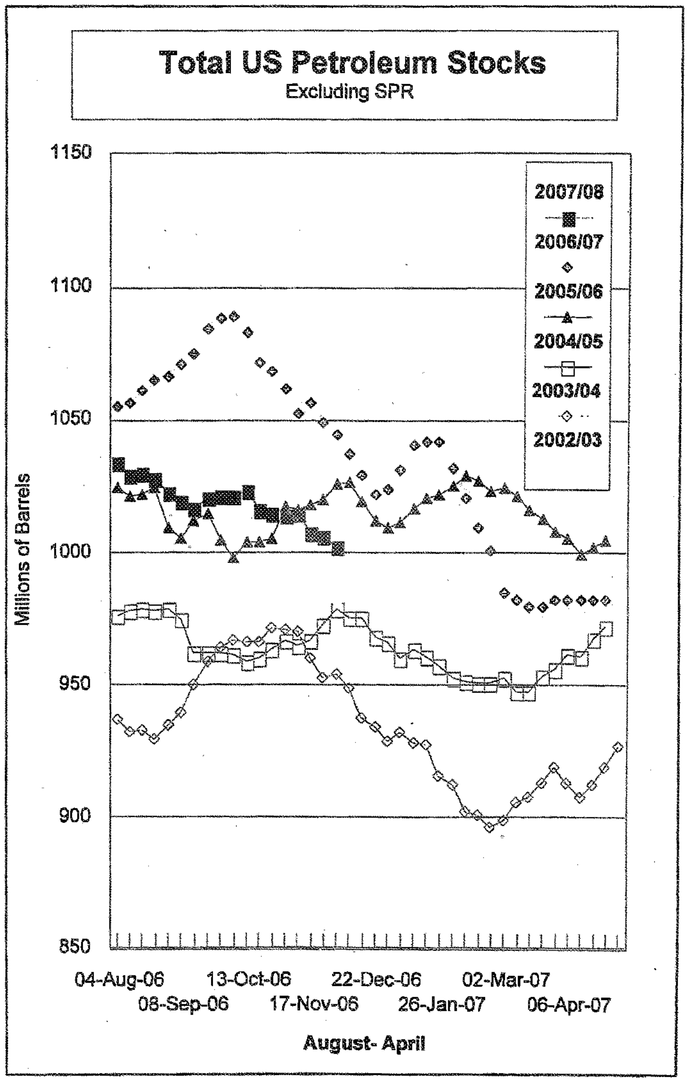
I thank you again, Mr. Chairman, and to your colleagues for this opportunity to share my insight on this issue. I am open to any questions that you might have.

APPENDIX: SUMMARY OF MAIN POINTS

The Petroleum Marketers Association of America and the New England Fuel Institute, representing America's independent motor vehicle and heating fuel marketers, believe that greater oversight is needed in the energy commodity markets because:

- The recent spike in crude oil and petroleum products, especially heating oil, do not reflect market fundamentals. Crude oil and heating oil inventories at ample supply levels. There has been a 32 percent increase in the wholesale price of heating oil since March, 2007 despite low demand for the fuel during that period. OPEC has confirmed that speculation is controlling the market.
- Abrupt and drastic increases in fuel prices due to activity on energy commodity markets hurt not only the consumer, but also the fuel dealer, who must struggle with strained credit lines with suppliers and banks, increased cash demands, higher credit card fees, payment collections; and "gouging" accusations. It also jeopardizes the reliability of fuel hedging programs. Fuel dealers and consumers are losing confidence in the ability of the markets to set prices based on economic fundamentals, putting the consumer at risk.
- Regulatory loopholes, including the "Enron Loophole" and the "No-Action Loophole" open the door to excessive speculation and abusive trading practices. Greater statutory authority should be provided to the CFTC by closing the loopholes and increasing funding so that all commodities markets are transparent, well regulated and accountable.

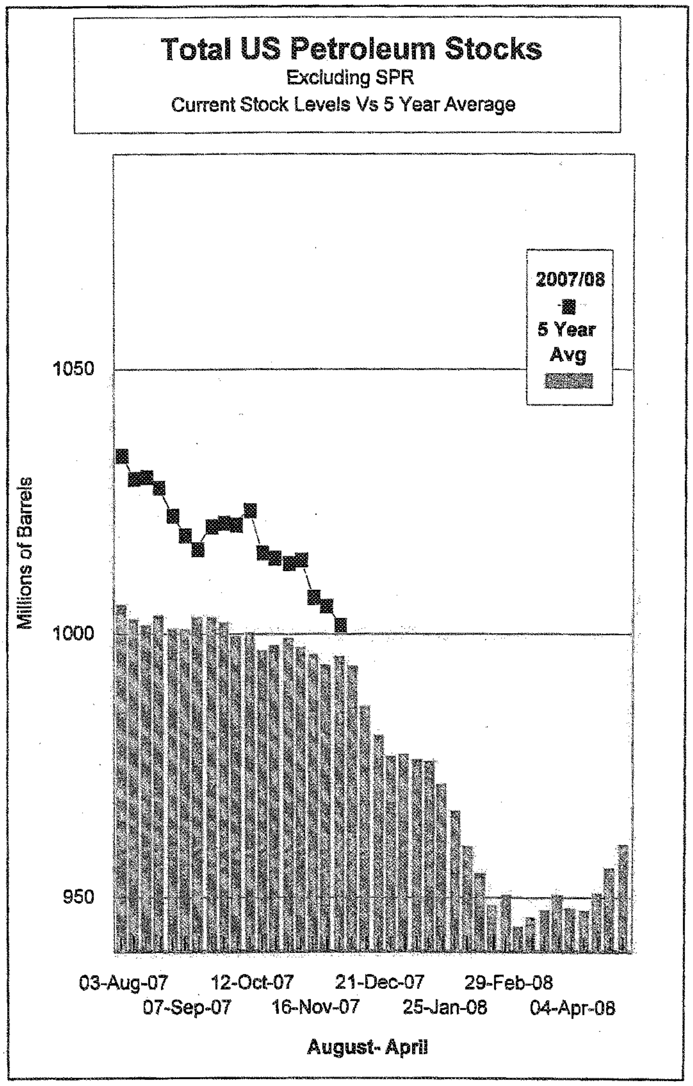
EXHIBIT 1. PETROLEUM STOCKS



Crude Oil Inventories are well over the 5-year average.

(Chart and data courtesy The Windham Group)

EXHIBIT 2. PETROLEUM STOCKS



Crude Oil Inventories are well over the 5-year average.

(Chart and data courtesy The Windham Group)

EXHIBIT 3. DISTILLATE STOCKS

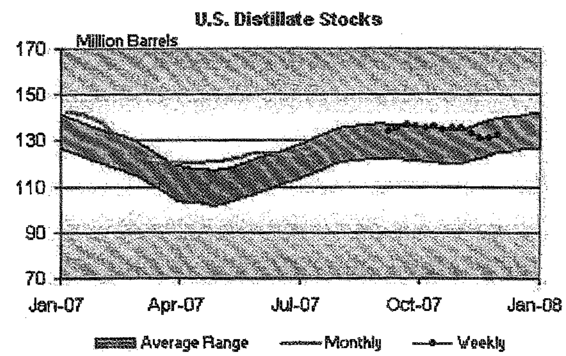
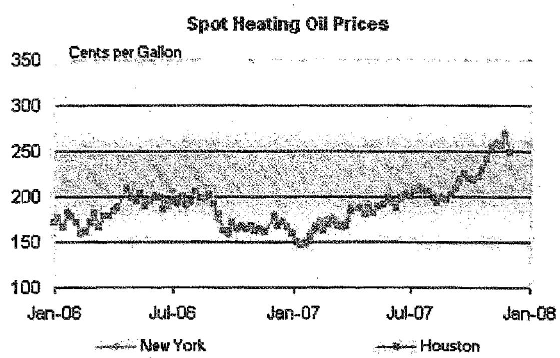


EXHIBIT 4. HEATING OIL SPOT PRICES



Heating oil prices continue to rise despite low off-season demand and above 5 year average inventory levels for distillate fuel.

(Source: EIA November 6, 2007)

Mr. STUPAK. Thank you. Mr. LaSala, please, opening statement.

STATEMENT OF THOMAS F. LASALA, CHIEF REGULATORY OFFICER, DIVISION OF COMPLIANCE AND RISK MANAGEMENT, NEW YORK MERCANTILE EXCHANGE, INC.

Mr. LASALA. Yes, Mr. Chairman and members of the subcommittee, my name is Tom LaSala, and I am the chief regulatory officer of the New York Mercantile Exchange, Inc. NYMEX is the world's largest forum for trading of physical-commodity-based futures contracts, including energy and metals products. NYMEX has been in business for 135 years and is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission, both as a derivatives clearing organization and as a designated contract market, or DCM. A DCM maintains the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current Law and regulation.

On behalf of the Exchange, its Board of Directors, and shareholders, I thank you and the members of the Subcommittee on Oversight and Investigations for the opportunity to participate in today's hearing. NYMEX is regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading, and markets. As a benchmark for energy prices around the world, trading on NYMEX is transparent, open, and competitive.

In the CFTC's direct monitoring of futures trading, NYMEX, as a DCM, has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by CFTC regulation and interpretation. As an SRO, NYMEX routinely uses tools such as large trader reporting, position accountability, and position limits to monitor and police trading in our contracts. A new statutory tier of trading facility, the Exempt Commercial Market, or ECM, was added to the CFTC's governing statute in 2000. The ECM is essentially exempt from substantive CFTC regulation and also has no explicit SRO duties by statute. In addition, to date, ECMs have not voluntarily assumed any SRO duties.

As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role and thus trigger public policy concerns and warrant a higher degree of CFTC oversight and regulation. From its vantage point as a DCM, NYMEX was able to observe firsthand how this regulatory disparity operated in the failure of Amaranth, a $7 billion hedge fund that focused upon trading of energy products that was active in a NYMEX natural gas contract.

In August of 2006, NYMEX proactively took steps to maintain the integrity of its markets by ordering Amaranth to reduce its open positions in the National Gas Futures Contract. Instead, Amaranth sharply increased its positions on the unregulated and non-transparent ICE electronic trading platform. Because ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive with each other, Amaranth's response to NYMEX's regulatory directive admittedly reduced its positions on NYMEX but did not reduce Amaranth's overall risk or the risk to Amaranth's clearing member. Unfortunately neither NYMEX nor the CFTC had efficient means to monitor Amaranth's positions on ICE or to take steps to have Amaranth reduce its participation in that trading venue.

A recent CFTC report to Congress recommends that such contracts should be subject by statute to large trader reporting, position limits, or position accountability, self-regulatory oversight, obligations, and emergency authority for both the CFTC and for the ECM itself. NYMEX strongly supports the CFTC's legislative proposals. These proposals are also supported by the President's Working Group on Financial Markets.

Finally, Congress created the CFTC in 1974, providing the new agency with exclusive jurisdiction over futures markets. Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation, a function which requires highly specialized skills. The CFTC has demonstrated such expertise. In subsequent reauthorizations, when Congress intended to create limited exemptions to that authority, it has always done so through express amendments of the CFTC's governing statute.

Consequently, most observers have concluded that Congress did not intend to alter the CFTC's exclusive jurisdiction with the Energy Policy Act of 2005. The contrary interpretation now being pursued by FERC substantially harms futures markets by adding the cost and uncertainty of conflicting standards. It also severely undermines the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

I thank you for your time today and welcome any subsequent questions you may have.

[The prepared statement of Mr. LaSala follows:]

Testimony of

Thomas LaSala, Chief Regulatory Officer

New York Mercantile Exchange, Inc.

House Energy and Commerce Committee

Subcommittee on Oversight and Investigations

Concerning

"Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?"

December 12, 2007

Mr. Chairman and members of the Subcommittee, my name is Tom LaSala and I am Senior Vice President and Chief Regulatory Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. NYMEX has been in the business for more than 135 years and is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a "derivatives clearing organization" and as a "designated contract market" (DCM), which is the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Subcommittee on Investigations and Oversight for the opportunity to participate in today's hearing on the question of "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?"

Overview

NYMEX is fully regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading and markets. In addition to the CFTC's direct monitoring of futures trading, as a DCM, NYMEX has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by

CFTC regulation and interpretation. Self-regulatory duties were voluntarily assumed by futures exchanges many years before the federal regulation of commodity markets. As an SRO, NYMEX routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

A new statutory tier of trading facility, the exempt commercial market (ECM), was added to the CFTC's governing statute in 2000. The ECM is essentially exempt from substantive CFTC regulation and also has no explicit SRO duties by statute. In addition, to date, ECMs have not voluntarily assumed any SRO duties. As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role and thus trigger public policy concerns and warrant a higher degree of CFTC oversight and regulation.

A recent CFTC report to Congress recommends that such contracts should be subject by statute to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. NYMEX strongly supports the CFTC's targeted and focused legislative proposals. The CFTC's recommended changes are also supported by the President's Working Group on Financial Markets.

Finally, Congress created the CFTC in 1974 and provided the new agency with exclusive jurisdiction over futures markets. Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation, a function which requires highly specialized skills, and the CFTC has developed such expertise. In subsequent reauthorizations, when Congress intended to create limited exceptions to that authority, it has always done so through express amendments of the CFTC's governing statue. Consequently, most observers have concluded that Congress did not intend to alter the CFTC's exclusive jurisdiction with the Energy Policy Act of 2005. The contrary interpretation now being pursued by Federal Energy Regulatory Commission (FERC) substantially harms futures markets by adding the cost and uncertainty of conflicting standards. It also severely undermines the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

NYMEX'S Role and Responsibilities as a DCM

NYMEX operates its trading facility as a designated contract market. As the benchmark for numerous energy prices around the world, trading on NYMEX is transparent, open and competitive and fully regulated by the CFTC. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts and, being price neutral, does not influence price movement. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information. Transactions can also be executed off-Exchange, i.e., in the traditional bilateral over-the-counter (OTC) arena, and submitted to NYMEX for clearing via the NYMEX ClearPort® Clearing website through procedures that will substitute or exchange a position in a regulated futures or options contract for the original OTC product.

Unlike securities markets, which serve an essential role in capital formation, organized derivatives venues such as NYMEX provide an important economic benefit to the public by serving two key functions: (1) competitive price discovery and (2) hedging by market participants. A CFTC glossary of standard industry terms informally defines hedging as follows:

> "[T]aking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; or a purchase or sale of futures as a temporary substitute for a cash transaction that

> will occur later. One can hedge either a long cash market position (e.g., one owns the cash commodity) or a short cash market position (e.g., one plans on buying the cash commodity in the future)."

The public benefits of commodity markets, including increased market efficiencies, price discovery and risk management, are enjoyed by the full range of entities operating in the U.S. economy, whether or not they trade directly in the futures markets. Everyone in our economy is a public beneficiary of vibrant, efficient commodity markets, from the U.S. Treasury, which saves substantially on its debt financing costs, to every food processor or farmer, every consumer and company that uses energy products for their daily transportation, heating and manufacturing needs, and anyone who relies on publicly available futures prices as an accurate benchmark.

As a result of the Commodity Futures Modernization Act of 2000 (CFMA), which is discussed in further detail below and which substantially modified the Commodity Exchange Act (CEA), NYMEX as a DCM generally must comply with a number of broad, performance-based Core Principles applicable to DCMs that are fully subject to the CFTC's regulation and oversight. These include eight Core Principles that constitute initial designation criteria, as well as 18 other ongoing Core Principles for DCMs. In addition to the terms of the Core Principles, the CFTC has published application guidance on compliance with the Core Principles. The guidance for each Core Principle is illustrative of the types of matters a board of trade may address, as applicable, and is not intended to be used as a mandatory checklist.

The CFMA explicitly provides that the board of trade, i.e. DCM, "shall have reasonable discretion in establishing the manner in which it complies with the core principles." The Exchange's ability to respond to rapidly changing markets as needed by introducing market-oriented changes to contracts and new risk management contracts has broadly benefited market participants.

In general, under the CEA, as a DCM, NYMEX has an affirmative statutory obligation to act as an SRO. In this connection, it is worth noting that the history of self-regulation by futures exchanges long predates the implementation of federal regulation of such markets. Indeed, self-regulatory duties were voluntarily assumed by futures exchanges not long after their inception and have been maintained over the years as a hallmark of U.S. commodity markets.

As an SRO, NYMEX must police its own markets and maintain a program that establishes and enforces rules related to detecting and deterring abusive practices. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. Thus, a DCM can list for trading only those contracts that are not readily susceptible to manipulation. In addition, a DCM must monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability for a listed contract, where necessary or appropriate.

NYMEX has numerous surveillance tools that are used routinely to ensure fair and orderly trading on our markets. The principal tool that is used by DCMs to monitor trading for purposes of market integrity is the large trader reporting system. For energy contracts, the reportable position levels are distinct for each contract listed by the Exchange for trading. The levels are set by NYMEX and are specified by rule amendments that are submitted to the CFTC, following consultation and coordination with the CFTC staff.

For example, for the physically delivered NYMEX natural gas futures contract (which is referenced by NYMEX by the commodity code NG), the reportable position level is 200 contracts. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing, among other things, on whether the futures markets price is converging with the spot physical market price as the NYMEX contract nears expiration. Large trader data is reviewed daily to monitor customer positions in the market. Specifically, on a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff. These data are collected by the CFTC and are also published in aggregate form for public view on the CFTC website in a weekly report referenced as the "Commitments of Traders" (COT) report. Historically at NYMEX, the open interest data included in large trader reports reflects approximately 80% of total open interest in the applicable contracts.

Any questionable market activity results in an inquiry or formal investigation. NYMEX closely monitors its contracts at all times in order to enforce orderly trading and liquidations. NYMEX staff additionally increases its market surveillance reviews during periods of heightened price volatility.

By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on NYMEX. Futures markets traditionally list futures and options contracts as a series of calendar contract months. For an expiring contract month in which trading is terminating, NYMEX uses a hard expiration position limit (i.e., NG at 1,000 contracts). For back months of the NG futures contract, NYMEX currently maintains an any–one-month accountability level of 7,000 contracts and an all-months-combined position accountability level of 12,000 contracts. When position accountability levels are exceeded, Exchange staff conducts heightened review and possible inquiry into the nature of the position which ultimately may result in NYMEX staff directing the market participant to reduce its positions. Breaching the position limit can result in disciplinary action being taken by the Exchange. Finally, NYMEX also maintains a program that allows for certain market participants to apply for targeted exemptions from the expiration position limits in place on expiring contracts. Such hedge exemptions are granted on a case-by-case basis following adequate demonstration of bona fide hedging activity involving the underlying physical cash commodity or involving related swap agreements.

Beyond the formal regulatory requirements, NYMEX staff works cooperatively and constructively with CFTC staff to assist them in carrying out their market surveillance responsibilities. NYMEX staff and CFTC staff regularly engage in the informal sharing of information about market developments. In addition to the Exchange's self-regulatory program, the CFTC conducts ongoing surveillance of NYMEX markets, including monitoring positions of large traders, deliverable supplies and contract expirations. The CFTC also conducts routine "rule enforcement" reviews of our self-regulatory programs. NYMEX consistently has been deemed by the CFTC to have maintained adequate regulatory programs and oversight, in compliance with its self-regulatory obligations under the CEA, which is the applicable standard of review for such assessments.

Moreover, NYMEX staff officials make referrals to CFTC staff for possible investigation, such as with respect to activity by a market participant that is not a NYMEX member or member firm. Thus, for example, in an investigation of a non-member market participant, the Exchange would lack direct disciplinary jurisdiction and the consequent ability to issue effective sanctions (other than denial of future access to the trading of our products). In that situation, NYMEX staff could (and has in the past) turned over the work files and related information to CFTC staff. All such referrals are made on a strictly confidential basis. On occasion, CFTC staff has made confidential referrals to NYMEX staff as well.

Overall, there is a strong overlap between the CFTC's regulatory mission and NYMEX's role as an SRO in ensuring the integrity of trading in NYMEX's contracts. As noted previously, NYMEX itself has a strong historic and ongoing commitment to its SRO responsibilities. The NYMEX regulatory program has a current annual budget of approximately $6.2 million, which reflects a significant commitment to both staff and technology.

Statutory Changes in 2000

The CFMA streamlined and modernized the regulatory structure of the derivatives industry and provided legal certainty for OTC swap transactions by creating new exclusions and exemptions from substantive CFTC regulation for bilateral transactions between institutions and/or high net-worth participants in financial and exempt commodity derivatives, such as energy and metals.

The CFMA also permitted bilateral trading of energy on electronic trading platforms. Under CFTC rules, these electronic trading platforms are called "exempt commercial markets" with transactions on such venues only subject to the CFTC's antifraud and anti-manipulation authority. Unlike a DCM, an ECM is, in essence, completely unregulated by the CFTC. Thus, the current form of an ECM has no express statutory self-regulatory obligations to monitor its own markets. However, unlike the regulated futures exchanges, which voluntarily assumed self-regulatory obligations long before such responsibilities were codified in federal law, ECMs have generally declined to assume such duties on a voluntary basis. Thus, it is left up to Congress to mandate such duties through legislative action.

Beyond the absence of any general or overarching SRO duties, ECMs are currently not required to maintain, nor have they voluntarily implemented any manner of surveillance tools to monitor activity on their markets to ensure the integrity of products listed on their trading venues. Therefore, ECMs do not presently utilize any tools to identify market participants who maintain large positions in their listed products, nor do they use any manner of restrictions or checks on the size of open positions that may be maintained in their products.

The CFMA was broadly embraced by the derivatives industry at the time of its passage as a landmark piece of legislation, and overall it continues to be quite effective in allowing the CFTC to keep pace with very complex and dynamic financial markets. However, with an ever-evolving market place, today's markets differ dramatically from only seven years ago, causing the need for reevaluation of certain aspects of the CFMA. Due to the changes in the market place, non-regulation of certain ECMs can no longer be justified. Specifically, a series of profound changes have occurred in the natural gas market since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the Intercontinental Exchange (ICE), an unregulated ECM, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably foreseen a few short years ago, the current statutory structure no longer works for certain markets now operating as "ECMs." The regulatory disparity between NYMEX and certain ECMs has created serious challenges for the CFTC as well as for NYMEX in its capacity as an SRO. In particular, the development of arbitrage activity between NYMEX and ICE has essentially caused the venues to become linked and to serve the same economic functions.

When the CFTC was in the midst of proposing and finalizing the implementation of regulations and interpretations for the CFMA, the natural gas market continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an "after-hours" basis, which contributed only approximately 7-10% of overall trading volume at the Exchange, at best a modest proportion of the overall market. Moreover, it was more than six months following the Enron meltdown before the industry began to offer clearing services for OTC natural gas transactions.

But in determining to compete with NYMEX, ICE not only copied all of the relevant product terms of NYMEX's core or flagship natural gas futures contract, but also misappropriated the NYMEX settlement price for daily and final settlement of its own contracts. As things stand today, natural gas market participants have the assurance that they can receive the benefits of obtaining NYMEX's settlement price, which is now the established industry pricing benchmark, by engaging in trading either on NYMEX or ICE.

For some time, ICE was the only trading platform that offered active electronic trading during daytime trading hours, following the launch of their market. In September of 2006, NYMEX began providing "side-by-side" trading of its products -- listing products for trading simultaneously on the trading floor and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume has increased dramatically to the extent that electronic trading now accounts for 80-85% of overall trading volume at the Exchange. The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets.

Thus, a number of market participants that specialize in arbitrage activity have established computer programs for electronic trading that automatically transmit orders to one market when there is an apparent price imbalance with the other venue or where one venue is perceived to offer a better price than the other. As a result, there is now a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive as two components of a broader derivatives market. No one could have predicted in 2000, when the exemption was crafted for energy swaps, how this market would have evolved.

In addition to the misappropriation of NYMEX's settlement price, ICE now has a significant market share of natural gas trading, and a number of observers have indicated that most of this trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the organization contracted by ICE to provide clearing services. Thus, there is now a concentration of market activity and positions occurring on the ICE market as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

Impact on Regulated Exchange from Lack of Regulation of Other Exchanges

From its vantage point as a DCM, NYMEX was able to observe first-hand how this regulatory disparity operated in the failure of Amaranth, a seven billion dollar hedge fund that focused upon trading of energy products and that was active in the NG contract. In August of 2006, NYMEX proactively took steps to maintain the integrity of its markets by ordering Amaranth to reduce its open positions in the natural gas futures contract. In June of this year, the U.S. Senate's Permanent Subcommittee on Investigations (PSI) issued a report on "Excessive Speculation in the Natural Gas Market." (PSI Report). As detailed in the PSI Report, Amaranth reduced its NYMEX position but sharply increased its positions on the unregulated and nontransparent ICE electronic trading platform. Because ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive with each other, Amaranth's response to NYMEX's regulatory directive admittedly reduced its positions on NYMEX but did not reduce Amaranth's overall market risk or the risk of Amaranth's guaranteeing clearing member. Furthermore, the integrity of NYMEX markets continued to be affected by and exposed to Amaranth's outsize positions in the natural gas market. Unfortunately, neither NYMEX nor the CFTC had an efficient means to monitor Amaranth's positions on ICE or to take steps to have Amaranth reduce its participation in that trading venue.

Because ICE price data is available only to its market participants, NYMEX does not have the means to conclusively establish the extent to which trading of ICE natural gas swaps contributes to, influences or affects the price of the related natural gas contracts on NYMEX. However, what is clear is that as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price, the two natural gas trading venues are now tightly linked and highly interactive. NYMEX staff has been advised that during most of the trading cycle of a listed futures contract month, there is a range of approximately only five to twelve ticks separating the competing NYMEX and ICE products (the NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01 cents per mmBtu). These two trading venues serve the same economic functions and are now functionally equivalent.

NYMEX staff has also been advised by market participants who trade on both markets that a rise or fall in price on one trading venue will be followed almost immediately by a rise or fall in price on the other trading venue, whether the change in price is initiated on either NYMEX or ICE. These observations of real-world market activity support the conclusion that trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX. These observations are now also supported by the research conclusions contained in an October 24, 2007 CFTC report to Congress that is noted below.

Aside from a lawsuit brought by NYMEX against ICE for the use of NYMEX's settlement prices, NYMEX does not have any other ongoing formal relationship with ICE. In particular, as ICE and NYMEX are in competition with each other, there are currently no arrangements in place - such as information-sharing - to address market integrity issues. As previously stated, NYMEX as a DCM does have affirmative self-regulatory obligations; as an ECM, ICE has no such duties. Yet, from a markets' perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive where trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

In connection with the Exchange's ongoing routine market surveillance programs and in conjunction with procedures that were described previously, NYMEX staff was aware of and monitored all open positions that Amaranth maintained in NYMEX trading venues, including the physically delivered natural gas futures contract. NYMEX conducted regular reviews of Amaranth's open positions in excess of position accountability levels prescribed in NYMEX Rule 9.26. The Exchange notes that various other contracts it offers, such as American and European options on natural gas, along with other various futures contracts, are aggregated into the Natural Gas Futures Contract (NG) for monitoring accountability levels on a futures equivalent basis. During the period in question documented by the Report, the NYMEX financially-settled Henry Hub Natural Gas futures contract (NN), was also aggregated into the Natural Gas Futures Contract for monitoring accountability levels on a "futures equivalent" basis, i.e., across several related NYMEX contracts.

As such, Amaranth's positions on NYMEX, when taken on a futures equivalent basis, were of significantly less magnitude on a percentile basis than is the case when reviewing the NG contract in isolation on a "futures-only" basis. NYMEX staff did routine monitoring of back month positions, based upon the application of position accountability levels applied on a futures equivalent protocol, which is the current standard procedure for U.S. futures exchanges. We note that consistent with statements made by NYMEX Chief Executive and President, James Newsome, NYMEX later amended certain position accountability rules in connection with lessons learned from the Amaranth matter In addition to conducting market surveillance on Amaranth's activities, NYMEX staff also conducted daily risk-based analytical "stress" tests of Amaranth's position at its carrying clearing member.

NYMEX staff members directed Amaranth in early August 2006 to reduce its open positions in the first two nearby contract months based upon what they believed to be a significant concentration in NYMEX markets in natural gas (relying upon an NG "futures only" approach). NYMEX believes that such a directive was prudent and effective with respect to reducing positions carried on our platform. As previously noted, NYMEX maintains no information sharing agreement of any kind with ICE; the Exchange also observes that, during the period in question, the CFTC was not receiving any regular information from ICE as to positions on its platform either. As a consequence, a shift of positions by Amaranth from NYMEX to ICE was undetectable both by NYMEX and the CFTC.

It is important to distinguish the activity of Amaranth from the category of hedge funds as a class of market participant. NYMEX issued a study in March of 2005, comprised of an internal market data study of trading volume and open interest analyzing the participation of hedge funds (broadly defined) in two of the Exchange's largest futures markets during 2004. The study analyzed the influence of hedge fund participation on price volatility and included a statistical test for causality. The findings were that hedge fund participation as a class of market participant did not cause volatility and, in fact, appeared to *dampen* volatility. In the natural gas futures contract, hedge funds made up 9.05% of trading volume. As a percentage of open interest, hedge funds constituted 20.4% in the natural gas futures market. In general, the study found that hedge funds tended to hold positions significantly longer than other market participants, indicating that they could be a non-disruptive source of liquidity to the market. An update conducted by Exchange staff from January to September 2006 found that while the percentage of volume contributed by hedge funds had increased (to 20.86%), the overall findings of the original study remained the same.

NYMEX is not supplied position data regarding other venues on a regular basis by either a market participant or another trading venue (such as ICE or other OTC platforms). However, by rule, NYMEX has broad authority to request and to be supplied "information" with respect to a position in excess of the prescribed accountability levels. NYMEX did gather information regarding expiring contracts in the process of approving hedge exemptions subject to NYMEX Rule 9.26 for Amaranth where they represented offsetting exposure.

Need for Legislative Change

We do not believe that the case has been made and therefore do not support any new regulation of derivatives transactions that are individually negotiated and executed off-exchange, i.e., not on a trading facility between eligible participants in the traditional bilateral OTC market. On the other hand, we *do* believe that ECMs like ICE that function more like a traditional exchange and are linked to an established exchange, should be subject to CFTC regulation. In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple effects for other clearing members and for various clearing organizations that share common clearing members.

Consequently, legislative change is now necessary to address public interest concerns created by the current structure. There is the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

CFTC Report

By letter dated October 24, 2007, the CFTC delivered to Congress a report that included recommendations to increase the oversight of some trading activity on electronic trading facilities. According to the CFTC, their report was designed to provide recommendations "to strike a balance between the appropriate level of market oversight and transparency while promoting market innovation and competition to ensure that these markets remain on U.S. soil," The CFTC report was developed in consultation with the President's Working Group on Financial Markets. The Commission's legislative recommendations include establishing the following for certain ECM contracts that serve a significant price discovery function:

1. **Large Trader Position Reporting** – comparable to reporting requirements that currently apply to contracts traded on regulated exchanges;

2. **Position Limits and/or Accountability Level Regime** – comparable to those that currently apply to similar contracts traded on regulated exchanges;

3. **Self-Regulatory Oversight** – designed to detect and prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process; and

4. **Emergency Authority** – to prevent manipulation and disruptions of the delivery or cash-settlement process.

Beyond the legislative changes proposed, the Commission also announced its intention "to: (1) establish an Energy Markets Advisory Committee to conduct public meetings on issues affecting energy producers, distributors, market users and consumers; and (2) work closely with the FERC to educate and develop best practices for utilities and others who use NYMEX settlement prices as hedging vehicles and benchmarks in pricing their energy products."

NYMEX strongly supports the CFTC's proposals. In this regard, the Exchange has consistently maintained that regulatory reform is necessary in order to promote transparent, fair and orderly markets, and the Commission's report validates this approach. ECMs contracts that serve a significant price discovery function trigger a number of public policy concerns and warrant a higher degree of CFTC oversight and regulation.

NYMEX agrees with the CFTC's conclusion and legislative recommendations that these contracts should be subject to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. These mechanisms have enabled NYMEX to provide market integrity and stability to the energy markets. NYMEX also looks forward to continuing to work with the CFTC and with the industry to establish best practices for the energy markets.

Following transmission of the CFTC's report to Congress, Senator Mike Crapo, by letter dated October 30, 2007, requested the views of the President's Working Group on Financial Markets (PWG) on the CFTC report and its recommendations. Last month, the PWG responded to Senator Crapo and expressed its support for the CFTC's recommended legislative changes. The PWG also noted its belief that the CFTC proposal "strikes the appropriate balance between protecting consumers and markets from trading abuse while ensuring continuing growth and innovation in the U.S. markets."

CFTC-FERC Jurisdictional Issues

Section 2(a)(1) of the Commodity Exchange Act provides that "[t]he Commission shall have *exclusive jurisdiction ... with respect* to accounts, agreements ... , and *transactions involving contracts of sale of a commodity for futures delivery, traded or executed on a [designated contract market* or derivatives transaction execution facility] ..." (emphasis added). This statutory grant of exclusive jurisdiction to the CFTC is unequivocal on its face. It embodies the clear intent of Congress to vest sole authority in one expert agency. NYMEX believes that this well-reasoned and wise decision of

Congress must be upheld. To allow FERC or any other federal agency to interpret its authority so broadly that it nullifies the plain meaning of the language would conflict with the clear Congressional intent. The resulting untended consequences would do grave harm to the markets, consumers and U.S. economy.

The Energy Policy Act of 2005 granted FERC new manipulation authority. At the same time, the EPAct directed that FERC establish a memorandum of understanding with the CFTC to work together in cooperation and to share information. In that memorandum of understanding, the FERC specifically conceded and acknowledged that the CFTC: "has **exclusive** jurisdiction with respect to accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery. . . ." (emphasis added.) More recently, however, FERC has broadly interpreted that authority to reach NYMEX futures transactions because many of FERC's jurisdictional entities use the NYMEX settlement price as a benchmark for their spot market pricing. The CFTC and FERC are now both exercising authority over the same conduct under different standards. The legal and practical arguments against this outcome are addressed below.

Statutory interpretation and legislative history arguments provide the legal support for preserving the CFTC's exclusive jurisdiction. These arguments are made clearly and persuasively in the recent futures industry amicus brief in support of CFTC exclusive jurisdiction and Defendant Amaranth Advisors' stay motion filed in the U.S. District Court for the Southern District of New York. NYMEX believes that a brief overview of some of those arguments is necessary and appropriate in the context of this hearing.

First, exclusive jurisdiction was intended to make the CEA and CFTC regulations the supreme body of law for futures markets and trading thereon. Congress enacted CEA exclusive jurisdiction to avoid legal uncertainty and the related market confusion and economic cost. The operation and competitiveness of U.S. futures markets are best served by virtue of one body of law applied exclusively to futures markets and trading. It ensures a cohesive and well-reasoned regime that provides financial and market integrity and ensures the legal certainty needed for the continued growth and competitiveness of U.S. futures markets. The FERC itself once found that Congress intended the CEA's exclusive jurisdiction provision "to give a single expert agency [the CFTC] the responsibility for developing a coherent regulatory program for the commodities industry and to prevent the costs and confusion associated with multiple regulators." New York Mercantile Exchange, No. EL 95-81-000, 74 FERC ¶ 61311 (1996).

Second, "jurisdiction ... with respect to ... transactions involving" NYMEX natural gas futures contracts – surely includes jurisdiction over an order to buy or sell, as well as the buying and selling of a futures contract. In fact, all trading conduct and misconduct, such as futures price manipulation, is covered by the terms "with respect to" and "involving" orders to buy and sell futures contracts and is therefore under the CFTC's exclusive jurisdiction. Any other interpretation would contradict the plain meaning of the statute and the clear intent of Congress.

Third, Congress did not create an exception to CFTC exclusive jurisdiction in 2005. Historically, when Congress has limited the CFTC's exclusive jurisdiction relative to particular products, it has done so explicitly through amendments to Section 2(a)(1)(A). To date, the limitations on the CFTC's exclusive jurisdiction apply to securities related products subject to the SEC's authority and not to energy products. If Congress intended to carve out a portion of the CFTC's jurisdiction to give to FERC, it is reasonable to expect that it would have expressly done so, as in the past. Furthermore, to provide an exception to the CFTC's exclusive jurisdiction in the context of the Energy Policy Act of 2005 would have undermined the purpose of the grant of exclusive jurisdiction in the Commodity Exchange Act. This outcome would be wholly inconsistent with the rules of statutory interpretation.

Finally, the legislative history unequivocally affirms the scope of the CFTC's exclusive jurisdiction. Congress enacted exclusive jurisdiction in the Commodity Futures Trading Commission Act of 1974. The Conference Committee, in reconciling the differing House and Senate versions of the pending bill's exclusive jurisdiction provisions, decided the House version was too ambiguous, and adopted the Senate's provision to ensure that "the Commission's jurisdiction over futures contract markets ...is exclusive ... and the Commission's jurisdiction, where applicable, supersedes State as well as Federal agencies." (WB: Cites Conf Rep at 35; S. Rep. at 6). The Conference Committee further explained that "under the exclusive grant of jurisdiction to the Commission, the authority of the Commodity Exchange Act (and regulations issued by the Commission) would preempt the field insofar as futures regulation is concerned." Conf Rep at 35.

Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation – a function which requires highly specialized skills. As intended, the CFTC has developed into an expert in futures market oversight and effectively carries out its statutory mandate "to deter and prevent price manipulation or any other disruptions to market integrity." (Section 3 of the CEA). This well-reasoned and successful approach to regulation of futures markets is now threatened by dueling regulators. The CFTC and FERC have different statutory mandates. The authority that FERC claims under its new manipulation mandate cannot co-exist with the CFTC's exercise of its exclusive jurisdiction over futures markets and transactions.

This reality was made clear in the recent enforcement actions brought under different standards for manipulation by both regulators against Amaranth Advisors for trading activity occurring on NYMEX. The statutory authorities under which FERC and CFTC operate with respect to preventing manipulation of the spot and futures markets differ significantly. FERC derives its authority from section 315 of the Energy Policy Act of 2005, which gives them manipulation authority over "any entity" that commits manipulation, directly or indirectly, in connection with FERC-jurisdictional transactions. FERC broadly interprets this new authority to include the ability to bring enforcement action on futures exchange activity, which is under the CFTC's exclusive jurisdiction. In developing the rule, FERC drew heavily from the Securities and Exchange Commission's rule 10b-5, under which the Supreme Court has defined manipulation as conduct "designed to deceive or defraud investors by *controlling or artificially affecting* the price of securities" or practices that "artificially affect market activity."

On the other hand, the CFTC's anti-manipulation authority is derived from Section 9(a) of the Commodity Exchange Act. It provides that it is a felony to ". . . manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity or knowingly to deliver or cause to be delivered . . . false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce . . . ."

Having two different standards for manipulation targeting the same trading activity and being enforced by two different federal agencies is a recipe for disaster. It causes confusion and uncertainty in the markets, is costly to our business and will impact the competitiveness of U.S. futures markets at home and abroad.

Example of FERC's Interest in Day-to-Day Regulation of Futures Exchanges

NYMEX has also experienced the impact of overlapping jurisdiction on the regulatory front. At the insistence of FERC, NYMEX changed its procedures for monitoring positions in excess of the expiration position limits in its expiring natural gas contract. That procedural change *resulted in a 40% loss of volume* in natural gas contracts on NYMEX in the expiration month. NYMEX recently became aware that data has been compiled, which confirms our suspicions that the volume leaving NYMEX has moved to the non-transparent, price linked, unregulated electronic market for natural gas. This is a prime example of regulatory arbitrage: market activity on the highly regulated futures exchange shifting to the unregulated market to avoid rules designed specifically to deter and prevent market manipulation.

On February 16, 2007, in an effort to cooperate with FERC and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NG futures contracts NYMEX adopted this new policy on an interim basis in a good faith effort to be cooperative with federal regulators. However, as detailed below, this experience has had an adverse impact on NYMEX's trading venues and is creating the result of shifting trading volume (during the critically important NG closing range period at NYMEX on the final day of trading) from our regulated trading venue to unregulated trading venues.

Pursuant to that advisory, NYMEX instituted new uniform verification procedures to document market participants' exposure justifying the use of an approved hedge exemption in the NG contract. These procedures apply to all market participants who carry positions above the standard expiration position limit of 1,000 contracts going into the final day of trading for the expiring contract. Specifically, prior to the market open of the last trading day of each expiration, NYMEX now requires all market participants with positions above the expiration position limit of 1,000 contracts to supply information on their complete trading "book" of all natural gas positions linked to the settlement price of the expiring NG contract. Positions in excess of 1,000 contracts must offset a demonstrated risk in the trading book, and the net exposure of the entire book must be no more than 1,000 contracts on the side of the market that could benefit by trading by that market participant during the closing range.

NYMEX has now experienced ten expirations of a terminating contract month in the NG futures contract since this new compliance advisory went into effect. NYMEX staff has observed a number of instances where market participants have reduced their positions before the open of the final day of trading rather than share sensitive trading information about proprietary trading with Exchange staff. As a result, NYMEX has observed reduced trading volume on the final day of trading in an expiring contract month relative to the final day of trading for the same calendar contract month in the prior year. The average volume on the final day of trading for these ten expirations were 30,955 versus 38,623 for the corresponding contract month in the prior year, or an 19.85% reduction

Even more significantly, the closing range volume for the 30-minute closing period on the final day of trading is sharply lower than for volume during the final day closing range for the same calendar contract month in the prior year. In most instances, the volume in the closing range is less than half of the volume in the closing range for the same calendar contract month in the prior year. The average closing range volume on the final day of trading for the ten expirations was 13,136 versus 22,319 for the corresponding contract month in the prior year, or a 41% reduction.

Overall market volatility in the natural gas market is somewhat lower this spring and summer than from comparable periods a year ago. This lower volatility stems from a lack of price volatility in the underlying physical cash commodity and in our opinion not from our implementation of this advisory. NYMEX's analysis of the volatility during on expiration day over the last five years suggests that other factors could have contributed equally to the decrease in volatility. The five-year analysis shows that the reduced volatility is consistent across the board during the timeframe in question. Thus, the volatility level under the new closing range procedure implemented in early 2007 is not inconsistent with typical trading patterns for NG. It is also worth noting that one of the biggest players in the natural gas market (Amaranth) no longer is present, yet another factor, which could be affecting volatility. Lastly, we have not experienced the harsh winter weather since implementation of the new procedure, which could also account for less volatility.

That stated, the lower volumes seen during the recent 30-minute closing ranges on the final day of trading since the implementation of the new policy actually create the potential for even greater volatility in the event of any significant market move. Thus, the new interim policy implemented by NYMEX on a good-faith basis has not only led to reduced volume on NYMEX during the critical 30-minute closing range period, which presumably has shifted to the unregulated trading venues, but has also failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX believes that legislative change is now necessary and appropriate.

NYMEX believes that the CFTC's role continues to be over futures trading and markets and that the FERC's new found authority should cover policing natural gas and electricity cash market manipulation. The CFTC and FERC can carry out their statutory duties in the futures and spot markets, respectively. NYMEX believes that it is better public policy for CFTC and FERC to cooperate and coordinate in instances where both spot and futures markets are involved in a situation involving a bad actor, rather than having FERC exercising direct authority over transactions that are under the exclusive jurisdiction of the Commodity Exchange Act.

At present, though, NYMEX is caught in an untenable situation. The FERC's indirect regulatory actions regarding NYMEX have had a direct impact on the volume and liquidity in the benchmark natural gas futures contract. This is a clear example of unintended consequences, which threatens the all important price discovery function of our market. The difficulties associated with conflicting regulatory standards also will severely undermine the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

Foreign Boards of Trade

While much of the focus on Capitol Hill has been on domestically based ECMs, similar issues potentially could arise with regard to U.S.-based products that are listed for trading on foreign boards of trade. As a note, NYMEX has long been a champion of vigorous competition and of greater globalization of services and products. As a rapidly growing global market presence, we have offices in London and Tokyo as well as in Singapore.

We also note that there have been substantial advances in technology since the former era of closed end proprietary trading systems. New exchanges have emerged that operate on a solely electronic basis, and products have now been listed under the CFTC staff no-action process that are parallel (if not identical) to other products listed by existing U.S. exchanges that are subject to full CFTC regulation. NYMEX believes that it would be prudent from time to time for the Commission or Commission staff to conduct a thorough review f of foreign markets operating in the U.S. under existing staff no-action letters.

In our recent experience, "regulatory arbitrage" is not a hypothetical concern but is actually already underway for certain of our listed products. This process could actually harm markets because of the distortion of market efficiency occurring when customers make choices among the same or similar products on the basis of differences in regulatory treatment among providers rather than on the basis of intrinsic distinctions in the products themselves or in related services. There are certain products now listed on foreign boards of trade that appear to be economically linked to competing products listed on a DCM. Thus, we believe that this issue warrants further examination both by Congress and by the CFTC.

Finally, we believe that the CFTC should be vigilant and proactive in ensuring that U.S. exchanges are not competitively disadvantaged by foreign exchanges operating under less stringent rules than those imposed on U.S. markets and to incorporate regulatory parity and consistency principles as fundamental components of the review process of applications being submitted to CFTC division staff by overseas exchanges.

Transaction Tax

A few proposals have surfaced recently for transaction tax on derivatives transactions. The PSI Report contained several recommendations, including a recommendation that "Congress should increase the CFTC budget and authorize CFTC user fees to help pay for the additional cost."

The PSI Report stated that the CFTC's budget should be increased "to provide the staff and technology needed to monitor, integrate, and analyze real-time transactional data from all U.S. commodity exchanges, including NYMEX and ICE." NYMEX agrees with this assessment and supports an expanded budget for the CFTC so that it may properly carry out its regulatory mission. However, NYMEX believes strongly that such funding is best addressed through the general revenue process, rather than through a special tax.

More recently, by letter dated September 4, 2007, the Office of Management and Budget (OMB) submitted proposed legislation to House Speaker Nancy Pelosi. Under that proposal, each derivatives clearing organization would need to pay to the CFTC a fee for any transaction cleared at a rate to be determined by the CFTC. As NYMEX understands it, under either proposed version noted above of this user fee or transaction tax, the tax would not be imposed on foreign boards of trade that listed competing products and that are currently offering direct electronic access to their markets to market participants based in the U.S., unless those products are cleared by a clearing organization that is subject to CFTC regulation.

In addition, the OMB proposal would create a significant disincentive to use of clearing services for OTC agreements and transactions. This result would undermine the stance taken by Congress in 2000 to encourage the use of clearing services to mitigate counter-party credit risk for OTC transactions and thus to enhance the financial integrity of transactions executed in OTC trading venues.

These proposals also run directly counter to the high-level efforts by key policymakers to strengthen the global competitiveness of U.S markets. In a November 2006 speech on the competitiveness of U.S. capital markets, Treasury Secretary Hank Paulson stated that "competitive capital markets will pave the way for continued economic growth that benefits all Americans." In addition, a study of New York's financial services industry released by Senator Chuck Schumer and New York Mayor Michael Bloomberg warned that "to maintain our success in the long run, we must address a real and growing concern: in today's ultra-competitive global marketplace, more and more nations are challenging our position as the world's financial capital." Implementing a tax on transactions conducted on U.S. commodity and derivatives markets would cause existing business to leave U.S. markets to avoid taxation. Equally as concerning, the tens of thousands of jobs that the industry provides in the U.S. may move or disappear as well.

Currently, U.S. futures exchanges such as NYMEX collectively spend tens of millions of dollars every year on internal self-regulatory programs. In addition, with regard to regulated futures transactions, the U.S. futures regulatory system already assesses our customers a fee to provide for the self-regulation performed by the National Futures Association (NFA), a self-regulatory organization authorized by Congress. By adding a new user fee at the clearing stage to the NFA assessment, which is calculated at the transactional stage, the OMB proposal n effect would be taxing participants both at the trading and at the clearing level Taxing market participants twice is both burdensome and unfair. It could encourage major market participants to avoid trading in U.S. derivative venues and instead shift trading overseas. Any such loss of market liquidity would harm hedgers and other U.S. businesses that look for the most cost-efficient venue to hedge the price risks they face every day. In addition, imposing this tax burden on U.S. market participants is particularly inappropriate given the public interests served by the U.S. futures markets, and the price discovery and dissemination benefits conferred by the exchange markets on many thousands of non-market participants.

The proposed user taxes would also greatly increase the trading costs of market-makers who provide liquidity vital to U.S. exchange markets. Their profit margins are razor thin, yet they provide critical liquidity that makes U.S. exchange markets more efficient and cost-effective to all customers who use them to manage risk. These individuals and small businesses would be forced to bear the weight of the tax, without regard to their profitability.

Finally, the Commodity Exchange Act establishes certain core purposes for the regulation of derivatives transactions. These purposes of the CEA thus include "to ensure the financial integrity of all transactions subject to this Act" and "to promote responsible innovation and fair competition among boards of trade, other markets and market participants." The OMB's proposed new tax would create a new and substantial disincentive to use of clearing services provided by CFTC-regulated clearing organizations. Those same OTC transactions could be shifted to a non-U.S. clearing organization for clearing. In addition, by imposing a tax only on transactions cleared by a CFTC-regulated clearing organization, Congress would be creating an unfair advantage for foreign boards of trade that already are listing products that are look-alikes of domestically traded products. Transactions cleared overseas would fall entirely outside the scope of the OMB proposal and hence the OMB immediately would create a real incentive for firms to shift their trading activity to overseas markets.

Conclusion

NYMEX is fully regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading and markets. In addition to the CFTC's direct monitoring of futures trading, as a DCM, NYMEX has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by CFTC regulation and interpretation. Self-regulatory duties were voluntarily assumed by futures exchanges many years before the federal regulation of commodity markets. As an SRO, NYMEX routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

A new statutory tier of trading facility, the exempt commercial market, was added to the CFTC's governing statute in 2000. The ECM is essentially exempt from substantive CFTC regulation and also has no explicit SRO duties by statute. In addition, to date, ECMs have not voluntarily assumed any SRO duties. As a result of market changes that were not anticipated in 2000, such as the effective linking of trading on unregulated venues with trading on regulated venues of competing products, certain ECMs now serve in a price discovery role and thus trigger public policy concerns and warrant a higher degree of CFTC oversight and regulation.

A recent CFTC report to Congress recommends that such contracts should be subject by statute to large trader reporting, position limits or position accountability, self-regulatory oversight obligations, and emergency authority for both the CFTC and for the ECM itself. NYMEX strongly supports the CFTC's targeted and focused legislative proposals. The CFTC's recommended changes are also supported by the President's Working Group on Financial Markets.

Finally, Congress created the CFTC in 1974 and provided the new agency with exclusive jurisdiction over futures markets. Congress intended the CFTC Act of 1974 to strengthen futures regulation, create a comprehensive regulatory structure for futures trading, and avoid regulatory gaps. Further, Congress intended that the new agency be an expert in futures regulation, a function which requires highly specialized skills, and the CFTC has developed such expertise. In subsequent reauthorizations, when Congress intended to create limited exceptions to that authority, it has always done so through express amendments of the CFTC's governing statue. Consequently, most observers have concluded that Congress did not intend to alter the CFTC's exclusive jurisdiction with the Energy Policy Act of 2005. The contrary interpretation now being pursued by FERC substantially harms futures markets by adding the cost and uncertainty of conflicting standards. It also severely undermines the ability of NYMEX and other regulated exchanges to carry out their SRO responsibilities.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions members of the Subcommittee may have.

ONE PAGE SUMMARY OF NYMEX WRITTEN TESTIMONY

- NYMEX is fully regulated by the CFTC, which by statute has long had exclusive jurisdiction over futures contracts, trading and markets. In addition to the CFTC's direct monitoring of futures trading, as a DCM, NYMEX has an affirmative statutory obligation to act as a self-regulatory organization, relying upon the standards set by statute and by CFTC regulation and interpretation. Self-regulatory duties were voluntarily assumed by futures exchanges many years before the federal regulation of commodity markets. As an SRO, NYMEX routinely uses tools such as large trader reporting and position accountability and position limit levels to monitor and to police trading in our contracts.

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Mr. STUPAK. Thank you, Mr. LaSala. Mr. Vice, for an opening statement, please, sir.

STATEMENT OF CHARLES A. VICE, PRESIDENT AND CHIEF OPERATING OFFICER, INTERCONTINENTAL EXCHANGE, INC.

Mr. VICE. Chairman Stupak, Ranking Member Whitfield, I am Chuck Vice, president and chief operating officer of the Intercontinental Exchange, or ICE. We very much appreciate the opportunity to appear before you today to give our views on energy markets.

As background, ICE was established in 2000 as an over-the-counter market. Since that time, ICE has grown significantly, both through product and technology innovations as well as through acquisition of other exchanges. Today ICE operates a leading global marketplace in futures and OTC derivatives across a variety of asset classes. Commercial hedgers use our products to manage risks while investors provide liquidity necessary to maintain and grow the markets. ICE hosts four separate marketplaces on our electronic trading platform.

First there is ICE's OTC energy market, which operates under the Commodity Exchange Act as an exempt commercial market, or ECM. Second, there's ICE Futures Europe, formerly known as the International Petroleum Exchange, which is regulated by the UK Financial Services Authority. Third, there is ICE Futures US, formerly known as the Board of Trade of the City of New York, or the NYBOT, which is a CFTC-regulated, DCM contract market. And fourth, there is the Winnipeg Commodity Exchange, which is regulated by the Manitoba Securities Commission.

ICE has always been and continues to be a strong proponent of competitive markets and of regulatory oversight of those markets. To that end, we have continuously worked with FERC, the CFTC, and other regulatory agencies in the U.S. and abroad to ensure that they have access to all relevant information regarding trading activity in our markets. We strongly support legislative and regulatory changes that will enhance the quality of oversight and available information with respect to the energy markets. Over the past several months, ICE has been working with members of Congress to create an enhanced but appropriate level of oversight over OTC energy markets that are either economically linked to a designated contract market and its price discovery function or serve a significant price discovery function themselves.

By appropriate, ICE means that any regulatory changes that are made need to reflect the varying nature of ICE's many OTC markets and the key differences between contracts on ICE that serve a significant price discovery function and those that do not. We welcome the opportunity to work with the subcommittee and its staff on these important issues.

Because OTC markets tend to be global in nature, most are increasingly electronic. ICE responded to the transparency and speed enjoyed in other OTC markets as an ECM by establishing its many-to-many electronic marketplace for trading physical energy commodities and financially settled derivatives or swaps. In effect, ICE performs the same function as a voice broker in the OTC market but does so through an electronic platform. Voice brokers offer limited transparency and only then to the largest firms. ICE, however, provides the same high-quality information to all traders, large and small, and at the same instant. ICE offers faster and more efficient execution while providing regulators with a comprehensive audit trail, none of which is available from voice brokers.

The introduction of ICE's platform has promoted competition and innovation in the energy derivatives market to the benefit of all market participants and consumers generally. As the CFTC pointed out in its Senate PSI testimony, "the ability to manipulate prices on either NYMEX or ICE has likely been reduced, given that ICE has broadened participation in contracts for natural gas." Importantly, greater participation means increased liquidity, lower transaction costs, and tighter bid/ask spreads, which lowers the cost of hedging energy price risk for businesses.

The problem with one-size-fits-all regulation can be illustrated by contrasting the historic nature of futures markets with the OTC markets. Recognizing the importance of futures pricing benchmarks to the general public and the retail accessibility of these markets, core principles were developed to facilitate regulation of futures trading by the designated contract market. The high level of liquidity typical in benchmark contracts makes application of core principles, such as market monitoring and position accountability, feasible and appropriate. Suggesting that these same DCM core principles, which were developed with the futures exchange model in mind, should apply to all OTC contracts traded on an ECM market is attempting to fit a square peg in a round hole.

While some level of additional reporting and a system of accountability limits is appropriate for certain contracts, most of the energy swaps on ICE are niche OTC products that have little in common with futures benchmarks and are not amenable to the application of DCM core principles.

I would now like to offer a quick comment on the CFTC/FERC jurisdictional question. Although many believe that FERC and CFTC's jurisdictions conflict, ICE believes they are complementary. That said, overlapping regulation in any market creates uncertainty over compliance with two separate varying and sometimes conflicting legal standards. There is a clear role for each regulator, and we believe that FERC and the CFTC should be able to coordinate rather than duplicate their responsibilities.

In conclusion, as an operator of global futures and OTC markets and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with the CFTC and FERC to ensure that they have access to all relevant information regarding trading activity in our markets. Mr. Chairman, thank you for the opportunity to share our views.

[The prepared statement of Charles A. Vice follows:]

TESTIMONY OF CHARLES A. VICE

1. ICE Operates a Transparent Platform. ICE provides a reliable, transparent over-the-counter market for trading physical energy commodities and financially-settled OTC derivatives. ICE has promoted competition and innovation on the derivatives market, which has lowered transaction costs for energy users.

2. One Size Regulation Does not Fit All Markets or Contracts. Many of the products on ICE are niche OTC products that trade in illiquid markets. Applying Designated Contract Market (DCM) core principles to these markets does not make sense. ICE supports creating appropriate oversight of energy markets that serve a significant price discovery market or impact a significant price discovery market on a DCM. However, the two-tier regulatory structure currently in place should be kept for DCMs and Exempt Commercial Markets.

3. The Federal Energy Regulatory Commission and the Commodity Futures Trading Commission have Complementary Jurisdiction. ICE believes that FERC and the CFTC have complementary jurisdiction in energy markets. However, dual regulation would cause harm to the markets. There is a clear role for each regulator to oversee the energy markets and FERC and the CFTC should be able to coordinate their oversight and enforcement responsibilities.

4. Funding of the CFTC. The CFTC is currently under-funded and ICE supports increasing their budget. However, ICE urges caution in levying a ″transaction tax″ or ″user fee.″

December 12, 2007

Chairman Stupak, Ranking Member Whitfield, I am Chuck Vice, President and Chief Operating Officer of the IntercontinentalExchange, Inc., or ″ICE.″ We very much appreciate the opportunity to appear before you today to give our views on energy markets.

As background, ICE was established in 2000 as an over-the-counter (OTC) market. Since that time, ICE has grown significantly, both through its own market growth fostered by ICE's product, technology and trading innovations, as well as by acquisition of other markets to broaden its product offerings.

Today, ICE operates a leading global marketplace in futures and OTC derivatives across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. Commercial hedgers use our products to manage risk and investors provide necessary liquidity to the markets. Headquartered in Atlanta, ICE has offices in New York, Chicago, Houston, London, Singapore, Winnipeg and Calgary.

ICE hosts four separate markets on our electronic trading platform - ICE's OTC energy market, which operates under the Commodity Exchange Act (CEA) as an ″exempt commercial market,″ or ECM, and three subsidiaries: ICE Futures Europe, formerly known as the ″International Petroleum Exchange,″ which is regulated by the UK Financial Services Authority; ICE Futures US, formerly known as ″The Board of Trade of the City of New York (NYBOT),″ which is a CFTC-regulated Designated Contract Market (DCM), and the Winnipeg Commodity Exchange, which is regulated by the Manitoba Securities Commission.

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and related derivatives, and of regulatory oversight of those markets. As an operator of global futures and OTC markets and as a publicly-held company, we strive to ensure the utmost confidence in the integrity of our markets and in the soundness of our business model. To that end, we have continuously worked with FERC, the CFTC and other regulatory agencies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets and we will continue to work with all relevant agencies in the future. ICE strongly supports legislative and regulatory changes that will enhance the quality of oversight and available information with respect to the energy markets.

Over the past several months, ICE has been working with members of Congress to create appropriate oversight of certain energy markets that either impact a designated contract market, and its price discovery function, or which separately serve a significant price discovery function. By appropriate, ICE believes that any legislative or regulatory changes that are made need to reflect the different nature of ICE's varied markets and the significant differences between contracts on ICE that serve a significant price discovery function and those that do not. We also believe that any consideration of possible changes to the current regulatory structure must be based upon an understanding of the operations of ″exempt commercial markets,″ such as ICE, and of the balance struck by Congress and the CFTC between overseeing these markets while still allowing them to function in the context of OTC trading by commercial and institutional participants. We welcome the opportunity to work with the Subcommittee and its staff on these important issues.

ICE OPERATES A TRANSPARENT PLATFORM

Broadly, because OTC markets tend to be global in nature, most OTC markets are now conducted electronically across most asset classes, including OTC markets for U.S interest rate instruments, foreign exchange and debt securities. ICE responded to the transparency and speed enjoyed in other OTC markets by establishing its many-to-many electronic marketplace for trading physical energy commodities and financially-settled over-the-counter derivatives, primarily swaps, on energy commodities. ICE in effect performs the same function as a ″voice broker″ in the OTC market, but does so through an electronic platform. Voice brokers offer limited transparency and only then to the largest trading firms. ICE, however, provides the same high quality information to all traders, big and small, and at the same instant. The ICE electronic market also offers faster and more efficient execution while providing regulators with a comprehensive audit trail with respect to orders entered, and transactions executed - none of which is available from voice brokers. The introduction and development of ICE's platform have promoted competition and innovation in the energy derivatives market, to the benefit of all market participants and consumers generally. The reliability of ICE's markets has also resulted in an increasing preference for electronic trading in these markets. NYMEX, in its recent testimony before the Senate Permanent Subcommittee on Investigations (the ″Senate PSI″), noted that 80-85% of its volume is now traded electronically, a development driven largely by competition from ICE. The CFTC also pointed out, in its Senate PSI testimony, that ″the ability to manipulate prices on either [NYMEX or ICE] has likely been reduced, given that ICE has broadened participation in contracts for natural gas.″ Importantly, greater participation means heightened liquidity, which results in lower transaction costs and tighter bid/ask spreads. This makes the cost of hedging energy price risk lower, which results in cheaper operating costs for businesses.

Participants on ICE enter bids and offers electronically and are matched in accordance with an algorithm that executes transactions on the basis of time and price priority. Participants executing a transaction on our platform may settle the transaction in one of two ways - on a bilateral basis, settling the transaction directly between the two parties, or on a cleared basis through LCH.Clearnet using the services of a futures commission merchant that is a member of LCH.Clearnet. In addition to providing the clearing house with daily settlement prices, ICE is also responsible for maintaining data connectivity to the clearing house.

It is important to note that there are substantial differences between ICE's OTC market, other portions of the OTC market, and the NYMEX futures market. These differences necessarily inform and guide the appropriate level of oversight and regulation of our markets. First, ICE is only one of many global venues on which market participants can execute OTC trades. A significant portion of OTC trading in natural gas is executed through voice brokers or direct bilateral negotiation between market counterparties. Of the available forums, only ICE (and any other similarly-situated ECMs) is subject to CFTC jurisdiction and the CFTC's regulations, or to limitations on the nature of its participants.

Second, participants in the futures markets must either become members of the relevant exchange or trade through a futures commission merchant that is a member. In contrast, ICE's OTC market, by law, is a ″principals only″ market in which participants must have trades executed in their own names on the system.

Third, the OTC market offers a substantially wider range of products than the futures markets, including, for example, hundreds of niche derivative contracts on natural gas and power pricing at over 100 different delivery points in North America. The availability of these niche markets on ICE has improved transparency and lowered transaction costs via tighter bid-ask spreads, but volume nonetheless remains very low at most points. The market reality, for most of these illiquid points, is that participation is limited to the very small number of marketers, utilities, and others that have some intrinsic supply or demand interest.

Fourth, the most liquid products traded in the OTC market broadly and on the ICE OTC market specifically are cash-settled swaps that require one party to pay to the other an amount determined by the final settlement price in the corresponding futures contracts but do not, and cannot, result in the physical delivery or transfer of energy commodities. These 'lookalike' swaps have been widely used by OTC energy market participants long before the creation of ICE. In fact, these swaps are useful and common in any market for which there are benchmark futures prices. Our Henry Hub natural gas swap, for example, constitutes an important commercial hedging vehicle and has served as an important complement to and a hedge for the NYMEX Henry Hub natural gas futures contract. An understanding of the ICE markets is critical to any determination of the appropriate regulation of these markets.

ICE and its market participants, including energy producers, distributors and users, benefited significantly from the regulatory flexibility embodied in the CFMA through the ECM structure established under section 2(h)(3) of the Act. The tangible benefits to the marketplace included more efficient hedging of energy price risk (tighter markets), greater price transparency in all parts of the marketplace, and vastly improved liquidity through the introduction of more participants (and thus greater price competition) in the markets. These benefits have not been limited to those brought about directly by ICE's business and its product offerings, but include those resulting from changes to the business models and product offerings of other market participants that responded to the competitive challenge presented by ICE's business.

As these markets have grown and developed since passage of the CFMA, new regulatory challenges have emerged. ICE advocates a targeted approach to any reform of the CEA. Such an approach recognizes the unique characteristics of the many customized markets that have evolved and the importance of continuing to encourage market innovation.

ONE SIZE OF REGULATION DOES NOT FIT ALL MARKETS OR CONTRACTS

The problem with ″one size fits all″ regulation can best be illustrated by contrasting the historic nature of futures markets (limited number of actively traded benchmark contracts, all transactions executed through a broker who can trade for its own account or that of a retail customer) with the ECM OTC swaps markets (large number of niche products, many illiquid and thinly traded, principals only trading). Recognizing the importance of futures pricing benchmarks to the general public (a DCM is obligated to publish its prices to be used by the broader market), and in recognition of the potential for conflicts of interest due to members trading for their own accounts alongside business transacted on behalf of customers, some of whom were retail customers, DCM core principles were developed to facilitate regulation of the markets by the DCM, which acted as a self regulatory organization. The typical high level of liquidity in benchmark contracts make application of core principles such as market monitoring and position accountability and limits feasible and appropriate.

Suggesting that these same DCM core principles, which were developed with the futures exchange model in mind, should apply to all OTC swap contracts traded on an ECM market is attempting to fit the proverbial square peg in a round hole. While some level of additional reporting and a system of position accountability limits may be appropriate for certain contracts - specifically, those that settle on a futures market contract price and that are the true economic equivalent of a contract actively traded on a regulated futures market - most of the energy swaps available on ICE are niche OTC products that trade in illiquid markets that are not amenable to the application of DCM core principles. For example, how would an ECM actively monitor an illiquid swaps market in an attempt to ″prevent manipulation″ where price changes can be abrupt due to the limited liquidity in the market? How would an ECM swaps market administer accountability limits in a market that has only a handful of market participants? Should the ECM question when a single market participant holds 50% of the liquidity in an illiquid market when the market participant is one of the only providers of liquidity in the market?

It is important to analyze these questions not in isolation, but in the context of market participants having alternatives such as OTC voice brokers through which they can conduct their business. Importantly, such OTC voice brokers can even offer their customers the benefits of clearing through use of block clearing facilities offered by NYMEX (and also by ICE). Faced with constant inquiries or regular reporting by the ECM related to legitimate market activity, and facing no such monitoring when it transacts through a voice broker, market participants might choose to conduct their business elsewhere. It is for these and other reasons that Congress and the Commission have developed the carefully calibrated two-tier regulatory structure applicable to DCMs and ECMs. We believe that the judgments made by Congress and the Commission thus far have been prudent and should generally be maintained.

FERC AND THE CFTC HAVE COMPLEMENTARY JURISDICTION

In 2005, Congress passed the Energy Policy Act, which granted FERC broader authority to police manipulation in energy markets. Although many believe that FERC and CFTC's jurisdictions conflict, ICE believes that they complement each other. As noted before, ICE operates a global company across the span of energy markets: physical, OTC, and futures. Accordingly, it works closely with FERC and the CFTC to help ensure fair, competitive trading. ICE believes that FERC and the CFTC are capable regulators in their respective areas in the physical, OTC, and futures markets.

It is important that this jurisdiction remain complimentary, however. Overlapping regulation of the same conduct would likely result in harm to markets. Applying dual regulation to energy markets would create uncertainty over compliance with two separate, varying and sometimes conflicting legal standards. The only certainty would be the increased cost to U.S. businesses from having to comply with two regulators. The possible effect would be that these firms, operating on a global scale, would take their business overseas to other trading venues. There is a clear role for each regulator to oversee the energy markets, and we believe that FERC and the CFTC should be able to coordinate, rather than duplicate, their oversight and enforcement responsibilities.

FUNDING OF THE CFTC

ICE believes that the CFTC is currently under funded and we support Congress increasing the CFTC's budget. ICE strongly supports increasing the Commission's budget, but urges caution in considering whether to levy a ″transaction tax″ or ″user fee″ on futures transactions. As an operator of both domestic and foreign futures exchanges, ICE recognizes that the futures industry is highly competitive, on both a domestic and global basis. Trading firms often operate on thin margins. A transaction tax could double the trading costs for market makers, who provide important liquidity to the market. If these trading participants left all or some markets, that would take important market liquidity with them. A recent study of transaction taxes on futures markets found that a futures tax would negatively impact volume and bid/ask spreads.[1] Consumers would feel the brunt of this tax, as businesses would be pass on the increased cost of offsetting price risk in less liquid markets to them.

Further, it is questionable whether a transaction tax would raise the revenue needed for the Commission. Again, firms operate on thin margins and might choose to move their business offshore or to less transparent markets. This would increase the Commission's cost of surveillance, while decreasing taxable transactions.

CONCLUSION

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and other derivatives, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with the CFTC and other regulatory agencies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets. We have also worked closely with Congress to address the regulatory challenges presented by emerging markets and will continue to work cooperatively for solutions that promote the best marketplace possible.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.

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[1] Robin K. Chou and George H.K. Wang, Transaction Tax and the Quality of the Taiwan Stock Index Futures, Journal of Futures Markets, 1195-1216 (2006).

Mr. STUPAK. Thank you, and thank you all for your testimony. We will begin with questions. Mr. Barton, did you wish to make an opening statement? It would be appropriate at this time if you would like, before we begin questions.

Mr. BARTON. Thank you, Chairman. Just very briefly. I will submit my statement for the record, but this is a very important hearing. We have energy prices nearing all-time highs, and this issue of jurisdiction, I was chairman of the Energy Conference 2 years ago, when we put in some language that was specifically designed for what has happened at ICE and what has happened with Amaranth. That wasn't serendipity. It was conscious. We wanted to do more. We weren't allowed to. So at the appropriate time, especially when Chairman Kelliher is here, I will go into that in more detail.

But I am very supportive of this hearing, Mr. Chairman. I remember explicitly this issue from 2 or 3 years ago, and if we need to clarify and put additional statutory authority for the FERC on the books, I am very willing to work with the majority to do that.

Mr. STUPAK. I thank the ranking member, and thank you for your statement. We will go 5 minutes. We will start with myself and go one or two rounds. Is that all right with you, Mr. Walden?

All right, I will begin. Professor Greenberger, for some time I have been saying if we could regulate these OTC trades, or over-the-counter trades, we could reduce the price of barrel oil by $20 or $30. People think I am just saying that. You are a professor. Maybe they will listen to you. Explain how that would work if we could do the regulation. How would it lower the price of a barrel of oil $20 to $30, as you indicated?

Mr. GREENBERGER. Well, just let us take the example of natural gas. I will get to barrel of oil. Amaranth, the day before it failed, natural gas was about $8.50 per MBTU, million BTU. The day after it failed, it went to $4.46. Senator Levin and Senator Coleman, in their bipartisan report, show in detail the way Amaranth gobbled up futures contracts to make it appear that there was a shortage of natural gas on ICE when there was no shortage.

In fact, NYMEX went to Amaranth and said, you guys are going to kill yourselves. We want you to lower your positions. Not only we want, we require it, because we are regulated.

Mr. STUPAK. Correct.

Mr. GREENBERGER. The next day they moved to ICE. Senator Levin's June 2006—Senator Levin, Senator Coleman have economists' statements that the manipulation of the futures prices, phony exchanges of contracts, buying up strategically futures contracts, has added $20 to $30 to the barrel of crude oil.

If ICE tomorrow was regulated like NYMEX and out from under this phony foreign board of trade exemption, the price of crude oil would start to drop. Just like when Congressman Graves went to the floor in December of 2005 and said, enough of this exemption on natural gas, it dropped from $14 per million BTU to $9. Just the threat of regulation, these traders will think someone is going to listen to these telephone calls.

[Chart shown.]

Mr. STUPAK. Well, let us go here to—this is chart No. 3 I had up earlier. The yellow line represents what we use as a country, like 21 trillion cubic, but yet we are trading—and that is 1 year's worth—200 and—what is it? I can't see here—239 cubic feet, and 237 trillion cubic feet on ICE. Is all this excess trading, if you will, is that what drives up the price?

Mr. GREENBERGER. Yes, because those guys, you heard their phone conversations. They are playing games, and in the same breath, they are saying, don't worry, guys. The CFTC can't touch us.

Mr. STUPAK. Because we are in the dark market.

Mr. GREENBERGER. The red with the blue, if you would listen to their phone conversations, they would stop doing that instantly. And the price of natural gas and crude oil would drop by about a third.

Mr. STUPAK. OK, Mr. Cota, I also mentioned in my opening statement that the price of a gallon of gas jumped 45 cents in 1 day in my district. Have you seen the same thing in the Northeast?

Mr. COTA. In the Northeast, particularly in heating fuels, we had a rapid increase in price.

Mr. STUPAK. The Northeast is more dependent on home heating oil as opposed to natural gas in the rest of the country, correct?

Mr. COTA. That is correct, but most of the commodities have followed both crude oil and heating oil with energy pricing. The one thing that has kept gasoline down a little bit has been actually a glut of ethanol and some of that trading. Otherwise, gasoline would be much higher than it is right now.

Mr. STUPAK. OK, thank you. Ms. Campbell, you said in your testimony that public gas utilities like yours have lost confidence, that prices for natural gas in the futures and economically linked over-the-counter markets are an accurate reflection of supply and demand. Explain precisely what is needed to remedy the problem of artificial prices in the natural gas markets.

Ms. CAMPBELL. Well, I think that Professor Greenberger has covered that in that what we are seeing is some manipulation, not so much the speculation but the manipulation. And so our position is that greater transparency in that marketplace, via the large trader reporting is really the answer to bring light, as we call the dark markets, to bring light to those markets such that we can see what is going on in those marketplaces and therefore bring back the consumer confidence in those markets.

Mr. STUPAK. Well, as a result of Amaranth's collapse, have you or other American Public Gas Association members made an estimate of the cost to your utilities and to consumers from Amaranth's efforts to drive up the price in the winter of 2006–07?

Ms. CAMPBELL. Memphis Light, Gas, and Water has not, but I know that the Municipal Gas Authority of Georgia, MGAG, has, and their estimate was about $18 million cost to them due to the Amaranth activities.

Mr. STUPAK. Mr. LaSala, I think you indicated that NYMEX supports CFTC's legislative proposal to regulate the exempt commercial markets. Is that correct?

Mr. LASALA. Yes, sir.

Mr. STUPAK. Are there specific improvements or changes NYMEX would suggest to those proposals, ways you would think——

Mr. LASALA. Speaking to the proposals or beyond them, we support——

Mr. STUPAK. Beyond the proposals.

Mr. LASALA. We support the proposals so far as the items that would trigger. You know, a linked market taking a settlement price, the things—the market serving a price discovery roles should trigger certain criteria. As we said, large trader reporting, position limits, self-regulatory authority and mandate that they have an SRO function as well as emergency action powers.

Mr. STUPAK. OK, you indicated in your testimony that Amaranth, when notified by NYMEX of too large of a whole position there, they then went to ICE. Have you seen that with other energy traders where they have informed you they would prefer to trade on an unregulated exchange rather than deal with NYMEX rules on disclosure and position limits?

Mr. LASALA. That is a good question, Mr. Chairman. We have certainly heard it before anecdotally from traders in the marketplace when we have—we said earlier we administer hard position limits on basically all of our contracts, all the physical ones and many of the cash settled ones. When we have tried to negotiate hedge exemptions where there have been like substitutes, whether on Intercontinental, we have heard the comment made, "I would just as soon—you know, you are beginning to tread so hard on me. I can easily move this over." We have also heard it in the context of WTI insofar as it affects the Foreign Board of Trade issue where, in direct conversations, in I will call "lessons learned from Amaranth" where we made some changes, lowered any one-month accountability levels, and also let us focus on them on a futures only basis. Where, in a conversation with a trader, the comment was made just simply I am being actively courted by the UK entity ICE Futures, and basically you are pressing me to want to shift gears.

Mr. STUPAK. My time is up. Mr. Walden, questions, please. We will second round. I have many more questions.

Mr. WALDEN. Thank you, Mr. Chairman. This is an issue that I have been concerned about for some time. And in fact, in May of 2005, organized a letter to the Government Accountability Office now, asking for a full scale investigation signed by 19 of my colleagues because of concerns that had come to me. And so, Mr. Chairman, I am glad we are having this hearing today because if indeed the market is being manipulated, as it appears it has been, then consumers are getting stuck with the bill. And that is not right, and it is time for us to step in.

Professor Greenberger, I want to go to your issue about how much you think this market manipulation or potential market manipulation is adding to the price of crude oil because there seems to be some dispute, not that we want to spend a lot of time on that. But others, including the GAO, say there are other factors involved, too. You really think that that is it, and it is about a third?

Mr. GREENBERGER. I feel every confidence—now it is my view—that it would drop at least $20. If this afternoon we went home and knew that ICE was—those telephone calls on ICE were going to be monitored, the phony games that are being played would stop, and the price would drop.

Mr. WALDEN. And do you think just——

Mr. GREENBERGER. Not to zero. There are reasons it is up near 100, but it would drop by about $20.

Mr. WALDEN. And do you think that just changing the language in the CFTC Reauthorization adding energy adequate, or does FERC need to have a role here?

Mr. GREENBERGER. No, FERC has got plenty of power. The CFTC, ICE, and NYMEX are fighting that power as Mr. Barton made clear. They have plenty of power in natural gas, but that is enforcement power after the horse is out of the barn. If you want to stop it to begin with, you have to regulate all of these exchanges.

I would just like to make one quick point. The famous quote is "what would Jesus do?" In forming this new legislation, the mantra has been, to close the Enron loophole, what would ICE do? Everybody is looking to ICE on how to close this loophole. Mr. Vice says do not regulate all our contracts, just the ones that "significantly" affect price discovery. So who is going to have to prove that? I am going to have to prove that. Ms. Campbell is going to have to prove what is "significant." Mr. Cota, the CFTC will have to prove it. You are going to have a contract-by-contract contest. Prior to the Enron loophole, ICE would be a regulated entity as a whole.

Just one more point. ICE says to you, my gosh, we have all these different contracts. One size doesn't fit all. Well, first of all, for the consumer, one price fits all.

Mr. WALDEN. Correct.

Mr. GREENBERGER. Nobody is worried about the consumer. Secondly, if I could just make this one point.

Mr. WALDEN. Make it quick. I only have 2 minutes.

Mr. GREENBERGER. OK, the Act allows the Commission to create exemptions if ICE proves that they need less regulation.

Mr. WALDEN. Got it. All right, Mr. LaSala, if I could get your attention for a second. I want to make sure I understood what you were saying. Is it when NYMEX begins to put some pressure on people in the market that you believe need a little more regulatory oversight, they are sort of pushing back, saying, we will just go over to ICE? Is that what you are saying?

Mr. LASALA. I am not saying that is a universal statement.

Mr. WALDEN. No, but——

Mr. LASALA. But that has certainly absolutely come up. It has come up in the context of the contracts that are natural-gas oriented, that are offered on Intercontinental. And it has also come up in the WTI contract, where there is a look-alike on the FSA-regulated ICE futures.

Mr. WALDEN. Mr. Vice of ICE.

Mr. VICE. Sir?

Mr. WALDEN. What do we do here?

Mr. VICE. Well, I think, first of all there are—particularly Professor Greenberger there, a number of issues that have all gotten rolled up together. So I am trying to pull the strings of that ball apart. You are talking about the ECM market specifically and natural gas and Amaranth. ICE is actually in complete agreement for the most part and has been working with Congress and the other exchanges like NYMEX, the President's Working Group, for some months now on additional regulation for ECMs for contracts that are determined to be significant price discovery contracts. And those are determinations that the CFTC, for the most part, has drafted and feel comfortable with. And it would be their determination on what falls into that category. We——

Mr. WALDEN. Do you think adding the word energy into the CFTC statute would provide proper regulatory oversight?

Mr. VICE. I think—I am not an expert.

Mr. WALDEN. That it would stop manipulation of this market?

Mr. VICE. I think the ECM category is a critically important category. If you look, ICE came along as a start-up company and competes fiercely with NYMEX today. It is one of the only corners of the U.S. futures where you can find that competition. And as a result, it has driven prices down. There has been product innovation. A lot of good has come out of that. What we are saying is, yes, that we agree there is room for improvement. Let us do something thoughtful, deliberate, and centering on the problem and not throw the baby out with the bath water.

Mr. WALDEN. My time is expired, but I just—you know, as we watch the sub-prime market implode, there seems to be some correlation here about derivatives and regulatory oversight and what went wrong. And I will tell you, a lot of consumers are starting to feel that way on the energy side, and it is very disconcerting. So I am not saying that is what is happening here, but——

Mr. VICE. Well, there is no question all commodities are at all-time highs. Metals, agriculture.

Mr. WALDEN. And I understand, and I understand demand and supply curves and all of that. I also understand that we know that there is market manipulation in these if there is a proper regulation. And so we got to find that balance.

Mr. STUPAK. Mr. Walden, if I could just take 1 second——

Mr. WALDEN. Yes.

Mr. STUPAK. Take a look at this one. This says right here—it is No. 7 in the book there. Mr. LaSala, you may want to look at that, the book right there in front of you. This is exactly what Mr. Walden is talking about.

[Chart shown.]

Mr. STUPAK. This chart shows the volume shift from NYMEX to ICE immediately after NYMEX imposed a rule earlier this year which required traders of natural gas who want to hold more than 1,000 positions going into the last day of trading prior to the expiration of futures contract to disclose their bilateral swaps, futures, and forward contract positions. So I almost have to ask Mr. LaSala the same thing Mr. Walden was asking. Why the shift? Why suddenly from NYMEX to ICE? Isn't it the case that your new rule is really simply putting teeth into existing 1,000-position contract or the contract limit there?

Mr. LASALA. Yes the policy shift again, with the March future certainly put an added level of detail, formalized submission on anyone who is excess of 1,000 contracts going into the last day. We typically would allow that. We could grant exemptions. This was a new procedure that came out in discussions with our regulator and the FERC, and as far as——

Mr. STUPAK. Well, that is your rule there, February 26, 2007, when the shift occurred, right?

Mr. LASALA. That is right. You see the curve shift out.

Mr. STUPAK. Right.

Mr. LASALA. We imposed commencing with the March expiration the higher standard, and immediately we see a significant drop-off in volume on the last trading day, specifically, even the 30-minute closing range. And just as a note, some of the concern in that loss in the 30-minute closing range is, at some point does loss and volume impact price discovery? I don't have an absolute metric to say at what point does it, but it could. And the shift is obviously a startling one.

Mr. GREENBERGER. Mr. Stupak, I could fill this hearing room with customers who have gone to NYMEX and said, you need to regulate more strictly, and NYMEX has said, we really feel sorry for you, but if we regulate more strictly we will lose business to

ICE. Don't forget ICE's ownership, Goldman Sachs, Morgan Stanley, British Petroleum, they trade on NYMEX. NYMEX has to pull its punches when it criticizes ICE, since it is criticizing its own traders.

And No. 2, you talked about the sub-prime meltdown, 3, 4 months from now you are going to have a hearing on the sub-prime meltdown, and you are going to find that this very same legislation deregulated something called collateralized debt obligations, CDOs. Those are futures contracts deregulated by the CFMA. CitiBank lost $11 billion. That is why Chuck Prince is not the CEO. You are going to hear about this CFMA coming and going.

And the final point is, I will answer the question about whether ICE would agree just to add "or energy." They won't, because that would mean they would be regulated altogether. What they want everyone to do is go contract by contract on thousands of contracts and prove significant price discovery.

Mr. VICE. First of all——

Mr. STUPAK. Take the mike, though, if you want to comment on it.

Mr. VICE. First of all, we are a publicly-held company so we are not owned by those firms Mr. Greenberger just said. And as I stated earlier, we think having that ECM category with ability for, I think—the CFTC has referred to it as low-cost on-ramp for competitors to get into this market—has been very good for energy. Energy went from basically probably the back end of the commodity market in terms of efficiency and transparency and bid offer spreads to probably near the front of the pack there. Yes, there is work to be done, but it doesn't make sense to us to say there are only two flavors of trading here: a regulated futures market with all the overhead and all of the position limits and market monitoring and emergency authority to order down positions. It is either that, or it is an opaque voice broker market. There is nothing in between.

And I think that people that are familiar and close to these markets recognize that energy and quite possibly many other commodity markets, there is an in-between. And it needs some of both of those worlds. Otherwise, you are just—the illiquid thousands of markets that Professor Greenberger refers to will just go back to voice brokers. And you will have no information, no audit trail about what anybody is doing in any of those markets.

Mr. STUPAK. All right, Kyle, could you put up exhibit 27? I think Mr. Walden has a follow-up he would like based on the back-and-forth we have been going here.

Mr. WALDEN. Yes, if I could, Mr. Chairman, I would just like to get clarification on the difference between the end-of-month data we just saw on that chart and sort of the contracts year-to-date or annualized, because it looks like the numbers have tracked pretty——

Mr. STUPAK. Exhibit 27.

[Chart shown.]

Mr. WALDEN. It is Exhibit 27 in that book, and it shows in the year 2006 NYMEX traded 23,019,000 contracts, natural gas contracts. ICE did 24,040,000. 2007 year to date NYMEX is at 25,146,000. ICE is at 25,910,000. These annualized numbers don't seem to show the volatility that the end-of-the-month day numbers show, and I am curious if you could explain that to me, why the difference and what the significance of the difference is.

Mr. VICE. I will try to explain the difference, Tom, if you don't mind. You go after me. One thing we haven't talked about here is the NYMEX contract and the ICE swap traded OTC are not the same thing. The NYMEX contract is a physically-delivered natural gas future. If I want, I can hold that contract. I can go to expiry and demand delivery and potentially squeeze a market.

The ICE swap has no ability to do that. If I hold it until expiration, I receive the NYMEX final settlement price. That is it, and so what you find is these swaps were around long before ICE was around. And in terms of market size, generally the futures market is, generally in any commodity, is several times larger than the underlying physical production. And the OTC market is typically several times larger than the futures exchange on any commodity you look at. So these numbers aren't surprising at all.

But if you look at how people use the two products differently, yes, they are economically linked. And we have acknowledged that there should be some regulation recognizing that. But they are used differently in that if I am a producer or a consumer like Memphis Gas, I am buying gas out there, and I am buying—in fact, this is the crux of FERC's argument in the Amaranth case of why they have jurisdiction—because it affected what is called next month physical gas trades, where people buy gas at the NYMEX, plus a basis spread. NYMEX settlement, plus a dime, plus 20 cents. And so a consumer may buy gas on that basis.

So now it has locked in the basis price, but it has exposure to the NYMEX settlement price. So to get rid of that risk, they could go buy a swap for a fixed price and eliminate that variability. But to maintain that perfect hedge they need to hold that swap to delivery, not trade out of it, as you would a natural gas future at NYMEX. You need to hold it to delivery and actually receive the NYMEX settlement price because you are going to pay the producer that same amount, plus 10 cents. So they are used differently, and it is an important point.

Mr. GREENBERGER. I would just add to that, Mr. Vice says they are connected, the physical and non-physical markets. They are identical, and anybody trying to tell you that there is a difference between the two is blowing smoke. They are identical, and in fact Mr. Cota is worried that physical markets may be so unimportant that they may end physical delivery, which would hurt the heating oil industry. And also, Mr. Vice tells you that Morgan Stanley, Goldman Sachs have no stake holding in that ICE company. They started that company, and if you look at Senator Levin and Senator Coleman's report on page 47, 48, they list Morgan Stanley, Goldman Sachs, and BP as large stakeholders. They may have reduced their positions, but they run—ICE is here for those companies.

Mr. STUPAK. Mr. LaSala, I think you wanted to comment.

Mr. LASALA. I want to comment here because this is the crux of this hearing and what we are doing. So——

Mr. STUPAK. Did you want to say something, Mr. LaSala, and then we will go on to Mr. Green for questioning?

Mr. LASALA. Absolutely. Again, they are different. One is physically settled, one is cash settled, but they are absolutely linked. And again I am bound by hard positions limits. I have to manage them. Whether you want to say pre- the new procedure or post- the new procedure, I have always been bound with SRO responsibilities on that. And parties can—with the ICE contract, there were no position limits whatsoever. So someone could load up. And you can, since they are linked, and I am asserting that, I think that others have done analysis and asserted that. You can drive the price up by activity in that market, and Mr. Vice is right. You don't have to get out. It is a financially settled one, so buy it at lower increments, drive it up, and get the final settlement price. If we agree that the markets are linked, that is absolutely possible.

Mr. VICE. One quick comment. They are linked. They are financially linked, and they should be looked at jointly in any kind of regulatory oversight. Despite what Mr. LaSala has said, though, NYMEX itself in early 2006 changed their rulemaking. Previously their swap and their natural gas future were counted together in administering position limits. They recognized that they were different and broke them out. So I don't know how they can say they are exactly the same, because their actions indicate otherwise.

Mr. LASALA. If I may.

Mr. VICE. Sure.

Mr. LASALA. In connection with that, we also put out a notice saying that untoward activity that, if you have position in the cash commodity, which we have on our books and we can monitor, if in fact there is underlying activity in the physical that the cash is—if a settlement derived by, we will prosecute you.

Mr. STUPAK. Mr. Inslee, for questions.

Mr. INSLEE. Thank you. Mr. Greenberger, your testimony is astounding in its implications, assuming you are correct. And I just want to ask you, tell me others who share your view of the ramifications of these failures.

Mr. GREENBERGER. Well, Mr. Cota does. Ms. Campbell does. Professor Frank Portnoy, at the University of San Diego, agrees with my position. I think every State Attorney General's office agrees with my position. And, by the way, if the CFTC/ICE legislation to close the Enron loophole is passed in its present format, the State Attorney Generals are going to have to go contract by contract to prove what everybody knows. Futures contracts cause significant price discovery.

If you make my change and put "or energy" back, ICE will be fully regulated. If they have some reason not to be fully regulated, they can apply to the CFTC for less regulation. But it is their lawyers, Goldman Sachs, Morgan Stanley, who would have to pay to get the change, not Mr. Cota, Ms. Campbell, and me, who have to prove that their contracts under the CFTC cause significant price discovery. Put the burden on ICE, not on the public.

Mr. INSLEE. So, game play for me those two different mechanisms.

Mr. GREENBERGER. OK, I will game play it exactly. ICE has hundreds of thousands of contracts. Mr. Cota is worried about one contract. He thinks it has significant price discovery. He is going to have to go to the CFTC and get engaged in a hearing. The CFTC itself is going to have to have a hearing, saying this contract, not the exchange, causes significant price discovery. They make a finding after a lengthy hearing. Is ICE or the traders going to challenge that in Court? You bet your life. There will be injunctions. There will be Court proceedings. The public and the CFTC will carry the burden every step of the way.

If you add "or energy" back to the definition of commodities that aren't exempt, just those two words, it will be ICE's burden to show that they shouldn't be regulated like NYMEX. They will have to carry the weight, Goldman Sachs, Morgan Stanley, British Petroleum, not the poor heating oil guy from Vermont. ICE will immediately be regulated and then have to prove, if they have the ability to prove it, that they should get less regulation, because Mr. Vice is worried that there are all these different contracts, and you should worry about them but not worry about the person back in your home district that is paying 30-percent premium over supply/demand for gas, heating oil, natural gas, and oil.

We shouldn't be worried about ICE and Goldman Sachs and Morgan Stanley. We should worry about your constituents. Put ICE back under regulation. Let ICE get out of it. ICE can get exemption under the Act as it exists. Don't make your constituents fight that battle on a case-by-case basis and then have to go into Court, District Court, Circuit Court, and maybe to the Supreme Court to show that one—and by the way, when that one contract is determined for significant price discovery, these traders are going to move to other contracts, just the way they moved from NYMEX to ICE.

You will have spent years convincing them that one contract causes significant price discovery. These guys will get on the telephone just like you heard them. Mr. Stupak played those recordings. And they will say, guess what, guys. We are moving to a contract that isn't regulated.

Mr. INSLEE. So you think those two words are worth 30 percent of the value of those products?

Mr. GREENBERGER. I absolutely do, and Enron had them taken out, and Enron made $2 billion the next year, forcing the California consumers to pay $40 billion in extra electricity bills. Is it worth $40 billion to put two words in? It certainly is.

Mr. INSLEE. That is a pretty per-word rate. Mr. Vice, would ICE be willing to give up its no-action exemption and register as a designated contract market just as NYMEX has?

Mr. VICE. Are you referring to the Foreign Board of Trade?

Mr. INSLEE. Yes.

Mr. VICE. Well, we—no, I think in the sense that the—I don't know that it is a matter of do it or don't do it. I think the CFTC went through a very deliberate, extensive, thoughtful process with all of the associations in the industry, all of the exchanges worldwide to really determine, what is a domestic contract. Is it where the computers are? Is it where the customers are? Is it where the contract is delivered? If it is cash settled, is it where the index that it settles on is delivered?

And I think what that process showed is that these are global markets, and there are no easy answers there. In fact, we have a U.S. DCM ourselves. We own the New York Board of Trade. We own that in New York. It trades, for example, agricultural products, coffee, cocoa, sugar, other things. None of those products are delivered in the U.S. If that were the criteria for deciding where regulation should occur, then Brazil would oversee the regulation of those markets.

Many of the financial instruments are traded at the CME, so those settle on London Interbank Overnight rates. So there are, when you start trying to figure out where, on one of those dimensions, where a market should be regulated, what that conference showed that the CFTC went through is, you run into a lot of problems. And I think the more pragmatic, more practical, and more effective approach that they put in place was a recognition of mutually-respected regulators and information-sharing arrangements between those regulators.

So in fact, today what our UK exchange ICE Futures Europe does, there is an information sharing——

Mr. INSLEE. Could I ask you just a real quick question? I am sorry to interrupt, but I want to make sure I understand it. Are you trading today U.S. commodities or U.S. terminals without being subject to the full panoply of CFTC regulations and transparency requirements?

Mr. VICE. We are trading futures that settle on delivery points to the U.S. and the position information is provided to the regulator in the UK, the Financial Services Authority, which is comparable to the CFTC. All that information is provided to the CFTC.

Mr. INSLEE. Do you think that is equivalent as full CFTC regulation?

Mr. VICE. I do.

Mr. GREENBERGER. Mr. Inslee, if it was equivalent, they would go to the CFTC.

Mr. VICE. Equivalently effective.

Mr. GREENBERGER. It is not just U.S. terminals and U.S. contracts, he is in Atlanta, Georgia. They just happened to buy a British Exchange. I signed a template for those foreign no-action letters. It was for foreign exchanges trading foreign products in a foreign country.

Mr. INSLEE. Mr. Chair, I am out of time, but Mr. LaSala wants to respond. Do you want to allow him or——

Mr. STUPAK. Sure.

Mr. LASALA. Thank you.

Mr. STUPAK. Then we will go to Mr. Barton.

Mr. LASALA. Just a comment. I think that, broadly speaking, the Commission's no-action process has been effective. However, things have changed insofar as certain contracts, basically taking to a point where it is a similar posture as our posture with the natural gas, where certain indicia are hit. For example, taking the WTI settlement price. It is basically a U.S. market that the no-action process should have the ability for the CFTC to prospectively put certain other requirements. I am not saying, make them a DCM. We are not saying, make them a DCM, but maybe in the no-action process, having a comparable position limit, having an absolutely comparable large trader requirement would be appropriate. That would be our suggestion.

Ms. CAMPBELL. Mr. Chairman, may I comment as well?

Mr. STUPAK. Ms. Campbell.

Ms. CAMPBELL. As far as APGA, our position is not that if we bring light to the dark markets that this is going to bring an immediate percentage change in the price. What we are looking to do is increase the confidence in the market, that this is truly the forces of supply and demand at work. And we support the risk-based regulatory regime as it is in that we have a tier in which ECMs can exist because they have brought a great deal of value to my customers on a physical basis.

We are able to—where we used to get on the phone—we have 2 hours to buy gas every morning. We used to get on the phone and call as many people as we could. Now we have a screen in front of us, and we have this great deal of price discovery on the physical side that we didn't have before.

But once we cross that line where we now have a natural gas contract on ICE that is a look-alike contract to the NYMEX, that is where we kind of cross that line, and we need to bring greater transparency to that contract, the ICE contract, so that we can see the full picture of the full marketplace. And then the CFTC can do their job to detect and deter the manipulation. Thank you.

Mr. STUPAK. Thank you. Thank you, Mr. Inslee. Mr. Barton, for questions, please.

Mr. BARTON. Thank you, Mr. Chairman. I want to start out reading something just—I want to, before I ask questions. Back in 2002 and 2003, the beginning of 2004, when oil prices started going up, and the price at the pump for gasoline started going up, and we also had heating oil prices going up, we had natural gas prices going up. We had a series of hearings on this committee about what caused the price and whether there was price gouging, things like this.

And I called the New York Mercantile executives to testify, and I also met with them privately in my office, and they talked about something called ICE, that was kind of the new kid on the block. And what I was wanting to do was see if we couldn't raise the margin call on buying these contracts, because on the New York Merc, the margin requirement was minimal.

And I asked, I said, how do you call—set the margin call? And basically the answer I got was—they didn't put it in these terms, but it was, like, we are financial bookies. We really don't care. We just want what the price is. We just want to create action, so we set the margin to create action. It is almost like an over/under betting line on sporting events.

And anyway, the Merc said, if you really want to do something, you are going to have to regulate this group called ICE down in Atlanta, because they don't play by even the rules that we play by. So in the Energy Policy Act of 2005, we put a paragraph in. And the paragraph basically, "it shall be unlawful for any", a-n-y, "any entity, directly or indirectly, to use or employ in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the commission", which is the FERC.

That was not serendipity. It was intentional. In fact, we wanted to do more, but that was as much as we could get approved on a bipartisan, bicameral basis. So this allegation that somehow we didn't mean what the Law says is silly. And this hearing shows that even this may not be enough, that we may need to do more.

So, my question to the young lady from Memphis Light and Gas, what do you get by trading on ICE that you don't get by trading on the Merc, which is at least more transparent and more regulated? What is it that Mr. Vice and his group have that is so much better? Is it just a cheaper price to conduct the transaction, or is there really some tangible benefit by using ICE as opposed to a regulated exchange?

Ms. CAMPBELL. Sure. Let me be sure I am clear. My comments earlier were, we were trading on ICE as a physical commodity as opposed to the futures. So every day we are out buying gas, the physical gas, we are looking to ICE.

Mr. BARTON. So you are not talking about these look-alike contracts?

Ms. CAMPBELL. We are not. I was not, but let me give you an example. Many of our members are very small, and so their volumes are very small. The NYMEX is for 10,000 MBTUs, which is much more than what they would typically use. So they look to hedge their risk through over-the-counter markets or through ICE, which has a smaller volume. So there is value there.

There is value in the credit-worthiness. You mentioned increasing the margins. Well, that may drive us out of the market, because we don't have the cash position to maintain those positions, so——

Mr. BARTON. But you are not in the market to speculate.

Ms. CAMPBELL. No, sir.

Mr. BARTON. At least I would hope not. You are a regulated——

Ms. CAMPBELL. We are completely hedging.

Mr. BARTON. Yes.

Ms. CAMPBELL. And so the thing to be careful of, as we start to look at what the right thing to do for these markets, is to be sure that we don't price the actual hedgers out of the market or do something that would put us out of the market. Because when you think about it, the traders can go anywhere and go, as we have said, to different markets. We have the natural gas market, the NYMEX, the OTC, to depend on so that we can lay off our risk, the price risk for the next winter. And remember this market is twice as volatile as the stock market, so we must do something to protect our customers on the price.

Mr. BARTON. Well, is it—and I will give Mr. Vice a chance. It is not fair to chastise his organization without giving him a chance to reply. But when you look at the statistics and the facts, the number of contracts that appear to be speculative in the natural gas market and the oil and gas and oil markets are skyrocketing 300 to 400 percent increases. We have the company, the Amaranth, which tried to corner the natural gas market. And when the Merc finally and the CFTC tried to put the brakes on it, they just moved most of their contracts to the ICE Exchange, just switched them over.

Mr. Vice, do you agree that speculators in—and in order to have a market, there have to be speculators. So I am not negative on speculators. I am somewhat negative when it looks like the speculators dominate the market at the expense of the hedgers that are physically trying to buy and sell to actually provide a product and provide a service.

Do you agree that the speculators have affected the price that consumers pay on the upside in the last 18 months?

Mr. VICE. I don't know that I can answer that question other than—I am not going to make a statement like Professor Greenberger. It would just be my opinion and nothing more.

Mr. BARTON. Well, yours is a——

Mr. VICE. I think——

Mr. BARTON. Technically, you are an informed opinion. I mean——

Mr. VICE. If I knew the right price for these commodities, I would be a trader, not——

Mr. BARTON. No, I didn't say, the right price. I am saying, everybody in the country seems to think that there is a premium, and different people disagree about what it is. But $2 to $3 in MCF. We have heard as high as $30 a barrel of oil, and you disagree with that, apparently.

Mr. VICE. Well, what I can say is that all commodities, ags, metals, and energies, are all up dramatically. And part of that is the demand of China, India, other demand on those commodities, part of it is they are all traded in dollar-denominated contracts. And the dollar is down 17, 18 percent in the last 2 years. So that directly drives the price of those up.

And all of those markets have gone—they are all essentially electronic now, and there is no question in moving—whether it is Eurodollars at the CME or natural gas at NYMEX or anything else—moving from a floor-based exchange to an electronic platform, you dramatically increase the transparency, the efficiency. The bid/ask spreads tighten, and the volumes go up dramatically. They do. And you see that in our numbers, and you see it in futures exchanges across the board.

Mr. BARTON. Mr. Chairman, may I ask one more question?

Mr. STUPAK. Sure.

Mr. BARTON. Well, Mr. Vice, since your contract doesn't require actual delivery, although less than one percent of the futures contracts actually end up in delivery, other than being a smaller contract, what advantages are there to using your market versus the mercantile market? Why would people use you if not purely for speculative purposes?

Mr. VICE. Well, I think you need a little history there. We traded a contract bilaterally for a number of years on our platform. It was the only place you could trade electronically. If you wanted to trade the economic equivalent of the physical future at NYMEX, you had to call a broker on the floor, and people were not—it was not the best execution. The price you were going to get was uncertain.

So on the screen over time, that became a very popular thing, and that grew. And for a number of years, the only place that you could hedge or speculate on the price of natural gas electronically with all the benefits of trading electronically—I said a minute ago, speed of execution, transparency and so forth—was on ICE.

Mr. BARTON. So you have an efficiency advantage?

Mr. VICE. We spent millions of dollars on our platform, on the functionality and the speed of it and the distribution of it. And that is some of the competition that I am referring to in the ECM category. And NYMEX has responded. They have dramatically——

Mr. BARTON. So if we changed the Law and explicitly regulate your market so you have to comply by the same rules, you will stay in business because you have an efficiency edge and you have a product differentiation that you think is positive? You are not going to go out of business?

Mr. VICE. I think what we are saying for our major contracts, like the Henry Hub contract, which the industry is starting to call significant price discovery contracts, yes, that is true. Those contracts, they behave to some extent like a future and therefore are amenable to DCM-type core principles being applied to them. We support that, and we are working with members of Congress to that end.

We are also saying that there are hundreds, thousands of other markets on our platform. One core principle, for example, is coming up, is for publishing every day "What is the open interest? What are the settlement prices? What are the opening and closing range?" Some of those products may trade once a week, and so to put the regulatory overhead on us but more importantly the thousand participants that are on ICE to somehow comply with any of that, the four or five Memphis Gas or other types of utilities that might be trading a very illiquid swap at some very liquid gas pipeline point, are going to say, forget it. I will just, I will go back to the voice broker.

Mr. BARTON. Well, we can handle the exceptions, but when you have thousands and thousands of contracts, and you have companies moving between the two exchanges, based on the regulatory reporting requirements, when you created a mirror market, it would seem to me that the Federal regulators in the Congress should make sure that everybody gets a fair shake and it is not just used as a way to evade transparency and the very things that you created your exchange allegedly to bring to the market.

And with that, Mr. Chairman, thanks for the courtesy of the extra time, and I yield back.

Mr. STUPAK. You bet you. Mr. Melancon, for questions, please.

Mr. MELANCON. Thank you, Mr. Chairman. I came in a little late, and I am still trying to put together the pieces of this thing. I grew up in the shipping industry, and the only people that make money trading sugar is the traders. The consumers are the people that are selling, usually are the ones that are not beneficiaries, and of course, what I found as I grew up was that the slightest rumor caused the price to spike up or down. And the reality is, it doesn't matter which way it goes, the traders make money.

So, I think I am sitting here listening to an argument over who is going to make money the easiest or the fastest or the least regulated, I think Professor Greenberger hit the nail on the head. This is all about making sure that the American consumer is the person that comes out ahead. When Ms. Campbell looks to purchase gas for Memphis, it is not about the broker making money. It is a combination of what is the easiest thing for me to do today to get the best price as quick as I can, if I understand what you are doing.

So I guess it brings me to trying to figure out, you know, we are looking at doing legislation. I am kind of a different kind of guy.

I am in the legislature, but I figure that we can solve more problems sometimes without actually legislating. We need to correct the problems, but I am more about mediating.

What I am seeing, I think, is a jurisdictional fight that was started by the Congress. The regulations that became kind of gray and the shifting of jurisdiction now had two agencies that are out there that are conflicted, and one maybe not talking to the other or both not talking to each other.

The question is: Can we bring some transparency, some regulation that is fair to all, and through a memorandum of understanding and jurisdictional oversight, whether it is joint committee or not, to make sure that what is taking place in this market is fair; that it doesn't allow for people to corner the market, as I think happened recently. I don't know what happened with the Hunt brothers when they tried to get all the silver in the world, but that is probably why they started trying to do some of the things legislatively that maybe brought us to the problem.

There is probably some need, but is it extensive, or is it minimal? And what MOU, with FERC and CFTC, more readily address the issue?

Mr. GREENBERGER. If I can just explain one thing. The fight between FERC and the CFTC only relates to enforcement of natural gas. It has nothing to do with what traders have to do from the get-go. It is only after the horse is out of the barn.

And only natural gas. And I hope minority counsel will tell Mr. Barton, when you fixed the Energy Policy Act, as I understand it, that was just natural gas. He has his consumers coming in and saying gasoline, heating oil. Well, what he has to tell his consumers is that ICE has two exemptions. They have the Enron loophole, because they moved "or energy" out of the CEA. And then, if you fix that, which is all the present legislative fix is addressed to, you have to tell your constituent that ICE, that is located in Atlanta, has Goldman Sachs, Morgan Stanley, BP supporting it. Goldman Sachs tells its customers, don't trade on NYMEX. ICE is in Atlanta.

Mr. VICE. I have to correct that.

Mr. GREENBERGER. Well, you had your chance, Mr. Vice. Yes, you will have your chance. You have to tell your constituents that ICE in Atlanta with all these great trading engines in the United States, trading United States West Texas Intermediate, we can't do anything about it because the staff of the CFTC said ICE should be regulated by the United Kingdom. Try telling people in Louisiana that an Atlanta company trading West Texas crude on the United States engines is out of the control of the United States.

Mr. MELANCON. Isn't natural gas priced by countries or by regions and not necessarily world price, like oil?

Mr. GREENBERGER. There are different kinds of gases, but ICE is trading gas delivered in the United States.

Mr. MELANCON. That is where I am——

Mr. GREENBERGER. Henry Hub.

Mr. MELANCON. And I think I am familiar with where——

Mr. GREENBERGER. And they are competing with NYMEX, and, poor NYMEX, they are suffering because they have to be regulated by the CFTC. They are doing fine. NYMEX may be bought by the

New York Stock Exchange. It is the most profitable exchange in the world. ICE says, don't do this to us. We have all these small contracts. We don't have time to go to the CFTC and use the exemptions in the statute to get these exempt. We want you to regulate around us, because we have a great trading engine, and we are great guys. Forget about telling the guy in Louisiana that we are in Atlanta with a trading engine in the United States trading United States-delivered products. But for crude oil, you got to go to the United Kingdom to take care of us. That doesn't make sense. People in Louisiana will not understand that, and there is no legislation addressing that. And the CFTC staff and the CFTC could fix that this afternoon under existing legislation. It has nothing to do with FERC.

Mr. COTA. We, as an industry, like speculators. Speculators are important. It is the excessive speculation that is the killer. I could not offer futures contracts to my consumers without having speculators in the market. The volume of speculation has gone out of control. We are figuring that for gasoline and heating oil, approximately 50 cents to a dollar a gallon could be a result of excess speculation. The volumes of trades are huge.

The contract that I am most familiar with is the heating oil contract. The heating oil contract is about 8 billion gallons in the U.S. annually. Well, that amount gets traded amongst NYMEX and ICE—I am not sure how much is traded on ICE, because there is no data that is reported to the markets unless——

Mr. VICE. It is zero percent.

Mr. COTA. The volume of trades are about four times the annual consumption per day. You know, is that too much trades? You know, we focus a lot of the time on small contract. The major contracts trade huge volumes daily of what the annual volume is. And because you don't see the data—if it is illegal to do a contract under a U.S. law, it is still illegal to do it. Just nobody has any of the data. My brother-in-law from New Jersey has often told me, he said, there is no body, there is no crime. So these dark markets have no light on them. You don't know what is occurring. Only the people that are doing the trades know. What is wrong with oversight?

Mr. MELANCON. Thank you. I ran out of time a couple of minutes ago. Thank you, Mr. Chairman.

Mr. STUPAK. Thank you, Mr. Melancon. Ms. Blackburn, for questions, please.

Ms. BLACKBURN. Thank you, Mr. Chairman, and I want to welcome all of our witnesses. I think that anyone who is watching this hearing today is probably just spellbound with the amount of debate between all of you. And they probably are sitting there thinking, what is this going to end up costing me? What does market manipulation cost me? And what does it mean to my heating bill?

And, Mr. Chairman, I have a question for Ms. Campbell, but before I ask it, I do want to welcome her. She is a constituent. She lives in Fayette County, Tennessee, and does a wonderful job for Memphis Light, Gas and Water. And I appreciate the expertise that she has brought to the panel today and also the manner in which she has presented it. And we welcome you, and I thank you for that.

I do have a question for you in light of my comments. When we talk about the market manipulation and in your testimony, you talked about the Amaranth activity. What kind of cost increase on a percentage basis do you pass on to your customers? How much fluctuation do they see? And let us say if natural gas were to go up a dollar MBTU—I think that is the unit, correct? So if it went up a dollar for an MBTU, then how much would that average customer see as an increase in their bill when they rip that envelope open and pull it out and look at it?

Ms. CAMPBELL. Goodness, the way that our mechanism works—and what you will find is that across the country, everyone's cost recovery mechanism works a little differently. The way ours works is that we look at what it costs us for gas this month, and we immediately pass that through the next month on our customers.

Ms. BLACKBURN. So you have a 1-month delay?

Ms. CAMPBELL. It is a 1-month delay. So if there is a $1 increase in the price of natural gas, and it is currently at about $7, so let us just say that it is a 20-percent increase, then typically with our rate structure, almost all of that will pass through. And it will be somewhere in the range of a 15- to 18-percent increase on our customers' bill because only of our customers' bill 80 percent of it is natural gas, and 20 percent of it is MLGW costs.

Ms. BLACKBURN. OK, thank you. So many times our constituents think that it is due to the weather, and I think that is an important point is that it is due to what the manipulations are in the market. Based on that, Mr. Vice, let me come to you. Let us say an average investor wants to know what contracts have been sold on a certain day, and he wants to know what contracts have been made in your market, in ICE's market. So is that information readily available on a day-by-day basis?

Mr. VICE. It is available for a fee.

Mrs. BLACKBURN. For a fee?

Mr. VICE. Yes.

Mrs. BLACKBURN. OK, and then what would that fee be?

Mr. VICE. I don't know the pricing of all our market data. If you want a real-time screen to sit there and watch it——

Mrs. BLACKBURN. Why don't you get that and get it back to me?

Mr. VICE. Sure, be happy to.

Mrs. BLACKBURN. OK, I think that that would be interesting to know, because we may have investors out there that are listening to all of this, and they are saying, my goodness, I am hearing from Ms. Campbell that it is all passed through. It is passed through on a month delay. There is this market out there. It is called ICE. I wonder what these contracts are—who they are being made with and what that pricing is every day. Let me ask you this also. Is ICE going to implement an electronic system that provides minute-by-minute and up-to-date information for public investors? Do you plan to do that?

Mr. VICE. Well, when you say ICE, we have, as I said earlier, we have a number of futures exchanges which already do that. In our over-the-counter markets, which is where our natural gas trades, we do do that. Keep in mind, our history up to this point has been that we are an over-the-counter market, which the point here is, means that it is a principals-only. It is a professionals-only market.

There is no retail access. There are no brokers. I could not personally go into that market and trade. There are $100 million asset requirements. So it is utilities, like Memphis Gas. It is banks. It is energy companies.

Mrs. BLACKBURN. OK.

Mr. VICE. And so until now, it has been a relatively small, it is the wholesale market if you think of it that way.

Mrs. BLACKBURN. So you keep the firewall in place, since it is a wholesale market. Mr. Greenberger, any comment to that?

Mr. GREENBERGER. Yes, you asked about what the price to your consumer, and let me just read to you from the bipartisan Senate staff report from the Senate Permanent Investigating Committee under the auspices of Senator Coleman of Minnesota, Senator Levin. The price for natural gas was $8.45 before Amaranth collapsed. NYMEX said, you got to reduce your position. They went over and moved all their trading over to ICE. They went bankrupt. The day after they went bankrupt, the price went down to $4.80.

"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." So eliminating that one speculator from ICE almost dropped the price of natural gas, which is a component of electricity, by one half. Now, that is a school of scandal. Everybody saw what Amaranth did. So others went right back into that market. It is back up to $7 now, but if we weren't talking about deregulating, it would be up to $10, where it was the day before people were talking about introducing legislation. That is what your consumers are paying too much.

Ms. BLACKBURN. Thank you, Mr. Greenberger. I am out of time. Again, Ms. Campbell, thank you for being with us today, and I yield back.

Mr. STUPAK. Mr. Burgess, for questions.

Mr. BURGESS. Thank you, Mr. Chairman. Mr. Vice, we may be a lot of things on this subcommittee, but we are unfailingly polite, and you were unable to respond to a statement that was made a minute ago. And if I have reconstructed the statement properly, I think it was that if you are on ICE, you can't trade on NYMEX. You wanted to make a comment about that. So let me give you a moment to do that.

Mr. VICE. Thank you, I appreciate that. Yes, I think Professor Greenberger several times has alleged that Morgan Stanley, Goldman Sachs own, control ICE, and he is saying things as outrageous as they are telling their people not to use NYMEX. In fact, those companies, I don't know if any of them own any shares of ICE anymore. I am pretty sure some of them don't. I know they probably own seats on the NYMEX, and they are also actively starting up new competitors, new businesses that will compete with us in various areas. So that is just patently false. I mean, it doesn't even make sense if you—that Goldman Sachs or anyone like that would be doing that type of thing. Thank you for the opportunity.

Mr. BURGESS. Well, I appreciate the clarification. Now, you have talked about the electronic trading platform and the investment that your exchange has made in that or, I guess, the multiple exchanges that are involved or that make up ICE. And you have referenced speed and transparency.

So that should be a good thing just from the perspective of a consumer if the trades can be made more in real time, if there is greater transparency. So, if, as Ms. Blackburn said, the price is right, you can go and have the real-time screen and know these things. That should be of benefit to the people who are purchasing, I would think.

So my previous career was in healthcare, and the more we can increase the speed of computing, and the more we can increase transparency, these are seen as positive things for the delivery of healthcare. And I would think the same could be said for pricing in the energy markets. Has NYMEX, for example, made this same, similar sort of investments into this electronic trading platform? Does that seem to be something that delivers value to the transactional process?

Mr. LASALA. Thank you. We certainly have transitioned into an electronic forum. We are operating on our core contracts on both venues, meaning a floor as well as electronic. But we definitely have migrated to a point where approximately 80 percent of our futures volume is now electronic. So I think that the marketplace has determined that the electronic medium is efficient. And at a point in time if the marketplace decides that that is the only form that they see as appropriate, we would be responsive to it. But until then, there is still a use for the floor.

Mr. BURGESS. Well, it just seems like, in an era where most young people today don't have any concept of what it means to go to the bank and write a check for cash, they go to the ATM and make withdrawals, it just seems like moving in a direction of the electronic trading makes a lot of sense. And if we create the right type of regulatory environment, it seems to me, and I am just a casual observer to this process, but it seems to me that the increased transparency could bring problems to light much more quickly than we sometimes find things in our current regulatory environment.

And I hate to keep going back to health analogies, but just like when we created the database that now the FDA is going to use to be able to flag problems with new medications in their post-market surveys, it just seems like the data could be collected on a real-time, ongoing basis by whatever regulatory body, whether it be FERC or CFTC or some new entity that is created. It just seems like that information would be delivered to them real time.

Mr. LASALA. Well, just a point on that is that with the electronic medium, we also have to, I believe from my perspective, factor in is that when the contracts are similar, the electronic medium even more moves to the point of linking the markets, meaning that there are electronic devices that are going to be on front-end systems that are going to treat the NYMEX market and the ICE market as effectively one and the same. So the notion of similar markets being linked, I think, becomes even more relevant in an electronic forum.

Mr. BURGESS. And is that a good thing or a bad thing? Does it increase competition? Does that benefit the consumer or harm the consumer?

Mr. LASALA. I think that, broadly speaking, it is a good thing, but with it comes the points that I have made earlier, that it moves the argument that, in fact, where one market is unregulated but linked, it suggests that regulation that would be good for the consumer would be appropriate.

Mr. COTA. These systems are very efficient in how they do it, but the flows of money are just huge. People think that there is an energy shortage. There is no energy shortage. Inventories are at 5-year highs across the board. You take a look 5 years ago, crude oil is trading at about $30 a barrel. We are now at $90. The volumes of money—we have got a glut of cash. The cash has moved out of the sub-prime market into the energy market, and they are just driving the price through the roof. It has nothing to do with supply and demand.

Mr. BURGESS. Well, let me interrupt you for a minute, because I do have to ask Professor Greenberger a question, because I am just dying to hear the answer, and it kind of ties into what you are—expensive. Oil is expensive. Starbucks coffee probably costs $1,000 a barrel, but we keep buying it.

But here is the question, Mr. Greenberger, if oil is too expensive, if crude is too expensive, why do we keep buying it?

Mr. GREENBERGER. Well, at some point there will be a stop, but there has not been a stop now. It is almost at $100. Predictions are—Mr. Cota was citing statistics—it will be at $105 very shortly.

Mr. BURGESS. But if we paid the same prices for energy at the pump that the Europeans do, what would the cost of oil per barrel be? If there weren't the taxes that the European markets add to their finished product, if just gas, because of crude price costs $7 a gallon in Denton, Texas, what would the price of crude be?

Mr. GREENBERGER. Probably $150, but are you going to tell your constituents, hey, Europeans pay more, and they are OK? Don't worry about it?

Mr. BURGESS. No, I am just asking the question. How expensive does it have to get before we stop buying it?

Mr. GREENBERGER. There will be movements to move to alternative fuels at some point.

Mr. BURGESS. Well, and would not we argue that that is something that this committee has spent a good deal of time and other subcommittees talking about?

Mr. GREENBERGER. That is great, but do you want to have that done on the backs of the consumer who are paying $30 for a barrel that they don't need to pay? Wouldn't it be better——

Mr. BURGESS. Not the question. The question is, if oil is so expensive, why are we buying it?

Mr. COTA. We are rapidly approaching demand destruction. Gasoline is relatively inelastic in demand. Heating use, we have seen a reduce in heating consumption. I have also seen a huge trend of paying with credit cards, because consumers are out of cash. When you get to the demand destruction point, you are going to have a collapse in this market, because the big players in the markets can move money faster than any consumer, more than Memphis Gas can.

Mr. BURGESS. Purely from observational data, and I am not arguing with you, because you guys are the experts, but purely observational data, a year ago, market destruction meant that Republicans lost the majority of the House because oil was $56 a barrel. $96 a barrel this year, and there seems to be no penalty for it. And as I drive around the metroplex, I don't see any diminution of the number of SUVs with a single occupant on the freeways.

Mr. GREENBERGER. Mr. Burgess, there will be in February a penalty if heating oil does not drop.

Mr. BURGESS. But with global warming, there is not going to be any need for heating fuel. We have actually obviated that problem.

Mr. GREENBERGER. May I also take the privilege of responding to one point?

Mr. BURGESS. Sure.

Mr. GREENBERGER. I am citing——

Mr. BURGESS. If it is OK with the chairman. I said, sure, but he is running the show here.

Mr. STUPAK. Go ahead.

Mr. GREENBERGER. This is the bipartisan June 27, 2006, report that was put out by Republicans and Democratic staffers under the chairmanship of the Republican Senator from Minnesota, Mr. Coleman. On page 48 of that report, which no one to today has said is wrong, says, "according to one energy trade publication, several of the large stakeholders, several of the large ICE stakeholders, BP, Total, and Morgan Stanley were "doing their best to support the ICE WTC contract, with Goldman Sachs directing its traders to use the ICE platform rather than NYMEX." Now, I may be wrong, but if I am wrong, Senator Coleman——

Mr. VICE. You are quoting an unnamed energy publication.

Mr. GREENBERGER. Market forces, big oil increases, market reach, Energy Compass, March 24, 2006.

Mr. BURGESS. Mr. Chairman, I think at this point, I am going to yield back my time.

Mr. STUPAK. What is the date of the report you are quoting from, Professor?

Mr. GREENBERGER. It is June 27, 2006, pages 48 to 49. This is the report where Senator Coleman, Senator Levin, through their staff, say, when oil was $77, $20 to $30 was being added by speculation.

Mr. BURGESS. Mr. Chairman, do we have a copy of that?

Mr. STUPAK. Yes, it is tab 24 in your document binder.

Mr. BURGESS. I don't have a document binder. I am on the minority.

Mr. STUPAK. Jeff has one. Be nice to your staff.

Mr. GREENBERGER. I would say to any member of this subcommittee that if you read nothing else, read the two bipartisan staff reports of the Senate Permanent Investigating Committee on speculation and crude oil prices and natural gas. They are dated June 27, 2006, and June 25, 2007. The first report says "$20 to $30 added to crude oil price". The second report says "Amaranth caused a $4 increase in natural gas". Both reports say, this has got to stop. The first report says, the loophole has to be closed, and an Atlanta company with United States trading engines and using United States-delivered contracts should not be delivered by the United Kingdom.

Mr. COTA. And the GAO put out a report 3 weeks ago that basically said similar things. That so much of the data is unavailable you can't tell whether there is market manipulation and again recommends that the CFTC regulate these markets.

Mr. BURGESS. Mr. Chairman, are we going to have time for a second round?

Mr. STUPAK. If we get there, yes.

Mr. BURGESS. OK.

Mr. STUPAK. No one else on this side. Mr. Fossella, who is a member of the full committee, but not the subcommittee. It has always been the practice of this subcommittee to allow members of the Energy and Commerce Committee, if they sit in, to ask questions. So, without objection, Mr. Fossella, if you would like to ask some questions. We will then go to a second round, Mr. Burgess.

Mr. FOSSELLA. Thank you very much, Mr. Chairman. Thanks for the hearing, and thank you to the panel. I find it very illuminating and great discussion. And maybe just to follow up, because I am curious, I know that the essence is here is not just whether more regulation is necessary but also impact on consumers and speculation and in some ways manipulation. And if I could just be clear, Professor, you made a pretty strong statement before, under oath, that Goldman Sachs tells its clients, I think you said, not to trade on NYMEX. You don't know that for a fact, or do you?

Mr. GREENBERGER. I know what I have read by the bipartisan Senate staff. It is in their report. I read that to you. That is what I am basing my testimony on.

Mr. FOSSELLA. OK.

Mr. GREENBERGER. That report, which is in an energy publication——

Mr. FOSSELLA. I understand. OK, so you are basing—I just want to be clear. You cited that report, and based on that, you believe that Goldman Sachs tells its traders not to trade on NYMEX. Is that what you believe?

Mr. GREENBERGER. My statement is based on this report.

Mr. FOSSELLA. Do you believe it to be true?

Mr. GREENBERGER. And I believe it to be true. I don't know it to be true, but I believe it——

Mr. FOSSELLA. OK, you believe that Goldman Sachs tells its traders not to trade on NYMEX?

Mr. GREENBERGER. Yes, and I will tell you why.

Mr. FOSSELLA. OK.

Mr. GREENBERGER. Goldman Sachs doesn't like NYMEX. They didn't control NYMEX. NYMEX got created before Goldman Sachs got in this business.

Mr. FOSSELLA. OK, I just want to be clear.

Mr. GREENBERGER. Goldman Sachs——

Mr. FOSSELLA. I am not here to defend Goldman Sachs. They are a small player in the field. I recognize that, but they can take care of themselves.

Mr. GREENBERGER. Goldman Sachs was not happy with NYMEX. They didn't control NYMEX. They didn't have power there. They helped create the Intercontinental Exchange insofar as it trades these products that we are talking about. I base my statement entirely on this staff report.

Mr. FOSSELLA. Fair enough.

Mr. STUPAK. And I think it would be appropriate at this time to move to put the June 27, 2006, staff report as part of the record. It will be made part of record, without objection.

Mr. BURGESS. Mr. Chairman?

Mr. STUPAK. Mr. Burgess, you are reserving the right to object. Let me just be certain that we have the additional minority staff views on the report, because they do take issue with several of the points that have just been made by Professor Greenberger.

Mr. BARTON. Would Mr. Fossella yield for a point of personal privilege?

Mr. FOSSELLA. Sure.

Mr. STUPAK. OK, well, let us finish with the motion. No objection. Then we will put the June 27 and the minority views in there, as Mr. Burgess suggested, in the record. Then it is to Mr. Fossella, to Mr. Barton.

[The information appears at the conclusion of the hearing.]

Mr. BARTON. I think it is a point of personal disclosure, since we are bandying Goldman Sachs around so much, my daughter is a trader for Goldman Sachs in New York City. So we need to put that on the record, too, if we are going to be investigating Goldman Sachs.

Mr. FOSSELLA. I am just curious. Mr. LaSala, he has made some statements about Goldman basing obviously and he clarified his belief. Do you know that to be true, that Goldman Sachs directs its trader not to trade on NYMEX?

Mr. LASALA. I have absolutely no idea as to what Goldman Sachs tells their traders.

Mr. FOSSELLA. Do you believe it? I mean, just trying to get—I mean, he is making statements about NYMEX. Have you heard that at all?

Mr. LASALA. I have not heard that, no.

Mr. FOSSELLA. You have not? OK.

Mr. LASALA. I have seen that report, but I don't know exactly what they——

Mr. FOSSELLA. You want to talk about manipulation of the markets. That is a pretty strong statement and a belief, OK. So you don't believe it to be true. Mr. Cota, you mentioned before, and if anybody else has a difference of opinion, I would be curious. What is the difference between speculation and excessive speculation?

Mr. COTA. It is the amount of contracts that are traded and the positions of single parties and how much they hold. Amaranth got caught, as an example, because they did their trades on NYMEX or a portion of their trades on NYMEX. Their February position for natural gas was about 70 percent of the total U.S. natural gas production. That was just their position. And they were trading all of those trades within the last 15 minutes of the month before the contract expires, because if you are not intending to take physical on a traded market, you have to close out that position.

I put it akin to if a trader was going to do an option deal to buy 70 percent of the single-family houses in the United States in the last 15 minutes of the month, would that have an impact? That would be excessive, perhaps. It depends what side of the transaction you are on. Certainly I would hate to rent that house afterwards, but that is the kind of excessive speculation, I think, that we are talking about.

And when a single player has too much of a total position, which is the large trader reporting, which is required by CFTC for NYMEX, and NYMEX discloses, it is not done in the other markets, that that becomes a problem for the whole validity of the futures contract market for that segment of the market.

Mr. FOSSELLA. But let me be clear, because I want to ask one question, and maybe if each of you, because I am curious, is excessive speculation in the eye of the beholder? I mean, is there an objective standard? And would you point to 70 as—and you could all just provide this in writing, because I don't want to abuse my privilege here. And if you can provide that in writing, in your opinion, what is the difference between—or words—what is the difference between excessive speculation and speculation?

But finally, it may be just a different perspective. Maybe it is not different. In light of the liquidity and the depth of our markets and the fact that we do live, as all has been acknowledged, in a more global marketplace. And the essence of this is whether greater regulation is necessary to stop price manipulation. There has been much talk in the last year, year and a half, about American competitiveness vis-a-vis the rest of the world, taxes, regulation, accounting amortization, many different points of view.

I think most folks are coming to the consensus that we are not alone anymore. We never were, but, you know. Is there an implication of greater or more regulation to the American marketplace? And let me ask it a different way. If we go too far in terms of more regulation, do we force international players away from the U.S., taking capital and jobs with it? Is that a concern or should be a concern? And I can go right down the line, please.

Mr. GREENBERGER. That is an excellent question, because it has been raised consistently as an argument against not regulating ICE. Of course, ICE bought the UK Petroleum Exchange and brought it to the United States. In the futures market, you have to be where the action is. You could not control 30 percent of West Texas Intermediate Crude Futures contracts trading in London, and they don't. They are in the United States. You have to be near the product.

When I was at the CFTC, I was asked to create the exemption to allow foreign boards of trade to bring their terminals in the United States. Now, you could say I could voice broker those trades. I could call them up in London and say make this trade. Or I somehow could by computer transact my trade, but the only way these exchanges could successfully sell their foreign products was to have terminals in the United States. For this product, Eurex, the largest German exchange, tried to open up as a United States exchange because they couldn't make it in the United States products trading in Europe.

Everybody wants to be here. Look at the list of foreign exchanges that have asked for permission to have U.S. terminals. They don't want you calling them in Europe. They don't want you sending them in e-mail. They want you to be able to sit down at a terminal physically located in the United States to trade, so U.S. customers would trade.

This is a U.S. industry. Henry Hub Natural Gas, West Texas Crude, other things, you have got to be in the United States. Everybody wants to be here.

Mr. FOSSELLA. OK, I am just saying, if we could make it a little—because I don't want to again abuse my time and privilege. If we could just give a sense whether we should be concerned about that.

Ms. CAMPBELL. Well, Memphis Light, Gas and Water is not going overseas. So we are depending on this market, and the natural gas market is certainly a domestic market. So I am less concerned about that, but I do think that you need to be measured in your response. And I think that transparency is that measured response where your large traders report their positions across the marketplace. And then that way it brings light to the dark markets, and then you have the full picture of the marketplace to determine manipulation.

Mr. FOSSELLA. Thank you. Mr. Cota.

Mr. COTA. The U.S. energy market is where the action is at. We are 20 percent of world demand. I think that if we had more electronic trading disclosure done under a fuller regime by CFTC you will actually see an increased flood of trading money into the United States because the brokers around the world have traditionally looked at this as a safe market. So you are going to get more of the smaller players to play in our market as a trading platform than in their other markets.

Whatever happens in Russia happens in Russia. You know, and people in Russia know that. So the U.S. boards of trade have always been a safer way of trading, and I think it would enhance their ability to do worldwide trading. And because we are a big part of the market. We are 20 percent of the world market.

Mr. FOSSELLA. Mr. LaSala.

Mr. LASALA. I think the U.S. boards of trade are robust, and the points that I made earlier that you may have missed is just simply that where U.S. based products potentially get offered overseas under other regimes that our suggestion would be that the CFTC could address this—and the no-action process it good. It works, but there might be some consideration of additional comparability standards or additional hurdles such as position limits if we have them here that, if there is a like contract offer in another regime, that the regulatory regime, that they might be considered to be appropriate to be imposed in the context of the no-action relief.

Mr. FOSSELLA. Thank you. Mr. Vice.

Mr. VICE. I have two quick, specific examples, one on your question about competitiveness, which is close to home. Our second or third or maybe fourth of those most liquid contracts on our ECM market, for example, is a fuel oil swap based on an index for fuel oil delivered into Singapore. I am proud of the fact that American ingenuity of this Atlanta company was able, through a lot of hard work, to have traders which are primarily—these are not U.S.-based traders.

These are Asian companies for the most part or Asian branches of banks that are trading fuel oil delivered in Singapore. Has little to nothing to do with the U.S. market, and I think that is an example of if you put a futures-style DCM rule across everything that is on our ECM, that market would—we would lose that overnight, and it would go elsewhere. So it is important to have that middle tier of——

Mr. STUPAK. OK, you are going to have to answer his question, or I am going to have to cut you off. We are way over. So did you want to answer it or not, because you were going to a different——

Mr. VICE. He was asking about American competitiveness.

Mr. STUPAK. OK.

Mr. VICE. And I think overregulation, that is an example close to home, where it would certainly hurt our competitiveness and potentially cost jobs.

Mr. FOSSELLA. OK, thank you, Mr. Chairman.

Mr. STUPAK. Thank you, Mr. Fossella. And we have been generous with time on everybody because I know it is a complex issue, but I want to keep things moving. Mr. Green, for questions.

Mr. VICE. One other thing. You asked about excessive speculation. It is defined in the Commodities Act. Section 6A, Commodities Act, defines excessive speculation.

Mr. STUPAK. Mr. Green, your questions.

Mr. GREEN. And I appreciate on how we can deal with it. I was wondering how we could deal with what, I think, our witnesses said, deal with the products in the U.S. markets. I say Texas market, because that seems like what we end up with a lot. But how can we do that if there is fuel oil for the Northeast? I think we shouldn't really care what is going on in Singapore even though it has an effect on world price. But it is not for the U.S. consumers, the U.S. market. But how can we do that? Mr. Vice, we say Amaranth moved its trades from NYMEX to ICE, and when they didn't like what NYMEX's orders were. If only certain contracts on ICE are brought under regulation, for example, U.S. contracts, what would ICE do if a trader in response to the speculative position limit in a regulatory ICE contract, would they simply move to a non-regulated? How would that work?

Mr. VICE. Well, the language being contemplated is not limited to U.S. It is up to the discretion on anything that is on our ECM including that Singapore example I gave. If said it is a significant price discovery contract, and we had to apply these DCM core principles, then we would be responsible for doing that.

I think one thing that might be helpful to understand, you fall off a pretty big cliff in our market when you move from talking about our Henry Hub look-alike swap, which is what most of this is about. It is about 70 to 75 percent of our OTC revenue, OK. And the No. 2 is a far, far distant No. 2.

Mr. GREEN. OK.

Mr. VICE. I mention that just because whereas people compare what goes on in Henry to the futures contract at NYMEX—and we acknowledge and are part of a discussion of how do we—it does need some additional future-style regulation—is important to realize that it is a big step to the next contract, and when you move to that second contract—it is not a look-alike contract. It may be even a Canadian-based contract. I don't know. You get into a whole hodge-podge of much less liquid contracts.

Mr. GREEN. Well, you satisfied one part that it has to be, because I know there are tankers that come in that may go to a refinery in Europe, or it could come to a refinery in our area of the United States. And so we would need to have oversight for that.

Ms. Campbell, you mentioned in your testimony the lack of over-the-counter or transparency, and in your response to questions, you have talked about that and the extreme price swings surrounding the collapse of Amaranth, which has caused some bona fide hedgers to become reluctant to participate in the markets in fear of locking in prices that may be artificial. Do you believe this reluctance to hedge will affect your organization or the overall economy, that if they don't have trust in those prices?

Ms. CAMPBELL. Certainly it will. You know, we entered this winter in trying to decide exactly how we were going to approach it. Fortunately the CFTC put in the special call provision, which gave us a measure of confidence in the natural gas market. So we did put on the hedges that we typically would, going into this winter.

But certainly, if you go back to the winter of 2 years ago, when there were the hurricanes, if we had not had the hedges we had in place, our customers would have been devastated. Just last year, we had $12.5 million of bad debt. I can't even imagine what it would have been the year before, had we not hedged. So it does have a direct impact on the consumer and on the overall economy.

Mr. GREEN. And should FERC have the authority to pursue the market manipulation cases which span both the futures and the physical market?

Ms. CAMPBELL. Yes, sir, I believe they should. We supported FERC's action on that. And I will say that we have a great deal of confidence in both FERC and the CFTC, and we are hopeful that they are going to work together to find some common ground there on addressing that issue.

Mr. GREEN. OK. Mr. Chairman, I have no other questions. Thank you.

Mr. STUPAK. Thank you, Mr. Green. A couple questions. We will go a second round here quickly, and we have been generous with time with everybody, because it is a little complex and technical area. Mr. LaSala, does NYMEX have what they call mini-contracts to accommodate people like Ms. Campbell if they want to do a smaller contract. Don't have something like that?

Mr. LASALA. We do have some cash-settled mini, half- or quarter-sized version contracts. That is correct. Cash settled, generally settled not on the last trading day, but they are penultimately settled.

Mr. STUPAK. Would that solve your issue of having to go to ICE?

Ms. CAMPBELL. Well, that innovation has come about just in recent times, and so I would hope that that would have come about, anyway. But I certainly think that the competition between ICE and NYMEX has been healthy. And so, yes, it would address that issue. We are glad to see the competition between them, though, to make sure that we have those tools at hand.

Mr. STUPAK. You mentioned 2 years ago, when the hurricanes hit. Remember, I mentioned the high-rise in my district that went from $5,000 to $7,000 in 1 month? That was that same period, because of the hedge funds, and that cost is directly passed on to consumers and one of the reason for the hearings today. Mr. LaSala, let me ask you this. In your testimony, you said, and I am quoting now, "there is potential for systemic financial risk from a market crisis involving significant activity occurring on an unregulated trading venue, which could arise from a mutualization of risk at the clearinghouse level, where large positions on unregulated markets are not monitored." What is your systemic failure, and could you describe a credible scenario where unregulated markets could trigger a systemic failure?

Mr. LASALA. Well, the example would be a scenario where a party has gotten excessive position in an unregulated market such as an ICE look-alike market. Granted, these positions are in fact margined by another clearing organization. But they are not regularly—they haven't been regularly monitored. And in fact, you have a scenario where there is active volatility, and no one is looking.

You know, again when you have this recent occurrence where there is a special call in place—and we appreciate that. We would like to see permanent regulation around it, but there could also be other contracts where the regulator does not see these underlying positions. And, in fact, there is a market move, and the clearing member or members—remember, gentlemen, many of the clients, these markets clear multiple houses.

So you have exposure being aggregated across multiple firms, and not every firm knows what the position is of the party necessarily at the other firms. So market event, in positions that a Federal regulator does not see all of them, could, in fact, cause a financial collapse of the client and possibly take down the carrying firm or firms themselves.

Mr. STUPAK. Mr. Vice, let me ask you with NYMEX's statement. Do you agree there is a potential for systemic financial risk from the market crisis involving significant activity occurring on the unregulated trading venue arising from the mutualization of risk at the clearing house level where large positions are not monitored?

Mr. VICE. I essentially don't agree with it. I mean, in the energy markets, between the NYMEX clearinghouse, and we use the London Clearinghouse—we don't own that clearinghouse, but they are both respected organizations with very strict risk management policies in terms of how margin is calculated and how collateral——

Mr. STUPAK. Well, London has less restrictions than CFTC or a NYMEX, right?

Mr. VICE. No, not at all.

Mr. STUPAK. Really?

Mr. VICE. No, the clearinghouses—I don't know all the rules, but the investment banks that are members of the NYMEX clearinghouse are the same investment banks that are the clearers that are members of the London Clearinghouse. And London Clearinghouse actually, I think, is the largest clearinghouse in the world. They clear the London Stock Exchange, the financial futures in London, the London Metals Exchange, and they clear our business as well.

But putting that aside for a minute, I think that the clearing concepts introduced in the OTC markets by ICE and NYMEX have made quite a service there in that so much of the business is cleared at one of our clearinghouses. The OTC business, whether you want to characterize it as unregulated or somewhat regulated, the point there is that is far more secure and far less vulnerable to systemic risk than the bilateral positions that, say, took down

Long Term Capital management or that is at work in credit default swaps in the sub-prime mess, where these products are not cleared. And these bilateral parties don't know what is on the other party's books.

So I actually would argue the energy market, probably more so than any other commodity, has less systemic risk than any other.

Mr. STUPAK. Well, that is why my pump-back legislation to prevent unfair manipulation of prices deals with bilaterals.

Mr. GREENBERGER. I would say any—Refco failed. It was the eighth largest FCM. It caused the 14th largest bankruptcy in the fall of 2005. When it failed, people were worried about systemic risk. I can assure you when Amaranth failed, even though there has been a lot of damage, you cannot say there has been systemic risk. But when Amaranth lost $6.6 billion in 4 days, I will say from my experience working with the President's Working Group that the President's Working Group was on the phone trying to figure out whether there would be a systemic break. There can be a systemic break, and an unregulated entity aggravates that, because you can't get the data you need to see how big the problem is.

Mr. STUPAK. Mr. Walden, for questions.

Mr. WALDEN. Thank you, Mr. Chairman. I just have a couple I am going to throw your way, folks. This is a question for the entire panel. Chairman Lukken, who is behind you there, of the CFTC, recently conducted a study of hedge fund speculation in the futures market, and that study concluded "speculative buying as a whole does not appear to drive up prices."

Now, we have heard a lot about speculation of the market driving up prices. Have you read that report? Are you familiar with it? What are we missing here? Mr. Vice, will you keep it kind of short, too, if possible.

Mr. VICE. I am vaguely familiar with it, so I don't know if I can comment on the report specifically. But I would say speculators speculate on prices going down as much as they speculate on them going up. In fact, most of what Amaranth was doing, I believe, was betting on the price going down as opposed to the settlement prices going up. So to say that all speculation is one way is kind of as false as saying that a market can operate with only hedgers and no speculation.

Mr. WALDEN. All right, Mr. LaSala, can you comment on Mr. Lukken's findings?

Mr. LASALA. Yes, sir. We conducted a similar analysis as the Commission, and just broadly speaking, what it showed is the hedge funds tended to chase volatility, not necessarily create it. In our analysis, I think that most of the arithmetic behind that was similar to the Commission's.

Mr. WALDEN. OK, now I am going to probably get to you all later on that point, but I want to go back to Mr. LaSala. In your testimony, you point out that NYMEX has experienced a 40 percent reduction in trading volume of natural gas futures on the last day of each month because, I think you said, traders wanted to avoid complying with your February 16, 2007, rule change requiring open books.

Now, the chart I put up earlier today showed that overall, year-to-date, the volumes were staying about the same. Given that you think there is this pick-up that occurs the last day of the month, or last 30 minutes of trading, or whatever, is the volatility that is evidenced there the right index to be setting the next month's price for natural gas in the market?

Mr. LASALA. Well, I think that the marketplace has found that to absolutely be the case. The market has come to rely on the NYMEX settlement price. We have seen, as you stated in reference to my testimony earlier, there has been an exodus of trading in the last 30 minutes. I don't know. I mean, there is less volume now setting the price.

The volatility on that last day, you have the data, has come in. There are other factors that might have affected. Storage is up slightly. I am not sure what caused it, and I am not sure—meaning that did the change in the policy create a lower volatility, or is it a byproduct? It is a chicken and egg. I am not sure what the cold of winter is going to do on those 30-minute closes yet. We haven't seen them.

Mr. WALDEN. I get back to some of the oversight hearing we did in this committee on Enron and the volatility of the electric market, electricity market on the West Coast, where we saw prices spike $1,000 or so. I mean, I would hate to have thought that last bid, that last set of bids, was going to set the price for the market for the next month, because it was totally out of whack with the bulk of the market.

So help me understand that last 30 minutes that is setting the, if I am correct, setting the price for the next month. How much volume is there versus overall volume of gas sold? Does that last 30 minutes represent the bulk of sales contracts, or tell me how that part works.

Mr. LASALA. Just as a note, the 30-minute closing range, to my knowledge, for purposes of rendering the final day settlement, like some of our other energy contracts, is the longest in the industry. There are other contracts that use the median of the last bid or offer or the last bid or offer. The volume in the 30-minute closing range is certainly less than you would typically see over the course of the whole day on the last day. And obviously we trade back months significantly more volume.

I am not sure if I am completely following your question. Forgive me.

Mr. WALDEN. Right, and you got to bear with me because I don't do what you do in the industry. What I am trying to figure out is, is that an accurate snapshot of the real price in the market?

Mr. LASALA. We believe it is. I think the industry——

Mr. WALDEN. Ms. Campbell, do you agree with that? Mr. Cota?

Ms. CAMPBELL. Absent any manipulation, yes. And I am sitting here thinking, if not NYMEX, what would we use? And really, the other things that we have at our——

Mr. WALDEN. I am not arguing whether or not it is NYMEX. I am arguing whether or not that last 30 minutes is the right look, and I realize—well, I am beginning to fully understand how complex this market situation is and need for proper regulation. But is that the right look?

Ms. CAMPBELL. Well, it is certainly disconcerting to hear that there are lower volumes in the last 30 minutes, but I would say that so far we have not had an issue, other than what we have seen in arrears from the actions that Amaranth was taking in the last 30 minutes to try to manipulate the price.

Mr. COTA. What makes a difference about NYMEX is that when you are in the physical market, you actually have to deliver it. In the whole futures game and the physical market is a big game of chicken, and whoever can hold out the last has the best advantage. Amaranth, through its forced reduction in hedges, had to get out of its trades early, so it was a blood bath.

What happens in the heating oil market, which is the one I am most familiar with, is that the people that are playing out those financial contracts in order to maintain the value as high as possible, the money center banks, they will take physical delivery of those markets. So they will take that product, put it into storage, deliver it to the wholesale market or to other contracts that they need to deliver because they can play the game all the way out.

And that is good from a supply standpoint. From a pricing standpoint, it all depends on the market. It is how bad is the direction going at that particular time, and that is where the large trader positions really make the biggest difference in my opinion.

Mr. WALDEN. All right. Mr. LaSala.

Mr. LASALA. Just a point of clarity for the record. Number one, all the prices that you are having in that 30-minute closing range are all transparent. They are disseminated. The other point being just by way of history, NYMEX doesn't determine—I said before, we think it is accurate—the marketplaces determine that. It is not necessarily my position or NYMEX's. I am just going back 10 years. I recall when the contract was first launched, the industry relied upon the average of the last 3 days. It migrated to the last 2 days. It migrated to the last day. Nowhere in there did NYMEX take a position and say——

Mr. WALDEN. I wasn't alleging that at all.

Mr. LASALA. I know. I just want to be clear.

Mr. WALDEN. But as that window narrows, are you going to be down to the last 30 seconds here?

Mr. COTA. Well, that has to do more with the physical delivery rather than with the financial transaction. In my segment of the business, we get re-priced all the time. I have price changes three times a day, and if you are in the wholesale segment of our market, what you will do is, you will actually open trades and close trades. Whatever you think your volume of storage is, you buy and sell that every day. And the only thing you don't sell is what you think you are going to sell that day.

So from a pricing standpoint, it is always priced in a relationship to other futures contracts in the next traded month for the spot month. So you are not locked into that price in the last 30 minutes. You are locked into that supply. So if you are relying on that supply for the next month, it is very important. But from a pricing standpoint, there are a lot of other ways to price the product.

Mr. WALDEN. OK. All right. Thank you, Mr. Chairman. Thank you for your testimony.

Mr. STUPAK. Mr. Green, for questions. Second round.

Mr. GREEN. No further questions for the panel.

Mr. STUPAK. Let me welcome Mr. Shimkus, who is going to be the new Ranking Member of O&I. Would you like to ask a few questions on this? I know you are up to speed on it.

Mr. SHIMKUS. Yes, that is right. I can talk about mercury, but, no, I just look forward to working with you, Bart, and I look forward to working with those you call before this Committee. And we want good government to operate, and we have a great relationship. And I think we can do good things. Yield back. Look forward to it.

Mr. STUPAK. Mr. Barrow is not a member of the subcommittee, but he has been here all day, and he is part of the Energy and Commerce Committee. If you would like to ask some questions, now would be the appropriate time.

Mr. BARROW. No question, Mr. Chairman. I want to thank you for your consideration in allowing me to audit these proceedings, and I thank the witnesses for their patience. I have been running back and forth between here and markups in other committees. Thank you, sir.

Mr. STUPAK. Thank you. Mr. Burgess, if you have questions, please.

Mr. BURGESS. Let me just, if I could, get a point of clarification from Mr. Vice. Does the market need speculators, or do speculators bring anything of value to the marketplace?

Mr. VICE. Absolutely. I mean, the marketplace is all about people that have risk and want to get rid of it, giving it to people that are willing to take that risk on for a price. That is how a market functions.

Mr. BURGESS. So speculation in and of itself is not an evil practice?

Mr. VICE. It is critical that it be part of the market, yes.

Mr. BURGESS. Does speculation bring any measure of liquidity into the market?

Mr. VICE. Absolutely. It is essential.

Mr. BURGESS. So it would be more difficult for the market to function without some degree of speculation. Is that correct?

Mr. VICE. That is correct.

Mr. BURGESS. So it is more collusion between speculators than it is the act of speculation itself that may cause a difficulty?

Mr. VICE. I wouldn't use the word collusion, but it may be periods of time for whatever reason that there is a majority of opinion, speculative opinion, that prices are going up long term or that prices are going down. And I am not smart enough to say that is where energy is right now, but it is one possible explanation.

Mr. BURGESS. Well, is it possible that the transparency brought by the entirely electronic platform would raise those red flags more quickly than the floor activity or the voice systems?

Mr. VICE. There is no question the electronic—it is fair in the sense that everyone gets the same information at the same time as opposed to paying for the rights to be on the floor and getting the information early. So that, whether you are Memphis Gas or you are Goldman Sachs or anybody else, you are getting the same quality of information, the same depth, at the same time, and the ability to act on it. And if you are the first one that hits that bid, you get the trade.

Mr. BURGESS. So the speed of information transfer is actually in some ways transforming your business. Is that correct?

Mr. VICE. That is correct.

Mr. BURGESS. And again I would just offer the observation that we need to be careful that we don't construct regulations that in fact damage that transformation. In Congress, we are inherently transactional. In my brief experience, sometimes the transactional can become the enemy of the transformational, and again I hope, Mr. Chairman, that we are careful about that.

Let me just take what little time I have left, and I know we have had the report, the Excessive Speculation Staff Report from June of 2007 placed into the record. I just want to read the paragraph from the minority report because it is way at the end of the report, and people may not get to that part. It reads, and I am quoting, "while we join with the majority in making these recommendations, we are unable to reach some of the same factual findings with the same degree of certitude.

For instance, although a number of facts presented in the report support the conclusion that Amaranth's trading activity was the primary cause of the large differences between winter and summer futures prices that prevailed throughout 2006, other facts seem to indicate the opposite, that the market fundamentals and price changes influenced Amaranth's positions.

These facts suggest that, at least at times, Amaranth was responding to the market rather than driving it. For example, although the price of natural gas declined substantially after Amaranth's demise, this alone does not prove that Amaranth's ability to elevate prices above supply-and-demand fundamentals, rather that the market may have simply reevaluated those fundamentals in light of the hurricane season ending without a major event and the prediction of a warm winter.

It is clear that different conclusions can be drawn from the same set of facts."

Thank you, Mr. Chairman. I will yield back the balance of my time.

Mr. STUPAK. Thank you. Let me ask one question, Mr. LaSala. Regarding NYMEX's self-regulatory efforts, are they being hamstrung when evaluating questionable activity or assessing whether trades have a bona fide for exceeding accountability limits or position limits by ICE, by trades on ICE? Are you being hamstrung by their activities?

Mr. LASALA. By ICE's activities?

Mr. STUPAK. Yes.

Mr. LASALA. The only way to respond to that is that I can't firsthand see their activity.

Mr. STUPAK. Correct.

Mr. LASALA. Can't see their activity, and I certainly can conduct business. But one of the issues is by not having a Federal regulator who also looks at it, I mean, I can be misrepresented to by someone. For example, Amaranth. In the Commission's case against Amaranth, there is a clear assertion that they misrepresented to NYMEX certain things. Some of it, what their exposure was. So, I am taking this back. I don't know if——

Mr. STUPAK. Well, you are the chief regulator and officer. You have to look at things that are going on at NYMEX.

Mr. LASALA. That is right.

Mr. STUPAK. Some things that may be questionable. You are trying to evaluate it. So I guess, what I am trying to say, when you are trying to assess whether traders have a bona fide reason for exceeding accountability limits or their positions limits and if they can go to ICE, does that hamstring you? Does that hurt your ability to regulate your own market, your own exchange?

Mr. LASALA. When they can go to an unregulated venue?

Mr. STUPAK. Yes.

Mr. LASALA. Absolutely, albeit I do believe that those positions on that exchange, which I think should be regulated further, are positions that have exposure, meaning that I would prospectively give them regard in evaluating some type of a position exemption or accountability level. I would regard them because I think that they are positions that are relevant.

Mr. STUPAK. And that was your position rule in, what, February 26, 2007, hearing in which you need that position rule to better evaluate what was happening?

Mr. LASALA. That was the genesis of what that process was about.

Mr. STUPAK. OK, thank you. Further anyone?

Mr. GREENBERGER. Mr. Stupak?

Mr. STUPAK. Yes.

Mr. GREENBERGER. If I could just add two quick points.

Mr. STUPAK. Sure, Professor.

Mr. GREENBERGER. First of all, I think what Mr. LaSala said should not be lost. It is not so much NYMEX not having that information as the CFTC not having that information. The CFTC has worked out an information sharing agreement, but an information sharing agreement alone is not going to solve the problem. With regard to the CFTC report that Mr. Walden referred to, I believe that was written before Amaranth collapsed and was only based—Mr. Lukken can correct me if I am wrong—was only based on looking at NYMEX, not looking at ICE where the speculation was excessive.

Everybody today agrees the Enron loophole has to be ended. I think we are way over at the point of saying that there is not excessive speculation. And with regard to speculation, yes, there must be speculation. You can't have future markets without speculation, and they should be electronic. That is great, but the Act prevents excessive speculation.

Now, true, that is a fine line, but when NYMEX told Amaranth to reduce its positions, it was saying, you are excessively speculating, and you may bring us down, stop. And they went over to ICE.

So CFTC, if it regulates, causes ICE to put position limits in place that tell them to stop the excessive speculation. Again, farmers learned this at the turn of the century. They need speculation to hedge, but excessive speculation will kill them.

And finally, with regard to the 2007 report and the minority opinion, the 2006 report had no minority opinion in it. And that was where the conclusion was reached that at least $20 is being added speculative to the price of crude oil.

And both reports should be read, because the first one deals with crude oil. The second one deals with natural gas.

Mr. BURGESS. Mr. Chairman, I would just add in the final paragraph of the minority views, the recommendation is for a definition of what is excessive speculation, and they say without a clear unequivocal definition of that term, the CFTC and regulated exchanges will continue to have difficulty monitoring and preventing price distortions. If we extend CFTC oversight and regulation to the electronic, over-the-counter exchanges, we must avoid unintended consequences, namely creating incentives for traders to shift their business to the far less transparent and unregulated bilateral voice brokered markets. I will yield back.

Mr. STUPAK. With that last sentence, that means you are a cosponsor of my legislation in bilateral trades. Let me thank this panel. It was a very good panel. We enjoyed having you here, and, as you saw, for the given goal for members and overtime, people were very interested in what you had to say. And thank you for helping us in this complex, technical world.

Thank you. I will dismiss this panel. We will call forward our second panel. Our second panel will be the Honorable Joseph Kelliher, Chairman of the Federal Energy Regulatory Commission, and the Honorable Walter Lukken, Acting Chairman of the Commodity Futures Trading Commission. I should also note in the audience is the Honorable Michael Dunne, Commissioner at the Commodity Futures Trading Commission. Commissioner Dunne, thanks for being here.

Now, gentlemen, it is the policy of this subcommittee to take all testimony under oath. Please be advised that witnesses have the right under the rules of the House to be advised by counsel during their testimony. Do any of you wish to be represented by counsel? Both indicated they do not. Let the record reflect the two gentlemen have taken the oath and replied in the affirmative, and you are now under oath. We will begin with your opening statement. Mr. Kelliher, if would you begin, please, sir.

STATEMENT OF JOSEPH T. KELLIHER, CHAIRMAN, FEDERAL ENERGY REGULATORY COMMISSION

Mr. KELLIHER. Thank you, Mr. Chairman. Mr. Chairman, members of the subcommittee, thank you for the opportunity to speak with you today about the Federal Energy Regulatory Commission's role in protecting energy consumers against price manipulation in wholesale energy markets. It is good to be back at the committee.

My comments today will focus primarily on the steps FERC has taken to ensure the integrity of wholesale gas markets and prevent market manipulation under the new authorities granted to it by Congress in the Energy Policy Act of 2005. I thank the committee for supporting FERC's request for this additional authority 2 years ago and credit the committee for recognizing that FERC needed new regulatory tools to discharge its historic duty to guard the consumer.

And particularly the Energy Policy Act amended our statutes in several significant ways to protect against market manipulation.

First, it granted us expressed authority to prevent market manipulation. It also gave us authority to issue rules to assure greater price transparency and wholesale gas markets as well as jurisdictional power markets. It also gave the committee enhanced civil penalty authority.

At this time, I do not believe that FERC needs any additional legal authority to protect consumers from market manipulation. You gave us the tools we needed 2 years ago, and we are using them. However, it is important that those tools not be taken away from us or diminished.

The Energy Policy Act granted FERC express authority to prevent market manipulation. This provides a strong grounding for our efforts to oversee wholesale energy markets. Under our final anti-manipulation rules, it is unlawful for any entity, directly or indirectly, in connection with the purchase or sale of electric energy or transmission services subject to FERC jurisdiction or the purchase or sale of natural gas or transportation service subject to FERC jurisdiction to engage in duplicative or manipulative practices.

In two recent cases, FERC issued orders to show cause and notices of proposed penalties in the course of market manipulation investigations. Under these orders, FERC made preliminary findings that two groups of companies and individual traders, collectively Amaranth and Energy Transfer Partners, may have manipulated energy markets. These orders do not represent final determinations and make no final conclusions. Both groups of respondents have been given the opportunity to rebut the preliminary conclusions set forth in the orders. However, if the final conclusions reflect the preliminary findings, we propose to impose penalties that approach the maximum for certain violations, $291 million for the Amaranth entities and $167 million for the Energy Transfer Partners entities for total civil penalties of $458 million.

Before I discuss the Amaranth and Energy Transfer Partners investigation, it is important to recognize that natural gas is traded in a wide variety of products. That was made clear in the discussion on the earlier panel. Some of these products are physical products, potentially subject to FERC jurisdiction. Other products are futures or financial products subject to CFTC jurisdiction.

However, month indexes used to price physical gas sales are constructed using transactions with prices set in part by futures prices. This is particularly true in the Eastern United States and the Gulf Coast, as shown by the map that is attached to my testimony. As a result, futures prices determine, in part, the price of physical natural gas purchased by customers and the effects on physical markets of changes in futures prices are direct and significant.

Based on the evidence developed in the investigation, we made a preliminary finding that Amaranth may have deliberately obtained and then sold large futures positions in the last half hour of trading on the settlement date and number of months in order to manipulate prices downward. Thus, Amaranth may have benefited from even larger opposing positions that they held on ICE, and they did this full well knowing that their actions would affect physical prices as well.

The Energy Transfer Partners investigation looked at a different scenario where we believe, based on preliminary conclusions, that Energy Transfer Partners may have manipulated physical prices, physical transactions, in order to benefit opposing positions they held in other physical products as well as CFTC jurisdictional financial products.

Now, in both the Amaranth and the Energy Transfer Partners cases, FERC began an investigation. We shared our information fully with the CFTC, and the CFTC began its own investigations of both matters soon thereafter. The two agencies cooperated closely throughout these investigations. I think that is a credit to the memorandum of understanding that the two agencies entered into in October 2005, as directed by Congress.

I think the MOU has worked very successfully over the past two years. Now, the MOU has worked very well and particularly during these investigations, during the 14 months of the Amaranth investigation as well as the 21 months of the Energy Transfer Partners investigations, and it continues to operate successfully. The two agencies conducted parallel investigations that were very closely coordinated.

Now, this cooperation was significant. Market manipulation can cross jurisdictional lines. It can cross product lines, as shown by both the Amaranth and the Energy Transfer Partners investigations. In a sense, one of these investigations examined manipulation that may have occurred within CFTC jurisdiction but affected FERC jurisdictional sales. The other involved manipulation that may have occurred within FERC jurisdictional markets that affected other CFTC jurisdictional transactions.

Both investigations involved possible manipulation that may have crossed the jurisdictional lines between the two agencies, and cooperation between FERC and CFTC is essential in order to police this kind of manipulation.

Now the enforcement actions, as I indicated, were coordinated, very closely coordinated as were the investigations themselves, and both agencies publicly praised the investigations conducted by the other agencies when we took coordinated enforcement action in July.

Now, since then Amaranth has raised arguments about whether FERC has jurisdiction over manipulation of the monthly futures price. Even before we issued our order to show cause in July, Amaranth's lead trader, Brian Hunter, filed in the U.S. District Court for the District of Columbia, seeking to enjoin issuance of our Order, claiming that FERC lacked jurisdiction. Judge Richard Leon denied their request for a temporary restraining order, and just on Monday of this week, he also denied the injunction.

Now, within weeks of the order to show cause, Amaranth also filed a motion to stay FERC's action and civil action filed by the CFTC against Amaranth in the U.S. District Court for the Southern District of New York. Amaranth argued, among other things, that we lacked jurisdiction, and CFTC has sole jurisdiction over the conduct prescribed in our order to show cause. Although CFTC opposed Amaranth's motion to stay our order, CFTC maintained that it had exclusive jurisdiction over all trading and natural gas futures.

This position would have the effect of preempting FERC's ongoing enforcement proceeding against Amaranth, and I consider this to have been a significant change in the CFTC position.

Now, at this point, the two agencies, we have a difference of opinion about the proper interpretation of the anti-manipulation provisions of the Energy Policy Act and how those provisions should be interpreted in concert with the Commodity Exchange Act, and this agreement will likely be resolved by the Courts. And I think that is appropriate.

But I just want to emphasize that there is a great deal at stake in this legal dispute. The key issue, the central issue, is the reach of FERC's anti-manipulation authority, the extent of our ability to protect consumers. If the attack on our jurisdiction is successful, our ability to guard the consumers from exploitation would be significantly reduced.

FERC and CFTC are different agencies with different duties. We are a consumer protection agency. The CFTC has a different mission. We have greater penalty authority than the CFTC and are more likely to order disclosure of profits in a market manipulation case, which holds out the promise to consumers that they might be made whole.

It is also much harder for the CFTC to prove manipulation that FERC since they operate under a high statutory standard. And I think consumers see a difference between the agencies. I think that is why the National Association of State Utility Regulators and a host of individual state commissions have declared support for FERC's position. They have even gone so far as to enter the litigation, filing briefs in the New York District Court supporting FERC.

But perhaps the best judge is the consumers themselves. Various consumers groups have filed briefs in support of FERC position, including one of the organizations represented on the first panel, American Public Gas Association.

Now, at FERC, we recognize that CFTC has exclusive jurisdiction to regulate aspects of future trading. FERC respects the CFTC's exclusive jurisdiction in these areas, and we do not seek to regulate futures or regulate NYMEX. And I do not believe that our enforcement actions that we proposed against Amaranth constitute regulation.

Now, FERC stands by our position that Amaranth's activities fall within our jurisdiction insofar as they affect physical sales of natural gas. We believe that the anti-manipulation and the anti-manipulation provisions in the Energy Policy Act 2005 give FERC broad authority to sanction manipulative conduct when it significantly affects jurisdictional sales.

Comments in floor debate on the Energy Policy Act clearly indicate Congress's intent that FERC implement the broadest possible prescriptions necessary to protect energy consumers.

I believe that the words in the statute mean something, both the words that Congress chooses and the words it does not choose. Here, the choices are significant. The FERC anti-manipulation authority applies to "any entity" rather than "a natural gas company", a defined term set in Law 7 years ago, meaning a company that engages in jurisdictional sales. We are authorized by the statute the sanction manipulation that directly or indirectly affects jurisdictional sales. And we can sanction fraud and deceit in connection with jurisdictional sales.

In addition, it is noteworthy that Congress included no saving clause in the anti-manipulation provision of the Energy Policy Act related to CFTC authority. I would be happy to discuss statutory interpretation at greater length if that is the will of the subcommittee.

Now, the question has been posed whether FERC should have exercised its anti-manipulation authority. I think one of the lessons of the California Western power crisis is that manipulation can hurt gas and power consumers. That is why you gave us the anti-manipulation authority 2 years ago. You gave us the tools, and we have been using them.

I think FERC has a duty to guard the consumer from exploitation, and exercise of our anti-manipulation authority is necessary to discharge that duty. And I respectfully suggest that if FERC had declined to use this anti-manipulation authority, the subcommittee should have held a hearing today to ask us why not.

Now, I regret that this disagreement between FERC and CFTC has arisen in recent months, but I want to make it clear that this disagreement over jurisdiction has not impeded cooperation between the two agencies. We have a respectful disagreement over interpretation of the anti-manipulation provisions of the Energy Policy Act, a disagreement that, in my view, is best resolved by the Courts.

But I also want to make it clear that I do not question CFTC's commitment to prevent market manipulation. They are as committed to preventing market manipulation as FERC. They have demonstrated that by continuing to cooperate with FERC on matters of mutual interest, notwithstanding their legal opinion on the scope of our jurisdiction.

So I just want to reassure the subcommittee that this disagreement has not impeded cooperation between the two agencies on ongoing investigations in areas of mutual interest. The MOU continues in place, and we continue to coordinate our information gathering, and we continue to coordinate our investigations.

Staff members from the two agencies continue to meet periodically to discuss more general ides of common interest, and the two agencies are discussing other ideas on how to improve cooperation investigations going forward.

Now, in conclusion, the Energy Policy Act gave FERC the tools that we need to oversee physical natural gas and electric power markets. Over the last 2 years, we have moved both carefully and quickly to implement the relevant provisions of the Energy Policy Act, especially the anti-manipulation civil penalty and the transparency authorities.

Our experience so far is that the new authorities gave us the tools we needed to penalize and deter price manipulation, and our track record shows how effective those authorities can be. But I do not anticipate that we would need further authorities. However, I do note that there is legislation being considered earlier today that would amend the Commodity Exchange Act. I think it is important, though, to make sure that FERC authority to look into ICE markets is not diminished by changes to the Commodity Exchange Act. And I ask the committee for your assistance in that.

However, a legal question has arisen. Yes, sir.

Mr. STUPAK. I am going to need you to wrap up.

Mr. KELLIHER. Yes, sir.

Mr. STUPAK. We are 7 minutes over, and we got votes now. I want to get Mr. Lukken in yet before we go.

Mr. KELLIHER. Can I have 10 seconds?

Mr. STUPAK. Yes, quickly.

Mr. KELLIHER. A legal question has arisen regarding one of our most important new authorities. We think it is important to clarify the extent of FERC authority in this area. We think there is a great deal at stake, and we think the Court is the right place to settle it. Thank you.

[The prepared statement of Mr. Kelliher follows:]

Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?

Testimony of the Honorable Joseph T. Kelliher, Chairman
Federal Energy Regulatory Commission
December 12, 2007

This testimony focuses on natural gas rate regulation and the steps FERC has taken to ensure the integrity of wholesale gas markets and prevention of market manipulation under the new authorities granted to it under the Energy Policy Act of 2005 (Energy Policy Act).

The Western energy crisis of 2000-2001 showed that energy consumers were exposed to the threat of market manipulation. The Energy Policy Act granted FERC express authority to prohibit market manipulation. Within six months after Congress enacted the anti-manipulation provisions of the Energy Policy Act, FERC had fully implemented this new authority. In January 2006, FERC issued Order No. 670, a final rule implementing regulations to prevent market manipulation in wholesale power and gas markets and in transmission and transportation services. As directed by the Energy Policy Act, the CFTC and FERC entered into an MOU to ensure that we share information quickly and effectively.

In July 2007, FERC issued two Orders to Show Cause and Notices of Proposed Penalties, where FERC made preliminary findings that two groups of companies and individual traders (collectively, Amaranth and Energy Trading Partners) may have manipulated energy markets. The FERC and the CFTC cooperated closely throughout the investigations that led to these orders. The MOU worked well throughout the investigations and continues to do so.

Amaranth has raised arguments about whether FERC has jurisdiction over manipulation of the monthly futures price. FERC does not believe Amaranth engaged in any FERC jurisdictional sales, but manipulated monthly futures prices in order to profitably increase the difference between futures and financial products. Physical next-month indices that can be jurisdictional to FERC, some of which are set using futures prices, were directly affected by Amaranth's actions as described in its order.

Legislative proposals intended to close the "Enron loophole" and give the CFTC jurisdiction over ICE and other electronic trading venues could affect FERC's ability to oversee natural gas and electric power markets. Many of the same venues trade physical as well as financial contracts, and any limitation on FERC's access to that information could reduce its ability to oversee jurisdictional markets.

The Energy Policy Act gave the FERC tools needed to oversee physical natural gas and electric power markets. However, if the courts were to resolve the legal question of the extent of FERC's authority to prevent market manipulation in favor of Amaranth, FERC's ability would be significantly impaired.

Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?

Testimony of the Honorable Joseph T. Kelliher
Chairman
Federal Energy Regulatory Commission
Before the
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives

December 12, 2007

Introduction and Summary

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to speak with you today about the Federal Energy Regulatory Commission's (FERC or Commission) role in protecting energy consumers against price manipulation in wholesale energy markets. Because of the critical role that energy plays in our economy and in the welfare of our nation's citizens, it is imperative that regulators have the necessary tools to protect energy consumers. I welcome the Subcommittee's review of these important issues.

FERC is an independent agency charged with regulating wholesale sales and transportation or transmission of natural gas and electric power, rates for oil pipelines, approval for new interstate energy facilities and licensing and safety for non-federal hydroelectric projects.

However, at heart FERC is a consumer protection agency. Our primary task since the 1930s is to guard the consumer from exploitation. Historically, we have done that by ensuring that jurisdictional wholesale rates for natural gas and electric energy are just, reasonable and not unduly discriminatory or preferential. We are charged under the Natural Gas Act and the Federal Power Act with regulating certain wholesale sales of natural gas and electric energy in interstate commerce, as well as transportation of natural gas and transmission of electric energy in interstate commerce.

Today my comments will focus primarily on our natural gas rate regulation and the steps FERC has taken to ensure the integrity of wholesale gas markets and prevention of market manipulation under the new authorities granted to it under the Energy Policy Act of 2005. However, I note that our authorities to protect customers against market manipulation generally are parallel under both the Natural Gas Act and Federal Power

Act. Manipulation in gas markets can also affect the price of electricity for consumers since natural gas is a key input to the cost of many electric power facilities.

FERC has adapted its regulations over the years to rely on a mixture of competition and regulation where possible to produce just and reasonable prices for wholesale energy customers, but to apply cost-based regulation where competition does not exist or where market power can be exercised. The Energy Policy Act gave FERC important new regulatory authorities to enhance its ability to protect natural gas and electric energy customers. I thank the Committee for supporting FERC's request for this additional regulatory authority two years ago and credit the Committee for recognizing that FERC needed new regulatory tools to discharge its historical duty to guard the consumer.

In particular, the Energy Policy Act amended our statutes in several significant ways to protect against market manipulation.

First, it amended both the Natural Gas Act and Federal Power Act to explicitly prohibit entities from engaging in deceptive or manipulative conduct in connection with FERC-regulated energy markets and authorized us to implement rules to enforce this prohibition. Second, it directed us to facilitate price transparency in jurisdictional markets and gave us authority to require any market participant to disseminate information about the price and availability of natural gas and electric energy and the transportation and transmission of those products. Third, it gave FERC enhanced civil penalty authority under both the Natural Gas Act and Federal Power Act. These tools provide FERC the foundation for a strong enforcement program to protect energy consumers.

We acted quickly to exercise the new regulatory powers Congress gave us to guard the consumer. In the wake of the Energy Policy Act, I established the Office of Enforcement at FERC. That office is charged with monitoring energy markets and with conducting investigations of possible violations of FERC rules, including our anti-manipulation rule. Significantly, the staff of the Office of Enforcement meet every day to discuss market developments over the prior 24 hours. In particular, they discuss price movements, and have the ability to initiate investigations in the event they identify price movements that do not appear consistent with market fundamentals. My testimony discusses the FERC market oversight and enforcement program in more detail.

As we monitor energy markets and protect against market manipulation, it is important to understand that price formation in sophisticated energy markets has become increasingly complex. Regulators must understand and consider the interplay between financial and futures energy markets, on the one hand, and physical energy markets, on the other hand. While FERC has jurisdiction over physical wholesale gas sales, and the Commodity Futures Trading Commission (CFTC) has jurisdiction over futures, the link between futures and physical markets cannot be overstated. In a sense, these markets have effectively converged. Manipulation does not recognize jurisdictional boundaries and we must be vigilant in monitoring the interplay of these markets if we are to adequately protect consumers.

When Congress passed the Energy Policy Act, it recognized the convergence of physical and futures energy markets and the need for FERC and CFTC to cooperate in their market oversight and regulation. The Act required the two agencies to enter into a memorandum of understanding (MOU) to share market information. I note that the two agencies accelerated their development of the MOU in the wake of Hurricanes Katrina and Rita, in order to improve coordination during a period of great volatility in natural gas prices. This is one of the Energy Policy Act deadlines that FERC exceeded. The MOU has worked extremely well with respect to information sharing and coordination of investigations and I want to reassure the Subcommittee that the recent disagreement between the two agencies with respect to the scope of FERC's anti-manipulation authority has in no way undermined the cooperation and effective interaction of the staffs of the two agencies. The two agencies continue to share market information and coordinate on a number of important investigations.

At this time I do not believe FERC needs any additional legal authority to protect consumers from market manipulation. You gave us the tools we needed two years ago. However, it is important that those tools not be taken away from us or diminished.

Energy Policy Act of 2005

FERC's core mission has remained the same for 70 years: to protect natural gas and electric power consumers from exploitation. But energy markets changed significantly since the 1930s. FERC reacted to those developments by changing its approach to regulation over time. Ultimately, it became apparent that we needed new regulatory tools to discharge our historical duty to guard the consumer from exploitation and we sought additional regulatory authority from Congress.

The experience of the Western energy crisis of 2000-2001 showed that energy consumers were exposed to the threat of market manipulation. Yet, market manipulation was not explicitly barred by either the Natural Gas Act or the Federal Power Act. FERC also lacked adequate civil penalty authority to assure compliance with both tariffs and market rules governing wholesale natural gas and power markets. I personally argued in favor of additional authority in these and other areas because I believed we could not otherwise adequately discharge our duty to protect consumers.[1]

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[1] Hon. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26:1 Energy L.J. 1 (2005); 108 CONG. REC. S13,999 (daily ed. Nov. 5, 2003) (statement of Sen. Cantwell introducing letter from

The Energy Policy Act granted FERC express authority to prohibit market manipulation. It also prescribed an underlying definition for market manipulation based on the long-standing precedent of the Securities Exchange Act of 1934. This provides a strong grounding for our efforts to oversee wholesale energy markets. We exercised this authority quickly, issuing proposed anti-manipulation rules two months after enactment of the Energy Policy Act, and making a final rule effective on January 26, 2006, making the rule effective immediately on an emergency basis. Within six months after you enacted the anti-manipulation provisions of the Energy Policy Act, we had fully implemented this new authority.

The Energy Policy Act also gave FERC greater authority to assure the transparency of wholesale energy markets. The transparency provisions gave us the authority to increase the amount of market information available to market participants and observers. We have exercised this authority as well. In proposed rules issued earlier this year, FERC proposed two changes that would increase the transparency of wholesale natural gas markets. The first change would require intrastate pipelines to post more information about physical flows on their systems, which would allow the market better to assess supply and demand trends. The second change would require annual reporting by wholesale natural gas buyers and sellers that would let us determine the overall level of index-based trading and activity in markets that set price indices. This second change would better allow FERC, market participants and others to assess the size of physical wholesale natural gas markets.

Before the Energy Policy Act, FERC did not have all the tools it needed to be a strong enforcement agency. The penalties we could apply to violations were largely limited to disgorgement of profits. The Energy Policy Act increased our civil penalty authority to $1 million per day per violation and greatly expanded the scope of violations subject to FERC civil penalties.

There were other important provisions of the Energy Policy Act that granted FERC significant regulatory authority. For example, Congress expanded our merger authority, which improves our ability to prevent the accumulation of market power. I will not discuss these provisions, since they do not directly relate to the subject of the

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FERC nominee Kelliher and pointing out his agreement that "markets subject to manipulation cannot operate properly and there is an urgent need to proscribe manipulation of [energy] markets"); *Market Manipulation Penalties*, Dow Jones, Feb. 17, 2003 (describing FERC nominee Kelliher's concern about need for anti-manipulation legislation and expanded FERC penalty authority).

hearing today. However, the Energy Policy Act clearly reflected a judgment by Congress that natural gas and electric power markets had changed significantly since the 1930s, and FERC needed additional regulatory authority to discharge its historical duty to guard the consumer. In my view, the Energy Policy Act represents the largest single grant of regulatory authority to FERC since the New Deal. You gave us the tools we needed.

Implementing the Energy Policy Act: Anti-Manipulation

The Energy Policy Act certainly provided FERC with needed new authorities. It also gave us a substantial to-do list with ambitious deadlines. I am proud that the Commission implemented all the provisions of the Energy Policy Act within those deadlines. We met every deadline you set for us – and even beat a few. We also were careful in the manner we implemented the new authorities granted by Congress two years ago.

In January 2006, we issued Order No. 670, a final rule implementing regulations to prevent market manipulation in wholesale power and gas markets and in transmission and transportation services. In my view, this provision of the Energy Policy Act was among the most important and challenging to implement.

We were careful in our approach. The anti-manipulation provision of the Energy Policy Act directed FERC to adopt the statutory model in section 10(b) of the Securities Exchange Act of 1934, rather than the anti-manipulation provision administered by the CFTC. We studied the securities model and adapted it where necessary to our legal construct. We also studied the anti-manipulation provisions in commodities law, which in turn is also modeled on the Securities Exchange Act of 1934. In the end, we modeled our rule closely on Securities Exchange Commission rules implementing section 10(b). We believe this approach makes germane the substantial body of precedent with respect to the 1934 Act.

The anti-manipulation regulations promulgated in Order No. 670 closely follow the language of the Energy Policy Act. Under our final rules, it is unlawful for any entity, directly or indirectly, in connection with the purchase or sale of electric energy or transmission services subject to FERC jurisdiction, or the purchase or sale of natural gas or transportation service subject to FERC jurisdiction, to (1) use or employ any device, scheme, or artifice to defraud, (2) make material false statements of fact or omit material facts, or (3) engage in any act, practice or course of business that operates or would operate as a fraud or deceit on any person.

That provides FERC structure to identify market manipulation and also gives market participants the information they need to discipline their own behavior. Importantly, consistent with the Energy Policy Act, these rules apply not only to public utilities and natural gas companies, but also to any entity that commits a fraud affecting jurisdictional transactions. "Public utility" and "natural gas company" are defined terms in federal electricity and natural gas law since the 1930s, meaning companies that engage in jurisdictional sales or provide jurisdictional transmission or transportation service. Yet Congress provided that our anti-manipulation authority apply not just to companies that engage in jurisdictional sales or provide jurisdictional service, but to "any entity" that engages in manipulation "in connection with" such sales or services. We have interpreted "any entity" to be a much broader category than "public utility" and "natural gas company," an interpretation which we believe to be consistent with Congressional intent.

Implementing the Energy Policy Act: Enforcement

The Energy Policy Act permanently changed FERC – turning us into an enforcement agency with significant civil penalty authority. We have used the new authority carefully and have developed a strong track record of enforcement over the past two years.

In October 2005, we issued a Policy Statement on Enforcement, establishing a general approach of "firm but fair" enforcement. To assure fairness, the Policy Statement provided that we would consider mitigating factors in determining penalties in any particular case, including whether the company reported its own violation, how committed it was to its compliance programs, and how well it cooperated with FERC during an investigation.

We also established a new process for "No Action Letters" for certain types of issues. This lets companies seek informal staff advice as to whether staff would recommend an enforcement action with regard to a particular transaction, practice or situation.

Moreover, we recently held a Conference on Enforcement Policy to assess the agency's implementation of its Energy Policy Act enforcement authority. We heard a variety of proposals for improving our processes from all parts of the industry. We will consider these proposals carefully in the coming months.

Since October 2005, FERC Enforcement staff has closed or completed 64 investigations. In 47 of these cases, we assessed no penalty either because there was not enough evidence of a violation or because the violation was not serious enough to warrant a sanction. The Commission has approved twelve settlements of investigations that resulted in the companies paying $39.8 million in penalties, filing compliance plans, and taking other remedial actions. We have exercised prosecutorial discretion to concentrate our enforcement resources on the most significant violations that pose the greatest threat to consumers.

In two key cases, we have issued Orders to Show Cause and Notices of Proposed Penalties. Under these orders, FERC made preliminary findings that two groups of companies and individual traders (collectively, Amaranth and Energy Trading Partners) may have manipulated energy markets. These orders do not represent final determinations and make no final conclusions. Both groups of respondents have been given the opportunity to rebut the preliminary conclusions set forth in the orders. Energy Transfer Partners has filed its answer, while Amaranth's answer is currently due December 14. If the final conclusions reflect the preliminary findings, we propose to impose penalties that approach the maximum for certain violations – $291 million for the Amaranth entities and $167 million for the Energy Transfer Partners entities, for total civil penalties of $458 million.

Amaranth and Energy Transfer Partners Investigations

Before I discuss the Amaranth and Energy Transfer Partners investigation, it is important to offer a few comments about natural gas transactions. Natural gas is traded in a wide variety of products. Some of these products are physical products potentially subject to FERC jurisdiction. Other products are futures or financial products subject to CFTC jurisdiction. Pricing of these products can be quite complicated. Natural gas futures in the United States are traded on the New York Mercantile Exchange (NYMEX). By contrast, many products, both physical and financial, are negotiated bilaterally, some online through brokers like the IntercontinentalExchange (ICE). For buyers and sellers interested in market prices, but not interested in trading themselves, physical next-day and next-month prices are collected by the trade press and used to construct price indices. As discussed below, along the East Coast and the Gulf Coast, monthly indices are constructed using transactions with prices set, in part, by settling futures prices. As a result, futures prices determine, in part, the price of physical natural gas purchased by customers. In addition, ICE supports trade of a financial swap, which is otherwise known as a "look-alike" swap, that sets its price based in the futures settlement price. These transactional links between futures and physical and futures and financial prices proved especially important in the Amaranth investigation, as discussed below.

The Amaranth investigation began when FERC Market Oversight staff noticed peculiar trading patterns in the close of the NYMEX futures contract for May 2006. In particular, prices fell dramatically toward the end of the last half hour of trading, which determines the final settlement price for the monthly contract. I credit the vigilance of FERC Market Oversight staff in identifying these patterns.

Of course, the CFTC has jurisdiction over the regulation of NYMEX markets. But the pattern of trading was important to us because a large number of monthly contracts for physical natural gas are pegged to the monthly NYMEX close, so that every penny change in the NYMEX close flows directly into the physical price.

To understand the relationship between futures prices and physical natural gas prices, it is necessary to recognize that some futures contracts become physical natural gas contracts, or, in the terms of the industry, "go to delivery." In addition, there is a class of monthly physical transactions (called physical basis transactions) that tie their prices directly to the settled futures price. These transactions are so common along the East Coast and the Gulf of Mexico that monthly indices in these regions depend almost entirely on physical basis transactions. The attached map shows the regions affected. In that way, the NYMEX contract closing price not only affects physical basis deals themselves, but also all deals that are linked to local indices. Thus, the effects on physical markets of changes in futures prices are direct and significant.

Based on the evidence developed in the investigation, we made a preliminary finding that Amaranth may have deliberately obtained and then sold large futures positions in the last half hour of trading on the settlement date in order to manipulate prices downward. Thus, Amaranth may have benefited from even larger, opposing positions they held on ICE, and that they did all this fully knowing that their actions would affect physical prices as well. Downward manipulation of the monthly futures contract would have benefited their financially settled swaps.

To be clear, we do not believe that Amaranth engaged in any FERC jurisdictional sales. Amaranth did not seemingly seek to manipulate monthly futures prices in order to obtain a benefit from the sale or purchase of physical products. We believe they may have manipulated monthly futures prices in order to benefit from the settling swaps and to influence the value of other positions within their portfolio. However, manipulation of the monthly futures price can affect physical gas sales, given the direct setting of contracts that go to delivery and the widely understood price relationship relating to physical basis and indices.

The Energy Transfer Partners case began when Commission staff received a call on its Enforcement Hotline, alleging that the market for monthly physical gas at the Houston Ship Channel was manipulated on September 28, 2005. Based on the evidence from the investigation, we made a preliminary finding that Energy Transfer Partners dominated physical fixed-price gas sales at Houston Ship Channel and may have manipulated the reported index price. Despite its sales at Houston Ship Channel, Energy Transfer Partners was consistently a net buyer of physical gas from contracts linked to the Houston Ship Channel index. Thus, Energy Transfer Partners may have manipulated the index price downward to benefit its overall portfolio of purchases and other financial positions.

Cooperation with the CFTC

In both the Amaranth and Energy Transfer Partners cases, we began an investigation and shared our information fully with the CFTC. The CFTC began its own investigations of both matters soon thereafter.

The two agencies cooperated closely throughout the investigations. As noted, the CFTC and FERC had entered into an MOU to ensure that we share information quickly and effectively. The MOU worked well throughout the fourteen months of the Amaranth investigation and the twenty-one months of the Energy Transfer Partners investigation, and continues to do so. The two agencies conducted parallel investigations that were closely coordinated.

This cooperation was significant. As described above, the Amaranth investigation examined possible manipulation of futures price to obtain a benefit from positions held in financial products. CFTC has jurisdiction over futures. Any such manipulation would affect physical natural gas consumers, given how the monthly futures price is used to price physical gas transactions. FERC is charged with protecting physical natural gas consumers. By contrast, the Energy Transfer Partners investigation involved possible manipulation of FERC jurisdictional physical natural gas sales to obtain a benefit from positions in other physical and financial products. In a sense, one investigation examined manipulation that may have occurred within CFTC jurisdiction and affected FERC jurisdictional sales. The other involved manipulation that may have occurred within FERC jurisdiction that affected other CFTC jurisdictional transactions. Both investigations involved possible manipulation that may have crossed the jurisdictional lines between the two agencies. Cooperation between FERC and CFTC is essential in order to police this type of manipulation.

In the end, the CFTC initiated action against Amaranth on July 25, 2007, and against Energy Transfer Partners on July 26, 2007. We initiated action against both parties on July 26, 2007. The enforcement actions were coordinated, as were the investigations themselves. Both agencies publicly praised the investigations conducted by the other agency.

Litigation on Amaranth Jurisdiction

Amaranth has raised arguments about whether FERC has jurisdiction over manipulation of the monthly futures price. Even before we issued our Order to Show Cause, Amaranth's lead trader, Brian Hunter, filed in the United States District Court for the District of Columbia seeking to enjoin issuance of the order, claiming FERC lacked jurisdiction. Judge Richard Leon denied the request for a temporary restraining order, at which point the litigation became an effort on Hunter's part to prevent further proceedings under the Order to Show Cause. The ruling in this matter has not yet issued.

Within weeks after the Order to Show Cause, Amaranth filed a motion to stay FERC's action in the civil action filed by the CFTC against Amaranth in the U.S. District Court for the Southern District of New York (under our respective statutes, the CFTC brought its enforcement action in court, while we proceeded administratively). Amaranth argued, among other things, that we lack jurisdiction and CFTC has sole jurisdiction over the conduct described in our Order to Show Cause. Although CFTC opposed Amaranth's motion to stay our order, the CFTC maintained that it had exclusive jurisdiction over all trading in natural gas futures. This would have the effect of preempting FERC's ongoing enforcement proceeding against Amaranth. I consider this to have been a significant change in the CFTC position.

On November 1, Judge Chin denied Amaranth's motion, holding, among other things, that under the Natural Gas Act, any review of our jurisdiction must be conducted in a court of appeals.

At this point, the two agencies have a difference of opinion about the proper interpretation of the anti-manipulation provisions of the Energy Policy Act, and how these provisions should be interpreted in concert with the Commodity Exchange Act. This disagreement will likely be resolved by the courts. In this regard, we recently issued an order addressing Amaranth's legal arguments on FERC's jurisdiction. Attached to my testimony is a copy of our order, which details our interpretation of the anti-manipulation provision.

There is a great deal at stake in this legal dispute. The key issue is the reach of FERC's anti-manipulation authority, the extent of our ability to protect consumers. If the attack on our jurisdiction is successful, our ability to guard the consumer from exploitation would be significantly reduced. As I stated earlier, our fundamental duty is to guard the consumer. We would not be able to sanction manipulation of CFTC-regulated futures markets that affects physical gas sales under our jurisdiction. We would not be able to discharge our duty effectively, as Congress has a right to expect.

FERC and CFTC are different agencies, with different duties. We are a consumer protection agency. The CFTC has a different mission. We have greater penalty authority than the CFTC, and are more likely to order disgorgement of profits in a market manipulation case, which holds out the promise to consumers that they can be made whole. It is also much harder for the CFTC to prove manipulation than FERC because they operate under a higher statutory standard. As a result, the CFTC is more likely to charge attempted manipulation, while FERC is more likely to charge manipulation. That is borne out by the Amaranth litigation.

I think consumers see a difference. That is why the national association of state regulators and a host of individual state commissions have declared support for FERC's position. They have even gone so far as to enter the litigation, filing briefs in the New York district court supporting FERC. Perhaps the best judge is the consumers themselves. Various consumer groups, including the American Public Gas Association, the American Public Power Association, and the National Electric Rural Cooperative Association also filed briefs there in support of the FERC position.

We recognize the CFTC has exclusive jurisdiction to regulate aspects of futures trading, such as the terms or conditions of sale of futures contracts, the operating rules of NYMEX, or traders' commodity accounts, and we recognize the importance of the futures markets. The CFTC focuses its efforts on regulating instruments related to futures and financial products and making sure that designated contract markets, such as NYMEX, operate properly. FERC respects the CFTC's exclusive jurisdiction in these areas and we do not seek to regulate futures or regulate the exchanges, nor do we seek to bar entities from trading as CFTC does. However, the CFTC is charged with protecting the integrity of futures markets, not energy markets.

In our order denying rehearing, we stand by our position that Amaranth's activities fall within our jurisdiction insofar as they affected physical sales of natural gas. Amaranth does not dispute that physical sales were affected. The statute provides that: "It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the sale of transportation service any manipulative or deceptive practice (as those terms are commonly used in section 10(b) of Securities Exchange Act of 1934 …." We believe that this language gives FERC broad authority to sanction manipulative conduct where it significantly affects jurisdictional sales. Comments in the floor debate on the Energy Policy Act clearly indicate Congress's intent that FERC implement the broadest possible prescriptions necessary to protect energy consumers.

The reference to "any entity" shows Congress's intent to capture not only natural gas companies historically subject to FERC jurisdiction under the Natural Gas Act, but also anyone else that engages in prohibited behavior that affect jurisdictional physical sales. Congress could have limited the expanse of FERC anti-manipulation authority to "natural gas companies." It did not do so. It chose a much broader term, namely "any entity." We must conclude that decision was deliberate and meaningful.

We also believe that the "in connection with" language in the statute indicates Congress intended an expansive definition of the activities we could sanction. Congress could have prohibited only manipulation that occurs in Commission-jurisdictional markets. It chose instead the more expansive language. It is hard to imagine what "in connection with" could mean if it does not cover conduct that clearly and substantially affects prices in physical markets under our jurisdiction. In fact, should the courts decide that we do not have jurisdiction, our ability to protect customers, as contemplated in the Energy Policy Act, would be substantially impaired.

Finally, we believe that, under the Energy Policy Act, FERC and the CFTC each have exclusive jurisdiction over the day-to-day regulation of their respective physical and financials markets. But where manipulation in one market directly or indirectly affects the other, both agencies have an enforcement role. This is a dual role that Congress intended and that will redound to the benefit of all market participants in the end.

Cooperation Continues

I regret that this disagreement between FERC and the CFTC has arisen in recent months. But I want to be clear that this disagreement over jurisdiction has not impeded cooperation between the two agencies. We have a respectful disagreement over interpretation of the anti-manipulation provisions of the Energy Policy Act, a disagreement that in my view is best resolved by the courts.

I also want to be clear that I do not question the CFTC's commitment to preventing market manipulation – they are as committed to preventing market manipulation as we are. They have demonstrated that by continuing to cooperate with FERC on matters of mutual interest, notwithstanding their legal opinion on the scope of our jurisdiction.

The disagreement has not impeded cooperation between the two agencies on ongoing investigations of mutual interest. Our MOU continues in place, and we continue to coordinate our information gathering. Staff members from the two agencies continue to meet periodically to discuss more general issues of common interest. And the two agencies are discussing other ideas on how to improve cooperation in investigations and enforcement.

Maintaining Access to Market Data

FERC oversees natural gas and electric markets vigilantly every day, using all of the information available to it. The Amaranth case arose because our analysts saw an anomaly in NYMEX trading as it was happening during the monthly close.

Several legislative proposals are currently circulating that would close what is called the "Enron loophole" and give the CFTC jurisdiction over ICE and other electronic trading venues that provide significant price discovery. Unless carefully crafted, these proposals could affect our ability to oversee natural gas and electric power markets, because many of these venues trade physical as well as financial contracts.

ICE is a good example. Some analysts have referred to ICE as a "dark market." Our experience is different. ICE produces a great deal of information about current and forward markets for both natural gas and electric power all over the United States.

Indeed, ICE is our leading source of information about a large part of the physical market for both commodities, especially in real-time. The attached graph shows the kind of detailed information that we have contracted to see every day from ICE, including the timing, volume and price of all the relevant transactions that occurred on ICE that day. In this case, the graph shows daily physical trading at Henry Hub for delivery on November 29, 2007. We do not see counter-party information, except when we undertake an investigation. But we can and do get such information under our subpoena power when needed.

Please note that in the attached graph, all of the transactions are for physical delivery of natural gas on the following day. It is true that most ICE transactions are for financial products – 95 percent of total trading. In fact, we track the transactions on ICE of their futures look-alike swap to give us additional context for natural gas price development. Far more important for us, most of the information we can see about many of our physical markets comes from the other five percent of trading on ICE. Also, some financial transactions, such as basis swaps, are central to setting many physical prices. Any delay or limitation on our access to this information would significantly diminish our Enforcement efforts.

The general point is that individual market venues, like ICE, frequently trade both physical and financial products. It is very important for us to maintain our current level of authority over, and information access to, the physical aspects of those market venues.

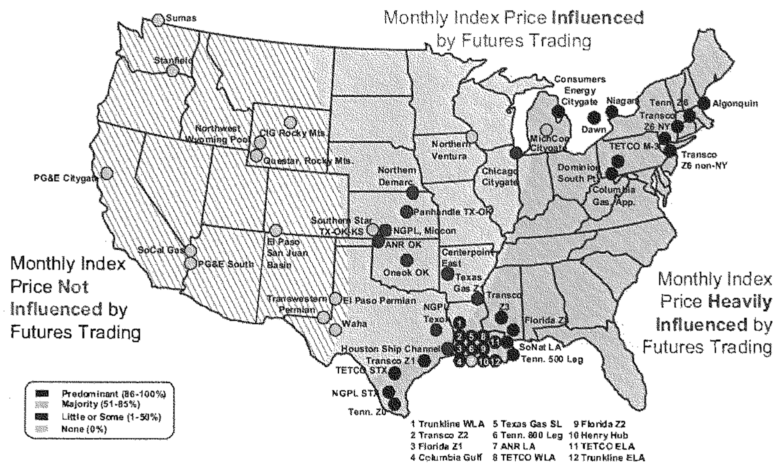
Conclusion

The Energy Policy Act gave us the tools we need to oversee physical natural gas and electric power markets. Over the last two years, we have moved both carefully and quickly to implement the relevant parts of the Energy Policy Act – especially the anti-manipulation, civil penalty, and transparency authorities.

Our experience so far is that the new authorities give us what we need to penalize and deter price manipulation. Our track record shows how effective those authorities can be. I do not anticipate that we would need further authorities.

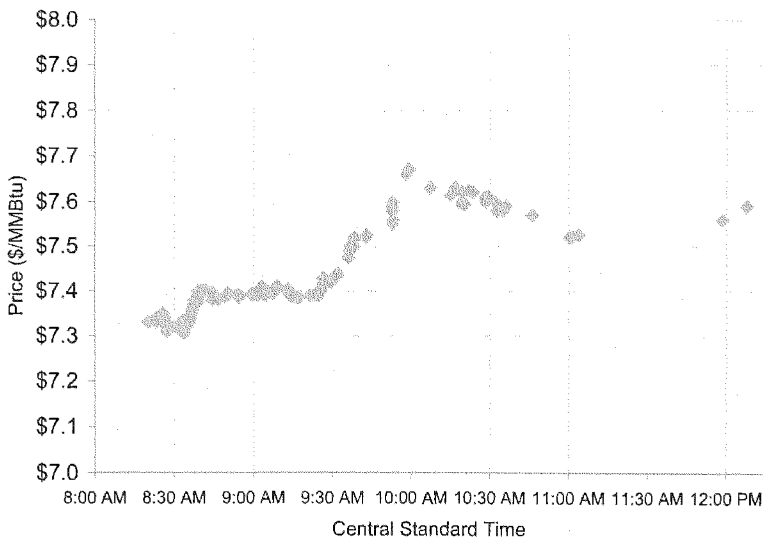
However, a legal question has arisen regarding one of our most important new regulatory authorities – our ability to prevent and sanction market manipulation. We believe it is important to clarify the extent of FERC authority to prevent market manipulation. There is much at stake in this dispute. If the courts were to agree with the position taken by Amaranth, FERC's ability to protect consumers would be significantly impaired.

Figure 1: Use of Physical Basis in Natural Gas Price Indices at Major Trading Points, 2007



Source: Derived from *Platts* data for January through October 2007 indices.

Figure 2: ICE Daily Physical Natural Gas Prices at Henry Hub, Flow Date 11/27/2007



Note: Every point represents one transaction

APPENDIX

121 FERC ¶ 61,224
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Joseph T. Kelliher, Chairman;
Suedeen G. Kelly, Marc Spitzer,
Philip D. Moeller, and Jon Wellinghoff.

Amaranth Advisors L.L.C. — Docket No. IN07-26-001
Amaranth LLC
Amaranth Management Limited Partnership
Amaranth International Limited
Amaranth Partners LLC
Amaranth Capital Partners LLC
Amaranth Group Inc.
Amaranth Advisors (Calgary) ULC
Brian Hunter
Matthew Donohoe

ORDER DENYING REHEARING

(Issued November 30, 2007)

1. This order addresses whether the Commission has authority under section 4A of the Natural Gas Act (NGA) to sanction manipulative trading of natural gas futures contracts when it finds that such manipulative trading had a nexus to and significant effect on the prices of Commission jurisdictional wholesale sales of natural gas. On July 26, 2007, the Commission issued an Order to Show Cause (OSC) to the above ten Respondents, directing them to show why they had not violated section 4A of the NGA and section 1c.1 of the Commission's regulations, 18 C.F.R. §1c.1 (2006) (Anti-Manipulation Rule) as well as to show cause why they should not be assessed civil penalties and be required to disgorge unjust profits, plus interest. On August 27, 2007, four of the ten Respondents, Amaranth Advisors, L.L.C., Amaranth Advisors (Calgary) ULC, Amaranth Management Limited Partnership, and Amaranth Group (collectively "Amaranth") filed a request for expedited rehearing of the OSC (Rehearing Request). Amaranth seeks to terminate the OSC proceeding because it claims that the Commission lacks subject matter jurisdiction over Amaranth's alleged manipulation. As discussed

below, the Commission denies Amaranth's rehearing request.[2] Some of the other six Respondents also filed requests for rehearing of the OSC but their rehearing requests are not addressed in this order. They will be addressed in a future order.[3]

I. **Background**

A. **The Order to Show Cause**

2. In the OSC, the Commission preliminarily concluded that Amaranth's trading in Natural Gas Futures Contracts (NG Futures Contracts) had a direct and substantial effect on the price of Commission-jurisdictional transactions, affecting natural gas customers and ratepayers across the United States, both of which the Commission is required by statute to protect.[4]

3. Amaranth traded in NG Futures Contracts[5] on the New York Mercantile Exchange (NYMEX). Trading NG Futures Contracts creates a "settlement price," which is the volume-weighted average price of trades made during the last 30 minutes of trading (typically from 2:00 p.m. to 2:30 p.m.) on the third-to-last business day of the month preceding the next calendar month. The Commission detailed in the OSC preliminary findings that Amaranth appears to have manipulated (in this case driving down) the settlement price of NG Futures Contracts by selling an extraordinary amount of NG

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[2] On October 12, 2007, the Commission extended the date for responses to the OSC to fourteen days after the Commission's ruling on Amaranth's Request for Rehearing. Pursuant to that Notice, Respondents shall now answer the OSC, as specified in P 140(a) and (b) of the OSC, not later than 14 days from the issuance of this Order.

[3] We are disposing of Amaranth's rehearing request in its entirety. We will address issues raised in rehearing requests by other Respondents, such as the authority to assess civil penalties, the construction of the term "any entity" as to individuals, or the liability of such Respondents, in a future order.

[4] *See generally Order to Show Cause*, 120 FERC ¶ 61,085 (July 26, 2007) (OSC).

[5] NG Futures Contracts are standardized contracts that specify the terms under which a buyer will accept and a seller will deliver a specified quantity of natural gas at a specified place and over a specified month in the future. Typically, NG Futures Contracts provide for the future delivery of 10,000 MMBtus of natural gas over the course of the contract month to the buyer's interconnection on the Henry Hub in Louisiana. *See* Natural Gas Futures Contracts, NYMEX Exchange Rulebook §§ 220.05, 220.10-12, http://www.nymex.com/rule_main.aspx?pg=33#220.05 (last visited Sept. 14, 2007).

Futures Contracts during the last 30 minutes of trading before the contracts expired.[6] Considered in isolation, Amaranth's trading could be economically irrational because it made less on the sales of these contracts. However, because Amaranth took positions several times *larger* in various financial derivatives whose value *increased* as a direct result of the decrease in the settlement price of NG Futures Contracts, Amaranth could have gained on its overall financial positions.

4. The Commission also explained that NG Futures Contracts are not purely financial instruments because some futures contracts traders take their contracts "to delivery," meaning they hold the contracts into the month during which the contract becomes a contract for actual purchase and delivery of 10,000 MMBtus' of natural gas at the Henry Hub delivery point in Erath, Louisiana.[7] The price of that *physical* natural gas transaction is the NG Futures Contracts settlement price. In addition, "physical basis" transactions are based on the NG Futures Contracts settlement price.[8] The NG Futures Contracts settlement price is directly incorporated into many published price "indices," which are relied upon by physical buyers and sellers as a benchmark to determine the prevailing price for natural gas at a given location, or a specified differential to a published price index in the event the gas is to be delivered at a different location.[9] Therefore, the Commission explained, Amaranth's actions, if proven to have driven down the NG Futures Contracts settlement price, had a direct and substantial effect on the price of several different types of *physical* natural gas transactions – transactions that are indisputably within the Commission's jurisdiction.[10]

5. If the NG Futures Contracts settlement price was driven down by Amaranth's trading, sellers who went to delivery on short NG Futures Contracts, as well as producers and other natural gas market participants, may have been paid an artificially lower price for their natural gas. Such manipulation undermines confidence in and integrity of energy markets that are critical to supporting an adequate natural gas infrastructure and

[6] OSC at PP 84, 91 and 106.

[7] *Id.* at PP 5, 26.

[8] *Id.* at P 20.

[9] *Id.* at PP 21-24. To compile monthly "indices" of those prices at various physical natural gas trading locations, publishers of natural gas industry newsletters (*e.g.*, Platts or NGI) conduct price surveys of market participants. Those surveys capture a significant amount of the aforementioned physical basis transactions. *See generally Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121, *clarification granted*, 105 FERC ¶ 61,282 (2003).

[10] OSC at PP 20-27, 108-10.

that provide consumers reasonable prices for natural gas. Finally, the pecuniary interests of state and federal governments may have been harmed when natural gas from public lands was sold for royalties that are also tied to the NYMEX settlement price.

6. The Commission preliminarily concluded in the OSC that Amaranth and the other Respondents violated the Commission's Anti-Manipulation Rule, which was adopted pursuant to section 4A of the NGA, 15 U.S.C. § 717, as amended by the Energy Policy Act of 2005, Pub. L. No. 109-58, § 315 (2005) (codified at 15 U.S.C. 717c-1) (EPAct 2005). It proposes that Amaranth pay civil penalties and disgorge unjust profits under similarly new enhanced penalty provisions also added to the NGA by EPAct 2005.[11] It also ordered responses to the OSC's specific allegations. Amaranth sought leave, and it and all other Respondents have been permitted, to file responses to the OSC within fourteen days after this ruling.

B. Amaranth's Request for Expedited Rehearing on the Issue of the Commission's Jurisdiction

7. Amaranth's rehearing request generally raises the issue of the Commission's subject matter jurisdiction to proceed with its OSC under section 4A of the NGA. New section 4A was added to the NGA, along with a parallel provision which was added to the Federal Power Act (FPA), by EPAct 2005. It provides as follows:

> It shall be unlawful for *any entity*, directly *or indirectly*, to use or employ, *in connection with* the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, *any* manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 . . .in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. (emphasis added).

8. In support of its Rehearing Request, Amaranth raises three principal points of error. First, Amaranth contends that section 4A of the NGA does not confer jurisdiction on the Commission to regulate trading of futures that takes place exclusively on the NYMEX because such transactions are within the "exclusive jurisdiction" of the Commodity Futures Trading Commission (CFTC).[12] Amaranth contends that the CFTC has exclusive jurisdiction to regulate manipulation within financial markets, even if such conduct directly and substantially impacts the Commission's jurisdictional natural gas

[11] *Id.* at P 75.

[12] Rehearing Request at 13-16.

markets. Amaranth maintains that the EPAct 2005 amendments to the NGA did not expand the Commission's jurisdiction to include trading "solely" in natural gas futures that affects Commission-jurisdictional markets and that there is no jurisdictional overlap between the Commission and CFTC because the Commodity Exchange Act, P.L. 74-765, 49 Stat. 149 (1936) (CEA) grants the CFTC "exclusive jurisdiction . . . with respect to accounts, agreements and transactions involving contracts for the sale of a commodity for future delivery."[13] Amaranth cites legislative history from 1974 to support its claim that the Commission is preempted from regulating futures markets.[14] In further support of this argument, Amaranth claims that the "savings clause" in section 23 of the NGA (a natural gas market transparency provision which was added to the NGA by EPAct 2005), confirms that Congress did not expand the Commission's jurisdiction to include manipulation of futures contracts, but instead withheld regulatory power from the Commission by re-affirming the CFTC's exclusive jurisdiction under the CEA.[15] According to Amaranth, decisions holding that two agencies may conduct separate investigations are inapplicable because the CFTC has exclusive jurisdiction over the claims at issue.[16] Amaranth also contends that section 23 gave the Commission authority only to collect from market participants and disseminate information about the availability and prices of natural gas sold at wholesale in interstate commerce.[17] According to Amaranth, the related requirement that the Commission enter into a Memorandum of Understanding (MOU) with the CFTC is intended to ensure only that information requests are coordinated, and not to authorize the Commission to take regulatory action.[18]

9. Second, Amaranth argues that the Commission exceeded its jurisdictional bounds, principally because the "in connection with" language of section 4A of the NGA does not confer subject matter jurisdiction over the types of futures transactions addressed by the OSC.[19] While the Commission stated in the OSC that EPAct 2005 expanded its authority to police all forms of manipulation in connection with its jurisdictional markets, Amaranth contends that the "in connection with" language in section 4A of the NGA

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[13] 7 U.S.C. § 2(a)(1)(A) (2000). *See generally* Rehearing Request at 16-25.

[14] Rehearing Request at 15.

[15] *Id.* at 16-21.

[16] *Id.* at 24-25.

[17] *Id.* at 17-18

[18] *Id.* at 18-19.

[19] *Id.* at 26-39.

added by EPAct 2005 did not confer upon the Commission jurisdiction to regulate so-called "non-jurisdictional" activity or entities even if the actions affect Commission-jurisdictional markets.[20] Because Amaranth was not itself a party to the purchase or sale of physical natural gas contracts, Amaranth claims the manipulation alleged by the Commission was not "in connection" with Commission-jurisdictional transactions. Specifically, Amaranth maintains that, our statements in the OSC notwithstanding, section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (2000) (Securities Exchange Act) and cases applying that provision, do not guide the analysis of whether the NG Futures Contracts transactions were "in connection with" physical natural gas markets because the Commission was not given the enforcement powers provided in section 10(b).[21] According to Amaranth, Congress only meant to incorporate into section 4A the definitions of certain *terms* used in section 10(b). Alternatively, if statutory construction of the "in connection with" clause of section 10(b) is applicable to NGA section 4A, Amaranth contends that legal precedent supports its position that Amaranth would be subject to the Commission's jurisdiction only if Amaranth traded in physical natural gas that "coincided with" or was "in furtherance" of the manipulative scheme.[22] Because Amaranth claims it did not engage in such transactions, it asserts that the "in connection with" element is not satisfied.

10. Third, accepting its own interpretation of the EPAct 2005 and the NGA, Amaranth argues that our Order No. 670 adopting the Anti-Manipulation Rule[23] likewise stated that we do not regulate fraud and manipulation in "non-jurisdictional" transactions, such as NG Futures Contracts.[24] Amaranth recites language from Order No. 670 which it claims is inconsistent with our preliminary conclusions in the OSC. From there, Amaranth contends the Commission's OSC is arbitrary, capricious, and an abuse of discretion because we failed to explain why we "departed" from our determination in Order No. 670.[25]

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[20] *Id.* at 26-31.

[21] *Id.* at 31-32.

[22] *Id.* at 34-36.

[23] *Prohibition of Energy Market Manipulation*, Order No. 670, 71 Fed. Reg. 4244 (January 26, 2006), FERC Stats. & Regs. ¶ 31,202 (codified at 15 U.S.C. 717c-1) (Order No. 670).

[24] Rehearing Request at 39-41.

[25] *Id.* at 41

II. Commission Determination

11. As the Supreme Court has held, the primary purpose of the NGA is to "protect consumers against exploitation. "[26] The Commission is required by statute to ensure that certain physical sales of natural gas sales are just, reasonable and not unduly discriminatory or preferential under the NGA and that natural gas consumers are thereby protected.[27] Beginning in the 1980s, the Commission regulated jurisdictional wholesale sales of natural gas on a market basis and thus its responsibility to assure just and reasonable rates is fulfilled by ensuring that natural gas markets remain competitive. In the OSC we preliminarily determined that Amaranth's manipulative trading of NG Futures Contracts, which are not directly regulated by the Commission on a day-to-day basis, nevertheless had a direct effect on the price of natural gas sales which are within the Commission's jurisdiction.[28] Because of this direct effect on jurisdictional sales, the behavior fell within the NGA section 4A prohibition of direct or indirect manipulation in connection with jurisdictional sales. In making our preliminary findings in the OSC, we took into account the CFTC's exclusive jurisdiction to oversee the operation of the futures markets.[29] The Commission neither asserted jurisdiction over day-to-day regulation of CFTC-regulated futures contracts transactions nor sought to interfere with that jurisdiction. Rather, as we stated in the OSC, the Commission's jurisdiction over activities that affect its markets is complementary to the CFTC's jurisdiction over the activities that affect futures markets.[30]

12. As discussed in detail below, the statutory language of NGA section 4A, in conjunction with Congress' recognition of the overlap in FERC and CFTC regulated markets in the NGA section 23 transparency provision that was enacted simultaneously by Congress, supports the Commission's interpretation. Further, the historical context in which Congress considered the NGA section 4A and parallel FPA section 222 amendments supports the interpretation that Congress intended the Commission to ensure that there is no regulatory gap in sanctioning manipulative behavior affecting jurisdictional gas and electric markets. The result of our interpretation is that although the Commission and the CFTC each have exclusive jurisdiction over the day-to-day regulation of their respective physical energy and financials markets, where, as here,

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[26] *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 610 (1944).

[27] 15 U.S.C. § 717t-2(a)(1) (2000).

[28] OSC at PP 108-10.

[29] *Id.* at PP 48, 55.

[30] *Id.* at PP 48.

there is manipulation in one market that directly or indirectly affects the other market, both agencies have an enforcement role. This is a dual role that was contemplated by Congress, that should be coordinated and consistent wherever possible, and that, in the end, will redound to the benefit of all market participants.

A. The Commission's NGA Section 4A Jurisdiction

13. Although presented as the second point in Amaranth's "specification of errors," the question of whether the Commission has jurisdiction, in light of the "in connection with" language of NGA section 4A, or otherwise, is the most fundamental issue presented (regardless of the CFTC's jurisdiction). Accordingly, we turn to that question first and, after resolving that question, we turn to Amaranth's other arguments, as necessary.

14. Before addressing Amaranth's jurisdictional arguments, we note four basic factual points that were contained in the OSC and are, at this point in the proceedings, undisputed by Amaranth:

a. Amaranth does not dispute that the alleged manipulation in this case involves three interrelated markets: (1) the NG Futures Contracts market; (2) a variety of "derivative" financial products; and (3) Commission-jurisdictional wholesale natural gas sales, namely, wholesale natural gas sales in interstate commerce that are not "first sales" within the meaning of the Natural Gas Policy Act of 1978 (NGPA).[31] Amaranth does not dispute that the first market affects the second and third inasmuch as the NG Futures Contracts settlement price determines, in whole or in part, the value of the derivatives and the price of a substantial volume of Commission-jurisdictional wholesale natural gas sales.[32]

b. Amaranth does not dispute that the "settlement price" attaches to any NG Futures Contracts that becomes a contract for the sale of physical natural gas. During the months of interest in this matter, blanket certificate holders such as ConocoPhillips, BP, Louis Dreyfus, UBS, and Merrill Lynch each sold natural gas by holding more than 2,000 NG Futures Contracts through expiration in one or more of the months for approximately 20 billion cubic feet of physical gas that went to delivery.[33] These physical natural gas sales were, in whole or in part, Commission-jurisdictional transactions. Amaranth presents no evidence or argument to the contrary.

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[31] 15 U.S.C. § 3431(a) (2000).

[32] OSC at PP 2, 6, 108-10.

[33] *Id.* at P 25 (*citing* NYMEX open interest, trade, and delivery data, ferc_item13_ng_top_tdr_final2.xls).

c. Amaranth does not dispute that substantial volumes of bid week[34] transactions are "physical basis" transactions that are priced using the NG Futures Contracts settlement price and that such sales are largely Commission-jurisdictional.[35]

d. Amaranth does not dispute that monthly indices at many trading centers are set primarily by physical basis transactions during "bid week" and thus also use the NG Futures Contracts settlement price as a reference price. Amaranth also does not dispute that, in turn such price indices are widely used in bilateral natural gas markets that are subject to the jurisdiction of the Commission.[36] Thus, as Amaranth agrees, the "public relies on the [NYMEX] settlement price" as a "key price benchmarked for physical . . . contracts involving natural gas."[37] Nor does Amaranth dispute that state regulators sometimes look to index or settlement price-based purchases of natural gas by local distribution companies in evaluating whether such purchases were prudent.

1. <u>The Commission's Preliminary Jurisdictional Findings and the Language and Purpose of the Anti-Manipulation Provisions</u>

15. Although the rehearing request offers a number of detailed and specific legal points and authorities, Amaranth's central argument with respect to our jurisdiction is that the NGA and the Anti-Manipulation Rule do not confer jurisdiction on the Commission to prohibit the conduct alleged in the OSC.[38] As with any issue of statutory and regulatory construction, we begin with text and purpose of the statute (including pertinent legislative history), our rule implementing the statute, and our order adopting the rule. We then apply the legal interpretation to the facts at hand.

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[34] "Bid week" is the last five business days of the month. *See generally Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121, *clarification granted*, 105 FERC ¶ 61,282 (2003).

[35] OSC at P 22.

[36] *Id.* at 22-23, 25.

[37] Letter from Michael Carrieri, Compliance Director of Amaranth, to Anthony Densieski, Senior Director, Market Surveillance, NYMEX (Aug. 30, 2006).

[38] Rehearing Request at 10-12 (rejecting the OSC findings in PP 44-51 and 108-10).

16. As noted above, section 315 of EPAct 2005 added a new section 4A to the NGA that provides in pertinent part:

> It shall be unlawful for *any* entity, directly *or indirectly*, to use or employ, *in connection with* the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, *any* manipulative deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) in contravention of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas ratepayers. (emphasis added).[39]

17. This language, in particular the broad and general terms used therein, is most reasonably read to give the Commission broad authority to sanction manipulative conduct where, as here, such conduct has a nexus to and significantly affects jurisdictional sales. The language making it unlawful for "any entity" to engage in manipulative conduct in connection with jurisdictional transactions demonstrates Congress' intent to capture not only natural gas companies or other jurisdictional companies historically subject to the NGA but rather any individual, corporation, or governmental or non-governmental entity that engages in the prohibited behavior. The language "directly or indirectly" is reasonably read to prohibit behavior not only by entities engaging in Commission jurisdictional transactions but entities engaging indirectly, for example through intermediaries, in such transactions, or in behavior indirectly affecting such transactions.[40] Similarly, the language "any manipulative device or contrivance" is

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[39] 15 U.S.C. § 717c (2005). With respect to the "subject to the jurisdiction of the Commission" element, section 1(b) of the NGA grants the Commission jurisdiction over "the sale in interstate commerce of natural gas for resale." 15 U.S.C. § 717(1)(a) (2000). The NGPA, 15 U.S.C. §§ 3301 *et seq.* (2000), and the Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157 (1989), exclude from the Commission's NGA jurisdiction all "first sales," 15 U.S.C. § 3431(a) (2000), which are all sales from the producer to the consumer, unless and until the gas is purchased by an interstate pipeline, intrastate pipeline, or local distribution company or an affiliate thereof. 15 U.S.C. § 3301(2)(21)(A) (2000). *See also Amendments to Blanket Sales Certificates*, Order No. 644, FERC Stats. & Regs. ¶ 31,153 at P 14 (2003), *reh'g denied*, 107 FERC ¶ 61,174 (2004).

[40] Cases interpreting section 10(b), which provides that it "shall be unlawful for any person, directly or indirectly," to use any instrumentality of interstate commerce in connection with a manipulative or deceptive device or contrivance, held that the "word 'indirectly' is quite broad and pervasive" and, therefore, use of a telephone to arrange a meeting for purposes of effectuating a fraud satisfies the requirements of section 10(b). *Nemitz v. Cunny*, 221 F. Supp. 571, 573 (N.D. Ill. 1963). Therefore, section 10(b) and Rule 10b-5 have been read to impose liability on any person who participated in a

reasonably read to capture a broad array of manipulative or deceptive conduct that may harm Commission jurisdictional markets and customers. The legislative history of the enactment of this new provision and the parallel provision in the FPA, section 222, supports a reasonably broad interpretation of the Commission's authority to sanction manipulative or deceptive conduct. While the Conference Report accompanying EPAct 2005 does not contain discussion of the anti-manipulation provisions, there is ample discussion in floor debates leading up to EPAct 2005 to demonstrate that Congress intended to confer on the Commission broad authority to prohibit manipulation affecting jurisdictional markets. In floor debates discussing the scope of manipulative practices to be prohibited, two different versions of the anti-manipulation provisions were introduced and considered in May 2005: the "Cantwell Amendment," which sought to add broad anti-manipulation language similar to that of section 10(b) of the Securities Exchange Act and a narrower "Domenici Amendment" that had a specific list of prohibited practices.[41] The broad Cantwell Amendment, modeled on section 10(b), became what is now section 4A of the NGA and section 4A expressly provides that terms common to section 10b and 4A are used in the same manner in section 4A as in section 10(b). Congress then expressly delegated *to the Commission* the task of adopting rules to give life to section 4A.[42]

18. In commenting on the essentially identical electric anti-manipulation provision that was ultimately adopted alongside section 4A, Senator Jeff Bingaman, Ranking Member of the Senate Committee on Energy and Natural Resources when EPAct 2005 was enacted, stated that "we should give FERC this tool and make it clear in the law that all of these deceptive and manipulative practices are illegal. Once we make that clear, we are in a position to hold FERC accountable, if in fact, manipulation or deceptive practices occur in the future."[43]

19. It is reasonable to infer from this statement that, in the aftermath of the manipulative practices by Enron and other companies that were uncovered in connection with the Western energy crisis of 2000-2001, Congress intended to give the Commission the tools needed to sanction future manipulation affecting jurisdictional prices and

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manipulative or deceptive scheme, even if a material misstatement by another person created the connection between the scheme and the securities market. *In re Lernout & Haupsie Sec. Lit.*, 236 F. Supp. 2d 161, 173 (D. Mass. 2003).

[41] *See* 151 Cong. Rec. S 7451 at 40 (daily ed. June 28, 2005) (Statement of Sen. Cantwell).

[42] *See* 15 U.S.C. §717(c) (2005) (the "Commission may prescribe as necessary [rules] in the public interest or for the protection of natural gas ratepayers.").

[43] 149 Cong Rec. S 10182 (daily ed. July 30, 2003) (statement of Sen. Bingaman).

services and to rely on the Commission's expertise and knowledge of relevant markets to craft rules that would most fully effectuate the prevention, detection, and punishment of manipulation affecting Commission jurisdictional markets.

20. To implement section 315 of EPAct 2005 and NGA section 4A, the Commission promulgated its Anti-Manipulation Rule, section 1c.1 of the Commission's rules, which prohibits:

> any entity, directly or indirectly, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission [from using] or employ[ing] any device, scheme, or artifice to defraud, [or from engaging in] any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity.[44]

21. In adopting this rule, we issued Order No. 670 and expressly ruled the Anti-Manipulation Rule is an intentionally broad proscription against all kinds of deception, manipulation, deceit and fraud.[45] We clarified the following elements of a manipulation claim: "an entity: (1). . .engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite *scienter*; (3) in connection with the purchase or sale of natural gas . . . subject to the jurisdiction of the Commission."[46] Order No. 670 explained that fraud is defined generally to include "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market."[47]

22. The Anti-Manipulation Rule applies whether or not the manipulator's principal or exclusive purpose is the manipulation of physical natural gas sales. In Order No. 670, we stated "we do not intend to construe the Final Rule so broadly as to convert every common law fraud that happens to touch a jurisdictional transaction into a violation of" the Anti-Manipulation Rule.[48] Yet, such a transaction would be covered if "in committing fraud, the entity . . . intended to affect, or have acted recklessly to affect, a

[44] 18 C.F.R. § 1c.1 (2006).

[45] Order No. 670 at P 49.

[46] *Id.* at P 50.

[47] *Id. (citing Dennis v. United States*, 384 U.S. 855, 861 (1966) (noting that fraud within the meaning of a statute need not be confined to the common law definition of fraud: any false statement, misrepresentation or deceit)).

[48] *Id.* at P 22 (emphasis added).

jurisdictional transaction."[49] We pointed out that the "in connection with" language is drawn from similar language of Rule 10b-5, which has been very liberally construed.[50] Accordingly, we held in Order No. 670 and observed in the OSC that the Anti-Manipulation Rule applies where there is a "nexus" between the manipulative conduct and the jurisdictional transaction. Under the analogous Rule 10b-5 precedent, the alleged manipulator need not be a party to the jurisdictional transaction, nor must the connection be overwhelmingly direct.[51] Finally, we also explained that a determination of manipulation, in general, is "a question of fact that is to be determined by all the circumstances of a case."[52] We note that after significant commentary relating to our notice of proposed rulemaking as to the Anti-Manipulation Rule, there were no appellate challenges to our Final Rule.

23. Based on information developed to date, the Commission preliminarily concluded that Amaranth's manipulation of the NG Futures Contracts settlement price was "in connection with" Commission-jurisdictional transactions.[53] First, the settlement price directly sets the price for any NG Futures contracts that ultimately went to delivery at Henry Hub. As noted, the contracts were substantial in number. This connection is certainly direct. Second, the settlement price is indirectly incorporated into the price for physical basis transactions. Finally, the price of a substantial proportion of physical basis transactions are used in indices, and those indices, in turn, price a substantial volume of physical natural gas. The OSC presented data supporting the conclusion that a significant proportion of these sales are jurisdictional to the Commission. As we noted in the OSC, millions of consumers, particularly on the East Coast, are affected by these prices. Some of these various types of connections are direct, others are indirect. They each vary in magnitude. As discussed below, all of them qualify Amaranth's conduct as "in connection with" Commission jurisdictional transactions.

2. <u>The Language of NGA Section 4(a) as Compared to NGA Section 4A</u>

24. Amaranth contends that the phrase "in connection with" in NGA section 4A

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[49] *Id.* (emphasis added).

[50] *Id.*

[51] As discussed below, the Anti-Manipulation Rule prohibits an entity from "directly or indirectly" committing fraud.

[52] Order No. 670 at P 50.

[53] OSC P 108-10.

should be interpreted identically to the same phrase that appears in NGA section 4(a)[54] (governing the Commission's ratemaking authority) because section 4A's anti-manipulation language "closely tracks" the section 4(a) ratemaking language.[55] In passing, we note that Amaranth's rehearing request makes several additional arguments about the "in connection with" language, including its relationship to other phrases in the Anti-Manipulation Rule, the breadth of the phrase under the securities laws, and the like. Thus, we are called upon to address it from several different perspectives throughout this order.[56] This particular argument rests on the fact that two sections of the NGA, 4A and 4(a), use the phrase "in connection with." Section 4(a) of the NGA provides that:

> [a]ll rates and charges made, demanded, or received by any natural gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission . . . shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.[57]

25. The language of section 4(a) provides the Commission with ratemaking authority over natural gas companies with respect to rates and charges "in connection with" the transportation or wholesale sales of natural gas within the Commission's jurisdiction as defined (and limited) in section 1(b) of the NGA. However, use of the term "in connection with" is where the similarity of the two provisions begins and ends, and the fundamental flaw in Amaranth's argument is that Congress expressly patterned section 4A, including the "in connection with" language therein, on section 10(b) of the Securities Exchange Act, *not* on section 4(a) of the NGA. No one challenged the Commission's statement in Order No. 670 that it would interpret "in connection with" in a manner consistent with section 10(b). Thus it is reasonable to rely on section 10(b) precedent, and not section 4(a) precedent, to interpret the phrase "in connection with." EPAct 2005 does not increase the variety of transactions within the Commission's ratemaking jurisdiction under pre-existing NGA section 4(a). We re-iterate here our findings in the OSC that such a jurisdictional transaction must be directly or indirectly affected by manipulative or deceptive conduct in order for the manipulation or deception to violate the Anti-Manipulation Rule.[58] However, Congress did broaden (with language

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[54] Prior to and after EPAct 2005, the NGA has a "section 4(a)." The new Anti-manipulation provision added by EPAct 2005, which did not replace section 4(a), was denominated "section 4A."

[55] Rehearing Request at 36-31.

[56] *See* further discussion *infra* at paragraphs 34-45.

[57] 15 U.S.C. § 717c(a) (2005).

[58] OSC at P 110.

in section 4A that is not present in section 4(a)) the conduct affecting such transactions that the Commission may police, namely manipulative or deceptive conduct by any entity that, either directly or indirectly, is in connection with the purchase or sale of natural gas or transportation services within the Commission's jurisdiction. *See* further discussion *infra* at paragraphs 30-45 and 59.

26. The cases cited by Amaranth for the proposition that "identical words used in different parts of the same act are intended to have the same meaning"[59] did not involve a situation, as here, where Congress amended a statute with a new provision expressly modeled on a provision in another act.[60] The "in connection with" language used in section 4A must be read in the context of the entire section 4A provision. We believe that the differences in the language used in section 4(a) and in section 4A, taken in their entirety, reflect the broad remedial purpose of Congress in enacting section 4A. Thus, it is not only reasonable as a matter of statutory interpretation, but is consistent with congressional intent to interpret each provision (4(a) and 4A) based on the entirety of each provision as a whole. Furthermore, section 4A, which was modeled after the Securities Exchange Act provision, provides that terms common to section 10(b) and 4A (such as "to use or employ, in connection with" and "any manipulative or deceptive device or contrivance in contravention of such rules") should be interpreted as those terms are used in section 10(b), not 4(a).

27. The section 4(a) cases cited by Amaranth supporting its restrictive interpretation of "in connection with" are inapposite. In *Conoco, Inc. v. FERC*, 90 F.3d 536 (D.C Cir. 1996) (*Conoco*), the court held that the phrase "in connection with" appearing in section 4(a) of the NGA did not allow the Commission to regulate gathering facilities because they are expressly exempt from the Commission's jurisdiction in section 1(b) of the NGA, 15 U.S.C. § 717(b) (1994).[61] Similarly, in *Federal Power Comm'n v. Panhandle Eastern Pipe Line Co.*, the Supreme Court ruled that facilities, such as reserves and gas leases used for gas production and gathering, are likewise beyond the jurisdiction of the Commission because they too fall within section 1(b) exemptions.[62] However, "the

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[59] Rehearing Request at 30.

[60] *See Envtl. Def. v. Duke Energy Corp.*, 127 S.Ct. 1423, 1424 (2007) (the same statutory terms used in different parts of the statute may be construed differently in order to satisfy distinct statutory objectives); *Bailey v. United States*, 516 U.S. 137, 145 (1995) (the meaning of statutory language depends on the context in which it is used).

[61] *Conoco*, 90 F.3d at 552 (section 1(b) expressly exempts from the Commission's jurisdiction the gathering of natural gas).

[62] 337 U.S. 498, 504 (1949).

scope of the Commission's power under the inclusive 'in connection' with' language of §§ 4 and 5 [of the NGA] was not at issue."[63] Finally, *Williams Natural Gas Processing-Gulf Coast Co., L.P. v. FERC*, 373 F.3d 1335 (D.C. Cir. 2004) (*Williams*) does not hold, as Amaranth contends, that a gathering affiliate is beyond the Commission's jurisdiction if it does not directly participate in natural gas markets. Rather, the *Williams* holding concerns whether the Commission can disregard the corporate form and reassert jurisdiction over a gathering facility, which is expressly exempt from regulation under section 1(b) of the NGA, because its activities are interrelated to an affiliated interstate pipeline.[64]

28. These decisions simply concluded that section 4(a) could not be construed in a manner that would expand the jurisdiction expressly foreclosed in section 1(b). They did not address (nor could they, since section 4A had not been enacted) the broader scope of section 4A which expressly applies to "*any* entity" – not just natural gas companies – that "directly *or indirectly*" take certain actions in connection with the "*purchase* or sale" of jurisdictional services. In this case, the Commission's construction of its jurisdiction under section 4A does not conflict with section 1(b) because that section does not exempt financial market participants, such as Amaranth, or trading in natural gas futures markets. Furthermore, the logic, if not the result, of the *Conoco* decision can be read to support the Commission's view here that when non-jurisdictional transactions, such as natural gas futures contracts, affect jurisdictional markets, the "in connection with" requirement of section 4(a) would be met.[65] We find no relevance to the few cases cited by Amaranth[66] in which the courts have rejected jurisdictional assertions by the Commission in other contexts that are not present here, other than for the general proposition that the

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[63] *See Northern Natural Gas Co. v. FERC*, 929 F.2d 1261, 1272 (8^{th} Cir. 1991) (discussing the scope of the Supreme Court's decision in *Federal Power Comm'n v. Panhandle Eastern Pipe Line Co.*).

[64] *Williams*, 373 F.3d at 1342-43.

[65] The court in *Conoco* held that when exempt gathering facilities become "intertwined with jurisdictional activities, the Commission's regulation of the latter may inpinge on the former." 90 F.3d at 549. Thus, "[a]s an abstract matter, [the court had] no reason to doubt the Commission's conclusion that a nonjurisdictional entity could act in a manner that would change its status by enabling an affiliated interstate pipeline to manipulate access and costs of gathering." *Id.* The holding in *Conoco* simply rested on the section 1(b) exemption which trumped the section 4(a) language, a construct not relevant here.

[66] Rehearing Request at 36-39.

Commission cannot create jurisdiction that Congress has not conferred.[67]

29. Amaranth's proposed reading is also problematic because it essentially eliminates much of the intended effect of the new section 4A that was hard fought for and prevailed in Congress. Prior to 2005, the Commission had authority under section 4(a) to punish manipulation by sellers in physical natural gas markets and, therefore, had promulgated "Market Behavior Rules" prohibiting manipulation by such sellers.[68] Congress is not presumed to enact surplusage.[69] The better interpretation is that Congress meant to expand Commission authority beyond what existed in 2005 to proscribe the conduct alleged in the OSC. *See* further discussion of the "in connection with" language *infra* at paragraphs 34-45 and 59.

3. Whether the Anti-Manipulation Rule is Limited to "Physical Sellers" or "Sales" Transactions.

30. Amaranth's next specific argument is that the Commission is "bootstrapping"[70] language in the NGA's new section 4A into a new and broad jurisdictional grant that reaches beyond physical sellers and their sales transactions. This argument is without merit because it ignores the simple fact that new section 4A was, indeed, a new and broad

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[67] Amaranth's reliance on *Altamont Gas Transmission Co. v. FERC*, 92 F.3d 1239 (D.C. Cir. 1996), *Bonneville Power Admin. v. FERC*, 422 F.3d 908 (9th Cir. 2005), *pet. for cert. pending,* No. 07-155 (filed Aug. 6, 2007); *California Indep. Sys. Operator Corp. v. FERC*, 372 F.3d 395 (D.C. Cir. 2004), and *N. States Power Co. v. FERC*, 176 F.3d 1090 (8th Cir. 1999) is misplaced. In each of these decisions, the courts concluded that the plain language of the statute clearly delineated FERC's jurisdiction. *Altamont,* 92 F.3d 1239 (NGA expressly reserved to states the authority to determine the intrastate rate structures); *Bonneville,* 422 F.3d 908 at 917-19 (FPA expressly states that FERC's jurisdiction extends to public utilities and that FERC's refund authority does not extend to governmental entities); *California Indep. Sys. Operator*, 372 F.3d at 401 (FPA limited FERC's authority over public utility boards); and *N. States Power Co.*, 176 F.3d at 1095 (federal regulation extends to matters not subject to state regulation and states have authority over retail rates and practices). In this case, the NGA expressly confers jurisdiction upon FERC to prohibit market manipulation that is "in connection with" its jurisdictional markets. No other NGA provisions limit FERC's authority to prevent market manipulation.

[68] *See* 18 C.F.R. § 284.403(a) (2005).

[69] *City of Roseville v. Norton*, 348 F.3d 1020, 1028 (D.C. Cir. 2003) (*citing Babbitt v. Sweet Home Chapter of Cmty. for a Great Oregon*, 515 U.S. 687. 698 (1995)).

[70] Rehearing Request at 36.

jurisdictional grant by Congress to the Commission that goes beyond prior Commission jurisdiction to prohibit manipulation involving entities and transactions traditionally not regulated by the Commission.

31. As Amaranth concedes, Congress granted the Commission broad authority to police market manipulation by "*any* entity." The word "any" gives the word it modifies (in this case, "entity") an expansive meaning.[71] Thus, Amaranth's argument that the Commission has authority to assess civil penalties for manipulation only against a physical seller of natural gas is inconsistent with the language of the statute.[72] First, section 4A and the Anti-Manipulation Rule prohibits any entity from "directly or indirectly" engaging in manipulation "in connection with" a jurisdictional transaction. Neither speaks in terms of conduct by an entity "engaged in" or "a party to" such transaction. Contrary to Amaranth's sweeping assertion that the physical and financial markets are "completely separate,"[73] the manipulation alleged here had a profound cross-market effect: on the futures contracts that went to physical delivery, on physical basis transactions, and on transactions based off indices calculated using physical basis transactions. "Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies ("LDC") . . . . is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract . . . without question a participant's trading conduct in one venue can effect, and has affected, the price of natural gas contracts in the other."[74] Second, Amaranth's contention that section 23 of the NGA, which directs the Commission to promulgate rules that facilitate price transparency in natural gas markets, confirms that the Commission has civil penalty authority only against "sellers" of natural gas is based on a misreading of the statute. Section 23, which is separate and distinct from section 4A, allows the Commission to obtain information about the price and availability of natural gas from

[71] *Norfolk S. Rwy. Co. v. Kirby*, 543 U.S. 14, 31-32 (2004) (the word "any" gives the word it modifies an expansive reading); *Dep't of Hous. and Urban Dev. v. Rucker*, 535 U.S. 125, 130-31 (2002); *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (one must give effect to each word in a statute so that none is rendered superfluous); *United States v. Gonzales*, 520 U.S. 1, 5 (1997) ("any" is an expansive term, meaning "one or some indiscriminately of whatever kind,"); *New York v. EPA*, 443 F.3d 880, 885-87 (D.C. Cir. 2006) (the word "any" is broadly construed to reflect Congress' intent that all types of physical changes are subject to the Clean Air Act's New Source Review program).

[72] Rehearing Request at 20.

[73] *Id.* at 26.

[74] Testimony of Laura Campbell, Assistant Manager of Energy Resources, Memphis Light, Gas & Water on behalf of APGA before the CFTC (Sept. 18, 2007).

"any market participant," not simply sellers.[75] Section 23(e) specifies that civil penalties for violating *this section* are limited to the three years before notice of the proposed penalty, except in cases where a seller engaged in fraudulent or manipulative activities in violation of section 4A that materially affected the sales contract.[76] This exception to a limitation on a subset of NGA violations implicated by section 23 does not override the broader language of section 4A.[77] In contrast, NGA section 22(a) specifies the Commission's civil penalty authority for violations of *the Act*, which includes violations of section 4A.[78]

32. Consistent with the foregoing authorities, Order No. 670 provides that the statutory phrase "any entity" (which is repeated in the Rule) covers not only companies that have traditionally been subject to the Commission's jurisdiction (such as natural gas pipeline companies or public utilities), but also any company or firm, and natural persons[79] who, "intended to affect, or have acted recklessly to affect, a jurisdictional transaction."[80] Amaranth's contention that only direct purchasers or sellers of physical natural gas are subject to the Commission's anti-manipulation jurisdiction not only is contradicted by the "any entity" language of section 4A, but is directly contradicted by the Supreme Court decision on which it relies. In *United States v. O'Hagan*, the Supreme Court stated that "as written, [section 10(b)] does not confine its coverage to deception of a purchaser or seller of securities; rather the statute reaches *any* deceptive device used "in connection with" the purchase or sale of a security." (citation omitted) (emphasis added).[81] Other cases decided under the Securities Exchange Act generally demonstrate that one can violate Rule 10b-5 (which implements section 10(b)) without being a purchaser or seller of a security.[82]

33. Moreover, section 4A expressly prohibits any entity from "directly or *indirectly*"

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[75] 15 U.S.C. § 717t-2(a)(3)(A).

[76] *Id.* at §§ 717t-2(e)(1) and (2).

[77] *Id.*

[78] *Id.* at §§ 717t-1.

[79] Order No. 670 at PP 2, 18.

[80] *Id.* at P 22.

[81] *O'Hagan*, 521 U.S. 642, 658 (1997).

[82] *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (permitting shareholder suit for damages under Rule 10b-5 where company made misleading statements that affected its own stock).

using a manipulative or deceptive device. The term "indirectly" supports the conclusion that Congress intended the NGA's anti-manipulation prohibition to apply to more than conduct *within* the Commission's traditionally regulated market and more than just the direct wholesale seller of the physical commodity. Amaranth's statutory interpretation effectively reads the term "indirectly" out of the statute, thereby violating the basic rule of statutory construction to give meaning to all statutory terms.[83]

4. The "In Connection With" Requirement

34. Amaranth contends most fundamentally that the Commission lacks jurisdiction over trades outside the physical natural gas markets because of the "in connection with" requirement in NGA section 4A.[84] We find that Amaranth reads the requirement too narrowly and in a manner that precludes the achievement of much of what Congress intended. Congress could have, but did not, prohibit manipulative or deceptive conduct that occurred *in* Commission-jurisdictional markets. Instead, Congress used expansive language that prohibits manipulative or deceptive practices by any entity, directly or indirectly, "in connection with" the purchase, sale or transportation of natural gas historically within the Commission's jurisdiction. We discussed this phrase in the OSC[85] and we revisit it more fully here.

35. Because the clause "in connection with" is undefined, we begin with an examination of ordinary usage.[86] According to Fowler's Modern English Usage, "in connection with" is noted for . . . its "pliability."[87] Furthermore, "connection" is defined by Webster's Third New International Dictionary 481 (1981) as a "relationship or association in thought (as of cause and effect, logical sequence, mutual dependence or involvement."[88] Therefore, in a variety of contexts, courts have broadly and flexibly

[83] *TRW Inc.*, 534 U.S. at 31 (each word in a statute must be given meaning).

[84] Rehearing Request at 26-39.

[85] OSC at PP 50, 110.

[86] *Engine Mfrs. Ass'n v. South Coast Air Quality Mgmt. Dist.*, 541 U.S. 246, 253 (2004) (statutory construction begins with the plain language of the statute and the assumption that the ordinary meaning of the language reflects the statutory purpose); *Bailey v. United States*, 516 U.S. 137, 144-45 (1995) (interpret undefined statutory terms by referring to the term's ordinary usage).

[87] Fowler's Modern English Usage 172 (R.W. Burchfield ed., 3d ed. 1996).

[88] *See also* American Heritage Dictionary of the English Language 400 (3d ed. 1992) (connection is an association or relationship).

interpreted the phrase "in connection with" to encompass a wide variety of relationships and always with an eye to accomplishing statutes' broad remedial purposes.[89]

36. In addition to considering the common definition of language used in the statute, we also evaluate (as we did in Order No. 670) how "in connection with" is used in section 10(b) of the Securities Exchange Act, on which section 4A was modeled.[90] Cases construing section 10(b) and Rule 10b-5, as well as legislative history of section 10(b), are therefore relevant to the Commission's construction of section 4A. In its Rehearing Request, Amaranth claims that only the phrase "manipulative scheme or device" (and not the rest of NGA section 4A) are to be construed consistent with section 10(b).[91] While section 4A states that the phrase is to be so construed, a comparison of identical phrases used throughout section 4A and section 10(b) shows that Congress intended section 4A and the implementing rules to be modeled after section 10(b).

37. The "in connection with" language of section 10(b) has been construed expansively by the Supreme Court to accomplish the broad remedial purposes of section 10(b) which was enacted to restore the integrity of securities markets and promote investor confidence following the stock market crash of 1929.[92] In *Zandford* and *Bankers Life & Cas. Co.*, the Supreme Court upheld the SEC's broad and flexible reading of the "in connection with" requirement of section 10(b) to accomplish the broad

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[89] *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (*Zandford*) ("in connection with" should be read broadly and flexibly, not restrictively); *Superintendent of Ins. of New York v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971); *United States v. Wyatt*, 102 F.3d 241, 247 (7th Cir. 1996) ("in connection with" is interpreted expansively); *United States v. Thompson*, 32 F.3d 1, 6-7 (1st Cir. 1994) (same); *SEC v. Hopper*, No. 04-1054, 2006 U.S. Dist. LEXIS 17772 (S.D. Tex. Mar. 24, 2006) ("[a] plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendants' deceptive conduct affects a market for securities.") (*quoting In re Parmalat Sec. Lit.*, 376 F. Supp. 2d 472, 505-06 (S.D.N.Y. 2005)).

[90] 15 U.S.C. § 717c (2005) (terms are used in the same manner as section 10(b)).

[91] Rehearing Request at 31-32.

[92] *See Zandford*, 535 U.S. at 819 (the "in connection with requirement" of the SEC regulatory scheme, on which the Anti-Manipulation Rule is modeled, should be interpreted flexibly, not technically and restrictively, to accomplish the statutes' remedial purposes of promoting market integrity and investor confidence) (*citing United States v. O'Hagan*, 521 U.S. 642, 651 (1997)); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 78 (2006) ("the magnitude of the federal interest in protecting the integrity and efficient operation of the market for nationally traded securities cannot be overstated"); *Bankers Life & Cas. Co.*, 404 U.S. at 10 (construction of section 10(b) extends beyond maintaining the integrity of securities markets).

remedial purpose of the statute. Here we note the historical similarity of the posture of the Securities and Exchange Commission (SEC) in 1934 to our own situation with respect to the anti-manipulation provisions. In response to the Western energy crisis of 2000-2001, EPAct 2005's parallel anti-manipulation provisions were added to both the FPA and NGA to ensure that the Commission had sufficient tools to address and punish manipulative behavior such as that engaged in by Enron during the crisis. Congress clearly did not want to limit the types of manipulation that might harm jurisdictional markets and thus provided broad, general language to allow the Commission to sanction unforeseen types of manipulation that could harm customers. As the SEC broadly construed the Securities Exchange Act in early enforcement actions to restore confidence in financial markets, we will similarly broadly construe the "in connection with" provision to effectuate the Congressional purpose of the anti-manipulation provisions enacted as part of EPAct 2005.

38. In *Zandford,* the Supreme Court held that the "in connection with" requirement was met when deceptive acts, such as the misappropriation of proceeds from the purchase or sale of securities, coincided with the purchase or sale of securities, even though the transactions themselves are lawful.[93] Similarly, *SEC v. Hopper* held that even though "round-trip" trading (which involves pre-arranged sham transactions designed to artificially increase trading volumes) may not have involved directly the purchase or sale of a security, "a plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendant's deceptive conduct affects a market for securities."[94] Thus, the court held that the alleged fraud which arose from statements about transactions, and not the transactions themselves, may satisfy the "in connection with" requirement if investors considered the energy company's false trading numbers in deciding whether to purchase or sell the company's securities.[95] Indeed, the entire line of

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[93] *Zandford*, 535 U.S. at 819-20 (even though the stockbroker's actual sale of securities was lawful, section 10(b) extends to the stockbroker's scheme to defraud his clients). *See also Bankers Life & Cas. Co.*, 404 U.S. at 12-13 (the "in connection with" requirement is met when the deceptive act of misrepresenting who would receive the proceeds from the sale of bonds "touches" the purchase or sale of a security). *See also Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 596 (2001) (although a formal transaction in the securities market did not take place, section 10(b) applied to an oral contract for the sale of an option on a security, while the seller secretly intended to never allow the purchaser to exercise the option.).

[94] *SEC v. Hopper*, No. 04-1054, 2006 U.S. Dist LEXIS 17772 at *39 (S.D. Tex. Mar. 24, 2006) (*quoting In re Parmalat Sec. Lit.*, 376 F. Supp. 2d 472, 505-06 (S.D.N.Y. 2005)).

[95] *Hopper* at *40-41.

section 10(b) "insider trading" cases where a "tipper" does not herself trade in securities but only the outsider "tippee" does so, are predicated on the notion that the section 10(b) violation need not be directly tied (either contractually or temporally) to the securities trading.[96]

39. In its most recent pronouncement on the "in connection with" requirement, the Supreme Court again reaffirmed the breadth of the phrase. "[W]hen this Court *has* sought to give meaning to the phrase ["in connection with"] in the context of section 10(b) and Rule 10b-5, it has espoused a broad interpretation."[97] Importantly, the Court in *Shadi* also affirmed that this breadth is imported into other statutes where, as with NGA section 4A, Congress replicates section 10(b) language in those other statutes.[98] "Congress can hardly have been unaware of the broad construction adopted by both [the Supreme Court] and the SEC when it imported the key phrase - - 'in connection with the purchase or sale' into" other statutes.[99]

40. Congress' intention to cover a wide range of conduct is further evidenced in the broad remedial purpose and legislative history of section 10(b), wherein the Congressional committee reporting on what became section 10(b) noted that deceptive practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers" in the regulatory agency "have been found practically essential."[100] Similarly, as noted above, the 109th Congress favored the broad prohibitory language we have in the statute today.

41. Amaranth states that in the vast majority of securities cases, the conduct may directly involve the purchaser of a security.[101] But this, even if true, is because the SEC

[96] *E.g. SEC v. Rocklage*, 470 F.3d 1, 8-10 (1st Cir. 2006) (spouse of insider who passed on inside information to a third person, but did not herself trade securities, satisfied the "in connection with" requirement and was found to violate securities trading laws within the meaning of *Zandford* because she knew that the likely result of her tip would be to affect securities trading).

[97] *Merrill, Lynch, Pierce, Fenner & Smith Inc. v. Shadi*, 547 U.S. 71, 85 (2006).

[98] *Id.* at 85-86.

[99] *Id.* at 85 (the court broadly construed the "in connection with" requirement contained in the Securities Litigation Uniform Standards Act of 1998).

[100] *Bankers Life & Cas. Co.*, 404 U.S. at 12 (*quoting* H.R. Rep. No. 1383, 73d Cong. 2d Sess. 7).

[101] Rehearing Request at 32.

would ordinarily seek to punish fraud that is perpetrated against a specific investor by an offeror or seller. In such cases, the sale of a security will be present. The frequency of this fact pattern, however, does not amount to a legal requirement. Where, as here, the Commission is responsible for protecting wholesale markets and the customers that rely on those markets, we believe it is reasonable to interpret section 4A in a way that does not permit market manipulation abuses that, as here, have a direct link to jurisdictional prices of gas, to go unremedied by the Commission.

42. There are multiple decisions holding that the "in connection with" requirement is met under fact patterns similar to those presented in the OSC. The Supreme Court defined market manipulation under Rule 10b-5 as conduct "*controlling or artificially affecting* the price of securities"[102] or practices that "artificially affect market activity."[103] Courts have sustained Rule 10b-5 claims when misrepresentations and omissions are made regarding Treasury bill futures contracts (even though futures contracts are not "securities") because the asset *underlying* the futures contract (a Treasury bill) is a security.[104] Similarly, in this case, the Commission preliminarily concluded in the OSC that Amaranth's trading in NG Futures Contracts actually set the NG Futures settlement price, which is directly incorporated into the pricing of physical natural gas within the Commission's jurisdiction. Given the connections between the trading behavior at issue and physical natural gas markets, a finding that the "in connection with" requirement is met is appropriate.

43. The cases cited by Amaranth to support its narrow construction of the "in connection with" requirement are inapposite.[105] First, *Ontario Pub. Serv. Employees v. Nortel Networks Corp.* is a *standing* case which concludes that one who is not actually injured by securities-related conduct cannot bring a private right of action.[106] Because the court found "that the plaintiffs lack standing under section 10(b), [the court did] not

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[102] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) (emphasis added).

[103] *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977).

[104] *Paine Webber, Jackson & Curtis, Inc. v. Conaway*, 515 F. Supp. 202, 210 (N.D. Ala. 1981). *See also Fisher v. Dean Witter Reynolds, Inc.* 526 F. Supp. 558, 560 (E.D. Pa. 1981) (fraud in the sale of treasury bills futures contracts violates SEC Rule 10b-5).

[105] *See* Rehearing Request at 33.

[106] *Ontario Pub. Serv. Employees v. Nortel Networks Corp.*, 369 F.3d 27, 33 (2d Cir. 2004) (*Ontario*).

reach the 'in connection with' requirement.".[107] Second, Rand v. Anaconda-Ericsson, Inc.[108] (*Rand*) did not hold, as Amaranth contends, that the fraudulent conduct must be *in* a securities transaction. Instead, the court held that a press release declaring a company in default under a security agreement does not violate Rule 10b-5's anti-fraud provision because the prohibited conduct did not have "incidental involvement of securities."[109] The *Rand* court also noted that "misrepresentations about the financial condition of a broker-dealer were 'in connection with' a securities transaction where the broker-dealer's financial strength was directly related to its ability to carry out obligations under agreements calling for the repurchase or resale of government securities. The misrepresentations went to the consideration for a securities transaction."[110] Thus, the *Rand* court clearly acknowledged that the purchase or sale of securities in the securities market is not a pre-requisite to SEC jurisdiction.

44. Amaranth reads the securities cases, particularly *Zandford,* as permitting the "in connection with" test to be satisfied only where the manipulation "coincided with the sales themselves."[111] We do not read the cited language of *Zandford* as the complete expression of the test, but were it so, the test would certainly be satisfied on the facts of this case.[112] The OSC alleges that Amaranth traded between 2:00 and 2:30 PM on each of the three settlement days with the specific intent and actual effect of artificially setting the price of the NG Futures Contracts. Further, the OSC alleges that within an instant of that trading, effectively at 2:31 PM, and as a direct result of that trading, the settlement price became the price for the above-identified physical sales at Henry Hub. It is difficult

[107] *Id.* This decision did not address whether a regulator could enforce a prohibition on the identified conduct.

[108] 794 F.2d 843, 847 (2d Cir. 1986).

[109] *Id.*

[110] *Id.* (*citing* in *SEC v. Drysdale Sec. Corp.*, 785 F.2d 38 (2d Cir. 1986)).

[111] Rehearing Request at 32 (*citing Zandford*, 535 U.S. at 820).

[112] Although the *Zandford* court certainly determined that the securities transactions "coincide"[d] with the wrongful conduct and "therefore were in connection with" securities sales within the meaning of §10(b)," *Zandford* at 822, we do not read the opinion as holding that this "coincidence" is the only way to meet the "in connection with" requirement. We read *Zandford* as supporting the view that "[t]he precise contours of the in connection with requirement are not self-evident. It seems unavoidable 'that the standard be fleshed out by a cautious case-by-case approach.'" *Chem. Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 942-43 (2d Cir. 1984).

to imagine how much more "coincidence" there could be between Amaranth's trading and Commission jurisdictional sales.

45. Finally, post-enactment oversight inquiries from Congress support the Commission's determination regarding its anti-manipulation jurisdiction. Senator Bingaman, who was Ranking Member on the Senate Committee on Energy and Natural Resources when EPAct 2005 was enacted, noted in a letter to the Commission that "the evolution of complex and interrelated markets for financial and physical energy commodities has elevated the importance of the Federal Energy Regulatory Commission's . . . role."[113] The Senator also inquired into "efforts [by the Commission] to monitor *trading of NYMEX gas futures contracts*, especially as it relates to end-of-month natural gas trading."[114] Similarly, the Government Accountability Office (GAO) noted that EPAct 2005 gave the Commission authority to "examine whether financial market transactions, which are not generally under the Commission's jurisdiction, affect the physical natural gas markets over which FERC has authority" and enforce it against any entity, if the manipulative trading, whether intentionally or recklessly, affects physical natural gas markets.[115] These views are consistent with the Commission's interpretation that section NGA section 4A properly applies to "producers, financial companies, local utilities, and natural gas traders, most of which were not previously regulated by FERC," that engage in manipulative conduct that affect the Commission's jurisdictional markets.[116]

B. <u>The Commission's Anti-Manipulation Authority As Compared to the CFTC's Jurisdiction</u>

46. Amaranth's central contention is that manipulation of natural gas markets of the type alleged by the Commission in the OSC is within the CFTC's "exclusive" jurisdiction and, therefore, even if the alleged conduct is covered by the NGA, the Commission is pre-empted from taking action.[117] Explicit in Amaranth's jurisdictional argument is the underlying notion that the financial and physical natural gas markets are "completely

[113] *See* Letter from Senator Bingaman, Chairman, Committee on Energy and Natural Resources, to Joseph Kelliher, Chairman, FERC (Feb. 6, 2007).

[114] *See Id. at* 2 (emphasis added).

[115] U.S. GOV'T. ACCOUNTABILITY OFFICE, ROLES OF FEDERAL AND STATE REGULATORS IN OVERSEEING PRICES at 16.

[116] *Id.* at 15. *See also* Order No. 670 at PP 2, 18, and 22.

[117] Rehearing Request at 12-16.

separate" markets (*see, e.g.* Amaranth CFTC Brief at 15), and that the CFTC is the only agency to police the financial markets, while the Commission may police only the physical natural gas market.[118] We address each argument below.

1. CFTC's Exclusive and Non-Exclusive Jurisdiction

47. Amaranth contends that section 2(a)(1)(A) of the CEA conclusively establishes that the CFTC has exclusive jurisdiction over Amaranth's conduct.[119] The CEA provides that "[t]he Commission [CFTC] shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery."[120] This Commission indisputably recognizes that the CFTC has exclusive jurisdiction over transactions involving contracts of sale of a commodity for future delivery, *i.e.*, futures transactions, just as this Commission has exclusive jurisdiction over rates, terms and conditions of jurisdictional sales of resale of natural gas in interstate commerce, *i.e.*, physical transactions. The fact that the CFTC has exclusive jurisdiction over these activities does not mean that it has exclusive jurisdiction over fraudulent or deceptive practices associated with those transactions, or that other agencies such as this Commission are precluded from examining fraudulent or deceptive conduct in exercising their regulatory responsibilities, particularly where this Commission has been provided express authority with respect to such conduct if it has a nexus to jurisdictional physical sales.[121] For the reasons discussed below, we do not believe it is reasonable to interpret section 2(a)(1)(A) of the CEA, when read in conjunction with other provisions of law, to give the CFTC exclusive jurisdiction over manipulative conduct involving futures transactions.

48. A line of court decisions under the CEA, known as the "exempt commodities cases," support the position that the CFTC does not have exclusive jurisdiction as to manipulation. The CEA provides that "agreements, contracts, and transactions" in "exempt" commodities, such as natural gas, are beyond the CFTC's jurisdiction.[122]

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[118] *Id.* at 13-16.

[119] *Id.* at 22.

[120] 7 U.S.C. § 2(a)(1)(A) (2006).

[121] *See FTC v. Roberts*, 276 F.3d 583, 591 (D.C. Cir. 2001) ("it does not follow from this, however, that Congress intended to preempt the activities of all other federal agencies in their regulatory realms.").

[122] *See* 7 U.S.C. §§ 2(a) (exclusive jurisdiction provision), 2(g) and 2(h) (exemptions from § 2(a)) (2000).

However, to assert jurisdiction over false reporting, manipulation, and other fraudulent and deceptive conduct in exempt commodities, the CFTC successfully argued that manipulation and deceptive conduct, by their very nature, do not involve a "mutual understanding" creating enforceable rights or obligations with counterparties and, therefore, such conduct is not a "contract, agreement or transaction," but merely conduct *related to* a "contract, agreement or transaction" in a commodity.[123] In *CFTC v. Bradley,*[124] the CFTC argued it had jurisdiction under the CEA to punish the manipulative conduct of knowingly providing false and misleading information concerning natural gas transactions. The CFTC argued that such manipulative conduct is not a "contract, agreement, or transaction," because those terms, "as commonly understood, denote[] a mutual understanding between the parties creating rights or obligations that are enforceable or recognized by law."[125] The court sustained that argument.

49. Accordingly, these cases stand for the general proposition that in interpreting the exclusive and non-exclusive jurisdiction under the CEA, manipulation does not involve a mutual understanding or meeting of the minds necessary to consummate an "account, agreement, or transaction," or a "contract, agreement, or transaction" as those terms are commonly understood and, therefore, manipulation is neither excluded from CFTC's jurisdiction over otherwise "exempt commodities" nor is it within the CFTC's *exclusive* jurisdiction. Although most of these cases involved manipulation of markets caused by

[123] *Roberts*, 276 F.3d at 591. *See also CFTC v. Reed*, 481 F. Supp. 2d 1190 (D. Colo. 2007); *U.S. v. Valencia*, No. 03-024, 2003 U.S. Dist. LEXIS 15264 (S.D. Tex. Aug. 25, 2003); and *CFTC v. Atha*, 420 F. Supp. 2d 1373 (N.D. Ga. 2006). These cases involved interpretation of a parallel provision of the CEA that uses the terms "contract, agreement, or transaction." Given the parallel language and same broad remedial purpose, the interpretation should be the same.

[124] 408 F. Supp. 2d 1214 (N.D. Okla. 2005).

[125] *Id.* at 1219 (*quoting* Black's Law Dictionary 318 (7th Ed. 1999)). In *CFTC v. Reed,* 481 F. Supp. 2d 1190 (D. Colo. 2007), the CFTC successfully argued that "false reporting of market information concerning natural gas and attempted manipulation of natural gas price indices [] does not implicate an 'agreement, contract, or transaction.'" *Id.* at 1198 (*quoting U.S. v. Valencia*, No. 03-024, 2003 U.S. Dist. LEXIS 15264 at * 36 (S.D. Tex. Aug. 25, 2003)). *See also CFTC v. Atha*, 420 F. Supp. 2d 1373 (N.D. Ga. 2006) (false price reporting is not an account, agreement or transaction). Most recently, the court in *CFTC v. Johnson*, 408 F. Supp. 2d 259 (S.D. Tex. 2005) held that false reporting of natural gas transactions is not an "account, agreement, or transaction" and, therefore, the CFTC had jurisdiction over attempted manipulation of natural gas prices.

false reporting of information (a fact not present here), the CFTC recently filed a case against Energy Transfer Partners (ETP), alleging attempted manipulation that did not involve false reporting.[126] In *ETP*, the CFTC maintains that it has jurisdiction over manipulative trading in physical natural gas markets, which are otherwise exempt from the CFTC's jurisdiction, because manipulative conduct is not a "contract, agreement, and transaction." By extension, manipulation is also not within the CFTC's exclusive jurisdiction.

50. The case of *FTC v. Roberts* (*Roberts*) is the most recent and comprehensive review of this subject and makes the distinction between the CFTC's exclusive jurisdiction over "accounts, agreements, and transactions" and its non-exclusive jurisdiction over fraudulent and deceptive practices. *Roberts* explained that "while the CFTC has clear statutory authority to regulate a [trader's] deceitful 'practices' .... there is no reason to think the authority is exclusive. A 'practice' or 'course of business' is quite plainly not a 'transaction' – either in life or in this statutory provision. (Nor for that matter is it an 'account' or 'agreement.')."[127] The D.C. Circuit held in *Roberts* that the notion that whatever the CFTC regulates it does so exclusively is a "specious contention."[128] Thus, the case law supports the interpretation that the exclusive jurisdiction provision cited by Amaranth does not apply to Amaranth's alleged manipulative conduct[129] and, the CEA language notwithstanding, "other agencies ... retain their jurisdiction beyond the confines of 'accounts, agreements, and transaction'"

[126] As with this matter, the Commission's staff coordinated its lengthy investigation with a parallel investigation by the CFTC staff into alleged market manipulation of physical natural gas by ETP. Those investigations, as here, resulted in simultaneous enforcement actions by the two agencies, including the CFTC asserting its jurisdiction in a complaint filed in the United States District Court for the Northern District of Texas. *CFTC v. Energy Transfer Partners, L.P.*, Civil Action No. 3-07-Cv. 1301 (N.D. Texas). The Commission's Order to Show Cause issued to *ETP* in IN06-3-002.

[127] 276 F.3d at 591.

[128] *Id.*

[129] *See also SEC v. Hopper*, No, 04-1054, 2006 U.S. Dist. LEXIS 17772 at *37-42 (S.D. Tex. Mar. 24, 2006) (because energy trading transactions were fraudulent and deceptive within the meaning of Rule 10b-5, the SEC could proceed at the same time as the Commission and the CFTC); *U.S. v. Reliant Energy Serv.*, 420 F. Supp. 2d 1043, 1045 (N.D. Cal. 2006) (the Commission's exclusive jurisdiction under the FPA to regulate the transmission and sale at wholesale of electricity in interstate commerce did not preempt the anti-manipulation jurisdiction under the CEA pertaining to electricity prices during the Western energy crisis).

for futures contracts.[130]

51. The majority of cases cited by Amaranth in support of the claim that the CFTC has exclusive jurisdiction in this case address the narrow question of whether CFTC or the SEC has enforcement jurisdiction *in the first instance* over certain market segments and products.[131] None of these cases address whether the particular manipulative activity was subject to the jurisdiction of both agencies or whether the manipulation was "in connection with" the SEC's jurisdictional markets, *i.e.*, whether the conduct might fall within both agencies' non-exclusive jurisdiction. Indeed, in *Chicago Merc. Exch. v. SEC,* the court expressly stated it was not deciding the related question of whether the SEC has authority to apply its anti-fraud rules to commodity options transactions.[132] The other cases cited by Amaranth generally resolve broad questions of whether the SEC could set terms or perform other "prospective" oversight or regulation over designated contract markets, a question not present here.[133] In any event, these cases pre-date the 2000 amendments to the CEA, which affirmed the SEC's jurisdiction over fraud claims involving futures.[134]

[130] *Roberts*, 276 F.3d at 591.

[131] Rehearing Request at 35-36 (*citing Chicago Merc. Exch. v. SEC,* 883 F.2d 537 (7th Cir. 1989), *Chicago Bd. Of Trade v. SEC,* 677 F.2d 1137 (7th Cir. 1982), *SEC v. Am. Commodity Exch.* 546 F.2d 1361 (10th Cir. 1976), and *SEC v. Univest, Inc.*, 405 F. Supp. 1057, 1058 (N.D. Ill. 1975)). Each case resolved a dispute over whether a certain financial product was a futures contract or an option on a futures contract subject to the exclusive jurisdiction of the CFTC, or a security or an option on a security subject to SEC regulation.

[132] 883 F.2d 537 (7th Cir. 1989).

[133] *Chicago Bd. of Trade v. SEC,* 677 F.2d 1137 (7th Cir. 1982); *Chicago Merc. Exch. v. SEC,* 883 F.2d 537 (7th Cir. 1989).

[134] In 2000, Congress passed the Commodities Futures Modernization Act (CFMA), which amended and re-authorized portions of the CEA. One purpose of the CFMA, *inter alia*, was to clarify that the CFTC and the SEC would *share* jurisdiction over products that had characteristics of both securities and futures. Because section 10(b) and Rule 10b-5 serve as the model for section 4A and Order No. 670, the legal precedent upholding the SEC's jurisdiction over fraud and manipulation in these "non-securities" transactions that involve a security as the underlying commodity strongly supports the Commission determination that the CEA does not eclipse section 4A.

2. The CEA "Other Regulatory Authorities" Savings Clause and the Commission's Jurisdiction

52. Even if the conduct alleged by the Commission in the OSC could be read to fall within the text of the exclusive jurisdiction provision of the CEA, "it does not follow. . . . that Congress intended to preempt the activities of all other federal agencies in their regulatory realms. . . . Preemption of the regulation of the market does not also mean preemption of all law that might involve participants in the market."[135] This is clarified in the "savings clause" contained in the CEA.

53. The CEA savings clause, which immediately follows the exclusive jurisdiction provision, states:

> Except as hereinabove provided, nothing contained in this section shall (I) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or any state, or (II) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws.[136]

54. The purpose of any savings clause is to "preserve something from immediate interference."[137] Contrary to Amaranth's claim, there is no evidence that Congress intended the savings clause to prevent a "regulatory overlap" between the CFTC and the Commission over manipulation of natural gas markets. Instead, "[i]nclusion of the so-called 'regulatory savings clauses,' § 2(a)(1)(A)(I)-(II), makes clear that other agencies . . . retain their jurisdiction beyond the confines of 'accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery.'"[138] The expansive anti-manipulation authority given to the Commission in NGA section 4A and FPA section 222 was enacted by Congress five years subsequent to the most recent amendments to the CEA, and several years after the Commission uncovered the manipulative practices occurring in both natural gas and electric markets in connection with its investigation of the Western energy crisis of 2000-2001. More to the point, neither section 4A nor section 222 contain a savings clause, suggesting that Congress did

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[135] *Roberts*, 276 F.3d at 591 (*quoting Poplar Grove Planting and Ref. Co. v. Bache Halsey Stuart Inc.*, 465 F. Supp. 585, 592 (D. La. 1979)).

[136] 7 U.S.C. § 2(a)(1)(A) (2006).

[137] *Knickerbocker Ice Co. v. Stewart*, 253 U.S. 149, 162 (1920).

[138] *Roberts*, 276 F.3d at 591(*quoting Chicago Merc. Exch. v. SEC,* 883 F.2d 537, 550 (7th Cir. 1989) (section 2 "carries no implicit pre-emptive force")).

not intend the CEA to trump the broad authority conferred on the Commission to take action against any entity that directly or indirectly employs, in connection with a purchase or sale subject to the jurisdiction of the Commission, a manipulative device. We interpret the CEA's section 2(a) savings clause to simply preserve any and all authority conferred to the Commission by Congress.[139]

55. Amaranth's argument that the CEA permits the Commission to retain jurisdiction only for matters "beyond the confines of accounts, agreements, and transactions involving contracts of sale of a commodity for future delivery"[140] is not in conflict with our own view. The manipulation in this case (as in the CFTC's cases pertaining to manipulation of physical natural gas) is conduct that goes "beyond" the "confines" of "accounts, agreements, and transactions."[141] However, if there is any doubt on this score, we interpret the savings clause, in conjunction with the broad wording of section 4A itself and Congress' reasons for adding the anti-manipulation provisions to the NGA and FPA, to resolve the issue in favor of our jurisdiction.

56. We do not interpret the phrase "except as hereinabove" in the CEA savings clause to transfer any jurisdiction over "accounts, agreements, and transactions" from other agencies to the CFTC. This would render the savings clause superfluous and would exclude other agencies (both federal and state) from taking any action with respect to those activities and there would be no need for a savings clause. The better view, which is consistent with basic rules of statutory construction and legal precedent discussing the purpose of savings clauses, is that the phrase "except as hereinabove provided" means that, unless Congress expressly modified "hereinabove" the jurisdiction of the SEC or other federal agencies, the jurisdiction of the SEC and other federal agencies remains undisturbed.[142]

[139] Similarly, the savings clause in NGA section 23(c)(2) likewise preserves the jurisdiction conferred by the CEA to the CFTC. That provision does not, as Amaranth contends at page 19 of its Rehearing Request, establish that Congress intended to withhold regulatory power from the Commission.

[140] Rehearing Request at 15.

[141] *Id.* at 15-16.

[142] In fact, Congress did just that in preceding sections where it divided certain areas of responsibility between the CFTC and SEC. *See, e.g.*, 7 U.S.C § 2(a)(1)(D). We recognize that a 1975 decision of a United States District Court, subsequently remanded without opinion, reached a contrary construction of the savings clause. *SEC v. Univest, Inc.*, 405 F. Supp. 1057, 1058 (N.D. Ill 1975). Our review of that opinion discloses virtually no analysis of the issues and we choose instead to follow an analysis which is

3. The Commission's Overall Construction of the Statutes

57. The Commission's jurisdictional determination is in harmony with Congress' more recent expression on these related issues, EPAct 2005, as well as judicial precedent permitting multiple agencies to protect their respective constituents.[143] Indeed, the foregoing analyses are the most reasonable way to harmonize the various provisions and precedents relating to our jurisdiction, the jurisdiction of the CFTC, and cases construing section 10(b) of the Securities Exchange Act, which served as the model for new NGA section 4A and the parallel FPA section 222.[144] It is a basic tenet of statutory construction that when courts are construing different statutes on the same subject matter, they do so in a way that gives effect to each.[145] Amaranth's interpretation undermines the very intent of section 4A to give the Commission ability to sanction manipulation that has a clear nexus to and significant effect on jurisdictional prices.

58. The Commission's determination does not interfere with the CEA's mandate that the CFTC regulate exclusively the day-to-day aspects of futures trading (albeit not manipulation), such as the terms or conditions of sale of NG Futures contracts, the operating rules of the NYMEX exchange, or traders' commodity accounts. The CFTC focuses its efforts on regulating instruments related to sixty-seven products and making

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more consistent with overall statutory scheme before us and the much more recent and thorough analysis of the D.C. Circuit in *Roberts* as noted above.

[143] *See FTC v. Cement Inst.*, 333 U.S. 683, 694 (1948) (two or more agencies may proceed simultaneously against the same parties and the same conduct); *Bristol-Meyers Co. v. FTC*, 738 F.2d 554, 559-60 (2d Cir. 1984) (concurrent Federal Trade Commission/Food and Drug Administration jurisdiction approved); *Warner-Lambert Co. v. FTC*, 361 F. Supp. 948, 952-53 (D.D.C. 1973) (court upheld concurrent enforcement action by the FDA and FTC, even though they involved the same parties or issues, because the statutory remedies of the two agencies are cumulative and not mutually exclusive). *See also U.S. v. Reliant Energy Serv.*, 420 F. Supp. 2d 1043, 1064 (N.D. Cal. 2006) (where two federal laws cover the same conduct, both may be applied because "congressional intent behind one federal statute should not be thwarted by the application of another federal statute").

[144] It is a fundamental canon of statutory construction that statutes relating to the same subject matter should be construed harmoniously and, if not, the more recent or specific statute should prevail over the older and more general law. *Tug Allie-B. v. U.S.*, 273 F.3d 936, 941 (11th Cir. 2001).

[145] *United States v. Borden Co.*, 308 U.S. 188, 191 (1939) (where two statutes address the same subject, the "rule is to give effect to both if possible").

sure that "designated contract markets," such as the NYMEX, operate properly. The CFTC is not focused on the underlying or downstream markets. The Commission respects these exclusive regulatory functions and the CFTC's expertise and exclusive regulatory authority with respect to operation of the futures markets for dozens of commodities. The Commission does not seek to police the NYMEX or other exchanges, nor does the Commission seek to prevent Amaranth from trading on futures markets. Instead, the Commission is exclusively concerned with protecting the integrity and competitiveness of energy markets. When manipulation of NG Futures Contracts spans both financial and energy markets, the Commission has authority to investigate and, if appropriate, punish that manipulation that affects its jurisdictional markets. Congress recognized through EPAct 2005 that both agencies have an enforcement role to protect their respective markets and interests. We pursued this role in the present case and the CFTC has taken similar action in its manipulation case against ETP. There, the CFTC alleged that ETP manipulated futures markets subject to its jurisdiction, even though the alleged misconduct occurred in physical natural gas markets that are subject to our exclusive jurisdiction, not that of the CFTC. There, as here, each agency has merely sought to police manipulation that substantially impairs the competitiveness of the markets it regulates.

59. The legislative history of EPAct 2005 confirms that Congress expanded the Commission's jurisdiction, while the CFTC's day-to-day market oversight program was already well known.[146] In fact, a few Senators expressed concern that the Cantwell Amendment would lead to "unnecessary duplication" of effort by enforcement agencies such as the SEC and the CFTC.[147] Congress nevertheless "put in place the first ever broad prohibition on manipulation in electricity and natural gas markets."[148] Congress knew that it was placing an additional cop on the beat alongside the CFTC and the SEC

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[146] 149 Cong. Rec. S 13997 at 9 (daily ed. Nov. 5, 2005) (statement of Sen. Bennett) (Both the CFTC and the SEC have broad authority to prohibit market manipulation); 151 Cong. Rec. S 7451 at 40 (daily ed. June 28, 2005) (statement of Sen. Cantwell) (the Cantwell Amendment, which was eventually incorporated into EPAct 2005, gave FERC the tools to prevent abuses in energy markets). *See also* 151 Cong. Rec. S 9335 at 16-17 (daily ed. June 29, 2005) (statement of Sen. Cantwell) ("This Energy bill puts in place the first ever broad prohibition on manipulation of electricity and natural gas markets" and is modeled on a measure authored by Senator Cantwell and passed twice in the Senate).

[147] *See* 149 Cong. Rec. S 13997 at 9 (daily ed. Nov. 5, 2005) (statement of Sen. Bennett).

[148] 151 Cong. Rec. S 9335 at 17 (daily ed. July 29, 2005) (statement of Sen. Cantwell).

by giving FERC additional tools to ensure that manipulative and deceptive practices do not occur in energy markets. Thus, Congress expected to hold "FERC [not just the CFTC] accountable if, in fact, manipulative or deceptive practices occur in the future."[149]

60. The legislative history of EPAct 2005 also confirms that Congress expressly rejected a proposal to state that the CFTC's exclusive jurisdiction was not trumped by the NGA. The House Energy and Commerce Committee Report on HR 6 contained a completely new provision to be added to the NGA, known as "section 26," which provided that *nothing* in the NGA shall affect the "exclusive jurisdiction of the [CFTC] with respect to 'accounts, agreements, or transactions in commodities under the CEA.'"[150] However, that provision was rejected, as it does not appear in the final bill. Instead, Congress included only a narrower savings clause in section 23 (Natural Gas Market Transparency Rules), which provides that nothing in that section (pertaining to gathering information from market participants) can be construed to limit the CFTC's exclusive jurisdiction. Nowhere in the EPAct 2005 amendments, whether a savings clause or elsewhere, did Congress indicate any intent to give only the CFTC authority over manipulative practices. Having considered the matter, had Congress intended to confer upon the CFTC exclusive jurisdiction over manipulation occurring in natural gas futures markets, it could have done so explicitly in the NGA section 4A and FPA section 222 sections, incorporated "section 26" into the NGA as a whole, or, at a minimum, included the savings clause in the NGA's Anti-Manipulation provision, section 4A. Instead, section 4A makes no mention of the CFTC's jurisdiction nor does it contain a savings clause, which is included in the more narrowly focused section 23.[151] Congress made an explicit choice to refer to the CFTC's exclusive jurisdiction only in the regulatory arena of information gathering, not in the Anti-Manipulation jurisdictional section at issue here. Thus, with respect to day-to-day regulation, such as gathering data as discussed in NGA section 23, the CFTC's jurisdiction is exclusive and the agencies must work through each other. With respect to enforcement against manipulation as specified in section 4A, jurisdiction is not exclusive and Congress did not include a savings clause. Therefore, Amaranth's arguments about the meaning of this savings clause in section 23 are unpersuasive and, in fact undercut Amaranth's position that Congress intended section 4A to confer only limited jurisdiction to the Commission.

[149] 149 Cong. Rec. S 10173 at 21 (daily ed. July 30, 2003) (statement of Sen. Bingaman). In our view, Congress' delegation to FERC in new section 4A indicates Congress' recognition that the Commission has expertise to bring to bear on matters of energy market manipulation. As we noted in the OSC, Commission staff includes experts in both the physical and financial natural gas markets. OSC at P 52.

[150] H. R. Rep. No. 109-49, at 7 (2005).

[151] *See* EPAct 2005 § 316(c)(1).

61. Amaranth also misconstrues the Commission's discussion in the OSC regarding NGA section 23 and its language pertaining to the MOU with the CFTC.[152] The Commission does not contend that section 23 confers jurisdiction over manipulation claims.[153] The statutory authority to issue the OSC comes from section 4A, not section 23. Instead, the Commission states that section 23 supports its construction of section 4A.

62. The Commission largely agrees with Amaranth that section 23 authorizes the Commission to collect information from market participants about the availability and prices of natural gas. Section 23 reflects Congress' recognition of the potential for the Commission and the CFTC to seek the same information, so it required the Commission and the CFTC to coordinate their data gathering activities. However, there is nothing in section 23 that prohibits the Commission from using that information in any investigation of manipulation, nor is there any language in section 23 suggesting that inter-agency coordination under the MOU would not include investigations. It is an odd notion indeed that Congress intended the Commission to gather information pertaining to exchanges under the CFTC's jurisdiction, but if we thereby detected manipulation affecting our jurisdictional markets to have no enforcement role to punish and deter such manipulation. Unremarkably, the MOU itself and the year-long joint Commission-CFTC investigation of Amaranth's conduct illustrate that both agencies (at least until recently) read the statute to contemplate joint investigation activities that go beyond the collection of information when they agreed that: "the CFTC and the FERC may from time to time engage in oversight *or investigations of activity affecting both CFTC-jurisdictional and FERC jurisdictional markets.*" MOU at 3 (emphasis added).

C. **The Commission's Assertion of Jurisdiction in the OSC As Compared to Order No. 670**

63. Amaranth's final assertion is that the Commission's determination that it has jurisdiction in this matter departs from Order No. 670.[154] Amaranth contends that the statement in Order No. 670 that "this Final Rule does not, and is not intended to, expand the types of transactions subject to the Commission's jurisdiction," is a concession by the Commission that its anti-manipulation subject matter jurisdiction is limited to "wholesale transactions that remain within the ambit of the NGA, NGPA, and FPA."[155] Amaranth's

[152] Rehearing Request at 16-17 (discussing OSC at P 48).

[153] OSC at PP 3, 44-45.

[154] Rehearing Request at 39-41.

[155] *Id.* at 40.

argument, which takes a few words in Order No. 670 out of context, is unavailing.[156]

64. Order No. 670 clarified that EPAct 2005 broadened the Commission's overall jurisdiction to prohibit any entity, directly or indirectly, from using a manipulative or deceptive device in connection with the purchase or sale of natural gas subject to the jurisdiction of the Commission. In Order No. 670 we delineated the elements essential to manipulation: "an entity: (1). . .engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity; (2) with the requisite *scienter*; (3) in connection with the purchase or sale of natural gas . . . subject to the jurisdiction of the Commission."[157] The language Amaranth points to deals only with the second part of the third element. As stated in Order No. 670, and we reiterate here, EPAct 2005 did not affect the Commission's jurisdiction under NGA section 1(b) to regulate ratemaking of interstate commerce and wholesale transactions of natural gas, and non-affiliated entities.[158] In fact, we agreed with commentators in the Anti-Manipulation Rule rulemaking, and re-affirm here, that the scope of "transactions" in that third element is the same as that covered by pre-existing NGA provisions and was not expanded by EPAct 2005.[159] Consequently, in neither Order No. 670 nor the OSC did the Commission assert that EPAct 2005 expanded the types of jurisdictional transactions that would satisfy section 4A's requirement that the affected markets must be "subject to the Commission's jurisdiction." For this reason, by way of example, we noted that a manipulation pertaining only to a "first sale" would not be covered.[160]

65. However, the broad language of section 4A enlarged the conduct (as identified in the other elements) with respect to those transactions that we can regulate.[161] Order No. 670 elsewhere clearly provides that manipulative or deceptive conduct that affects the very same jurisdictional markets identified in section 1(b) would be subject to the

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[156] NARUC characterized Amaranth's argument as "exceptionally convoluted." NARUC *Amicus* Brief at 11.

[157] Order No. 670 at P 49.

[158] 15 U.S.C. § 717b (2005).

[159] Order No. 670 at P 20.

[160] *Id.*

[161] *Id.* at P 21 (specifically rejecting comment urging that section 4A did not increase the Commission's reach beyond the rules already promulgated).

Commission's broader Anti-Manipulation Rule.[162] Moreover, the statement in Order No. 670 that the new regulations apply where there is a *nexus* between fraud and a jurisdictional transaction (as opposed to conduct that *is* a jurisdictional transaction) is consistent with section 4A's "in connection with" requirement.[163] In this case, the Commission preliminarily finds that the requisite nexus is established because Amaranth's manipulation directly and substantially affected *jurisdictional* transactions. Therefore, the Commission's preliminary findings in the OSC are entirely consistent with EPAct 2005, the Anti-Market Manipulation Rule, and Order No. 670.

III. Conclusion

66. The Commission denies Amaranth's request for expedited rehearing on the issue of the Commission's jurisdiction to punish manipulative trading of NG Futures Contracts that had a direct effect on the price of physical natural gas within the Commission's jurisdiction. The Commission's determination is supported by the language of the NGA; it is consistent with, and does not infringe upon, the jurisdiction of the CFTC; and it furthers the objective of the NGA to ensure that energy markets remain fair and competitive. Our tolling order in this docket, dated September 26, 2007, remains in effect as to all other timely filed rehearing requests. In addition, pursuant to the Notice issued October 12, 2007, Respondents shall now answer the OSC, as specified in P 140(a) and (b) of the OSC, not later than 14 days from the issuance of this Order.

The Commission orders:

Amaranth's request for rehearing is hereby denied.

By the Commission.

(S E A L)

Kimberly D. Bose,
Secretary.

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[162] *Id.* at P 22 ("the Commission views the 'in connection with' element in the energy context as encompassing situations in which there is a nexus between the fraudulent conduct of an entity and a jurisdictional transaction.").

[163] *Id.* at P 16 ("[a]bsent such *nexus to a jurisdictional transaction* . . . fraud and manipulation in a non-jurisdictional transaction (such as a first or retail deal) is not subject to the new regulations.") (emphasis added).

Mr. STUPAK. Thank you for your testimony. Mr. Lukken, please, if you would, your testimony. We have four votes on the floor, but we are going to get to this testimony, and then we would recess for a bit. And then we will come back for questions. Mr. Lukken, please.

STATEMENT OF WALTER LUKKEN, ACTING CHAIRMAN, U.S. COMMODITY FUTURES TRADING COMMISSION.

Mr. LUKKEN. Thank you, Mr. Chairman, members of the subcommittee. On behalf of the Commodity Futures Trading Commission, I appreciate the opportunity to appear before you today. The CFTC's mission is broadly two-fold: to protect the public and market users from manipulation, fraud, and abusive trading practices, and to promote open, competitive, and financially sound markets for commodity futures and options.

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and options markets in the United States. With the passage of the Commodity Futures Modernization Act in 2000, the CFTC became the only Federal financial regulator that operates under a principles-based regulatory approach.

A principles-based system requires markets to meet certain public outcomes in conducting the business operations. For example, registered futures exchanges, also known as designated contract markets, or DCMs, must comply with a set of core principles in order to uphold their good standing as a regulated exchange—ranging from maintaining adequate financial safeguards to conducting market surveillance. As technology and market conditions change, exchanges may discover more effective ways to meet a mandate principle and their self-regulatory responsibilities.

The CFTC's regulatory approach is complemented with a strong enforcement arm. Robust enforcement is essential to effective market regulation in order to punish and deter abusive activity in our markets. I call this "prudential regulation with a bite" and our enforcement record reflects this bookends approach.

During the past 5 years, the Commission has filed a total of 295 enforcement actions and obtained more than $1.8 billion in total monetary sanctions, including restitution, disgorgement, and civil monetary penalties. Protecting the energy markets is vital to our national interests because of the direct impact of energy prices on consumers and the economy in general. In the energy sector, during the last 5 years, the Commission has filed 39 enforcement actions, charging 64 individuals and companies with manipulation, attempted manipulation, and/or false reporting.

To date, these actions have resulted in civil monetary penalties of more than $434 million. Most recently, the CFTC and Department of Justice obtained a record settlement of $303 million with BP for manipulating their propane gas market. Indeed, we maintain a zero-tolerance policy toward anyone who attempts to manipulate or disrupt prices in the energy markets.

On this front, I would also note our continued positive working relationship with FERC on many enforcement matters. The CFTC and FERC share the common goal of ensuring that the energy markets remain free from manipulation.

Since the CFTC and FERC entered into a 2005 memorandum of understanding on information sharing, our agencies have had a good collaborative relationship. I am committed to continuing to develop this cooperative relationship, given the inter-relationship between futures and cash markets in the energy sector. As the MOU recognizes, Congress provided the CFTC exclusive jurisdiction over the futures markets. The policies that support this jurisdictional grant by Congress are as important today as they were when they were enacted 35 years ago.

Exclusive jurisdiction of futures trading ensures that the futures markets, where many commodities also have a separate cash market regulator, will not face inconsistent and redundant regulation and the uncertainty of differing legal standards.

But this does not mean that FERC and CFTC's respective enforcement authorities cannot exist in complement of each other, as evidenced by the solid working relationship we share with other Federal and State enforcement authorities. I am committed to striking this balance with FERC. Already, our staffs have met to discuss possible ideas that would further coordinate our missions. I am hopeful that these efforts will help to align the implementation of our mandates going forward.

I would also like to touch on a recent CFTC proposal specifically aimed to reduce concern on exempt commercial markets or ECMs. Congress created the ECM category in 2000 to allow commercial participants to trade energy and certain other products in a light-touch regulatory environment. This spurred innovation and competition to the ECM platform, provided a low cost on-ramp to launch new ideas for contract design and trading methodologies.

However, the success of this type of trading facility has also led policymakers to reexamine whether the regulatory requirements for these exchanges remain adequate. In September the CFTC conducted an extensive hearing on ECMs, several of the witnesses in the prior panel were part of those hearings. We found that certain ECM energy contracts were performing as virtual substitutes for regulated futures contract and may be serving a significant price discovery role.

The Commission concluded that changes to our Act were necessary in order to detect and prevent manipulation involving ECM futures contracts that serve a significant price discovery function. To that end, the Commission recommended legislative changes in a report delivered to Congress that would require, one, large trader position reporting of non-significant price discovery contracts on ECMs; two, position limits or accountability levels for these contracts; three, self-regulatory responsibilities for ECMs; and four, CFTC emergency authorities over these contracts.

This proposal, crafted in full consultation with the President's Working Group on Financial Markets, has the support of the entire Commission. I am pleased to report that the House and Senate Agriculture Committees are actively considering these recommendations. In fact, the full House Agriculture Committee this morning marked up and passed out our recommendations as part of their reauthorization mark.

With these important changes, I believe the CFTC's principles-based approach, in combination with its enforcement arm, will continue to be effective in policing our markets and allowing this industry to continue on its upward path of growth. With that, Mr. Chairman, I yield back the rest of my time, and I appreciate the opportunity to testify today.

[The prepared statement of Mr. Lukken follows:]

Commodity Futures Trading Commission
Office of External Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Testimony

Written Testimony of
Acting Chairman Walter Lukken
Before the Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives
December 12, 2007

Thank you, Mr. Chairman and members of the Subcommittee. On behalf of the Commodity Futures Trading Commission (CFTC or Commission), I appreciate the opportunity to discuss the CFTC, our role with respect to the futures markets, and our view of the markets as the government regulator charged with overseeing them.

CFTC Mission

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The CFTC's mission is broadly two-fold: to protect the public and market users from manipulation, fraud, and abusive practices; and to promote open, competitive and financially sound markets for commodity futures and options. To do this, the Commission employs a highly-skilled and dedicated staff who work to oversee the markets and address any suspicious or illegal market activity.

The Commodity Exchange Act (CEA or Act) grants the Commission exclusive jurisdiction with respect to accounts, agreements, and transactions involving commodity futures and options contracts that are required to be traded or executed on an exchange or a designated contract market, also known as a "DCM." One of the purposes of the CEA is "to serve the public interests . . . through a system of effective self-regulation of trading facilities . . . under the oversight of the Commission." DCMs are regulated entities that are self-regulatory organizations (SROs) subject to comprehensive oversight by the CFTC. DCMs can list for trading any type of contract, they can permit intermediation, and all types of traders (including retail traders) are permitted to participate in their markets. The CFTC's Division of Market Oversight (DMO) is responsible for monitoring and evaluating a DCM's operations and it conducts market surveillance of all activity on DCMs, as described below.

DCMs must comply with a number of designation criteria and core principles as a condition for initial CFTC approval and continuing operation. Once operational, DCMs, as self regulatory organizations (SROs), must establish and devote resources toward an effective oversight program, which includes surveillance of all activity on their markets to detect and deter manipulation and trading abuses. The CFTC regularly assesses the regulatory and oversight activities of DCMs through periodic examinations of DCMs' self-regulatory programs to evaluate their compliance with applicable core principles under the Act and the Commission's regulations.

The CFTC's market surveillance mission regarding DCM activity is to ensure market integrity and customer protection in the futures markets. Traders establishing positions on DCMs are subject to reporting requirements so that CFTC staff and the DCM can evaluate position sizes to detect and deter manipulation. In addition, trade practice surveillance involves compilation and monitoring of transactional-level data by the Commission and the DCM to detect and deter abusive trading such as wash sales, money laundering and trading ahead of customers (trade practice surveillance).

Another mission of market surveillance is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for the estimated 1,400 active futures and option contracts in the U.S., CFTC market surveillance staff monitors the activities of large traders, key price relationships, and relevant supply and demand factors to ensure market integrity.

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advises the Commissioners and senior staff of significant market developments at weekly surveillance meetings (non-public, closed meetings) so they will be prepared to take action if necessary.

It should be noted that surveillance of DCM trading is not conducted exclusively by the Commission. As SROs, DCMs have significant statutory surveillance responsibilities. Typically, however, surveillance issues are handled jointly by Commission staff and the relevant DCM. Typically, the Commission gives the DCM, as the front-line regulator, the first opportunity to resolve any issue arising in its markets. If a DCM fails to take actions that the Commission deems appropriate, the Commission has broad emergency powers under the CEA to order the DCM to take specific actions. The Commission has had to take emergency action four times in its history.

The Commission's Division of Enforcement (Enforcement) also plays a large role in maintaining the fairness and integrity of our markets. At any one time, Enforcement is investigating and litigating with approximately 700 to 1000 individuals and corporations for alleged fraud, manipulation, and other illegal conduct. Working closely with the President's Corporate Fraud Task Force, Enforcement is staffed with skilled professionals who prosecute cases involving complex over-the-counter (OTC) and on-exchange transactions. Enforcement also routinely assists in related criminal prosecutions by domestic and international law enforcement bodies.

During the last five years, Enforcement maintained a record level of investigations and prosecutions in nearly all market areas, including attempted manipulation, manipulation, squeezes and corners, false reporting, hedge fund fraud, off-exchange foreign currency fraud, brokerage compliance and supervisory violations, wash trading, trade practice misconduct, and registration issues.

In the energy sector, Enforcement investigated and prosecuted Enron and BP, dozens of other energy companies, and hundreds of energy traders and hedge funds. At the same time, in other market sectors, Enforcement prosecuted more than 50 hedge funds and commodity pool operators for various violations, and filed actions against more than 360 individuals and companies for off-exchange foreign currency fraud and misconduct.

In CFTC Enforcement actions in federal court, the CFTC may obtain temporary statutory restraining orders and preliminary and permanent injunctions, restitution to victims, disgorgement of ill gotten gains, civil monetary penalties, appointment of a receiver, and the freezing of assets.

The CFTC also refers enforcement matters to the Department of Justice. Criminal activity involving commodity-related instruments can result in prosecution for criminal violations of the CEA and for violations of federal criminal statutes, such as mail fraud or wire fraud.

Exempt Commercial Markets

The Commodity Futures Modernization Act of 2000 (CFMA) included a provision to create a new trading facility known as an Exempt Commercial Market (ECM). ECMs are not "registered with, or designated, recognized, licensed or approved by the Commission." ECMs, as well as transactions executed on ECMs, are statutorily exempt from most provisions of the CEA. Trading on an ECM is not subject to regular, ongoing market surveillance oversight by the Commission. The Commission does retain fraud and manipulation authority over ECMs.

To assist the Commission in carrying out its fraud and manipulation authority, ECMs are required to maintain a record of allegations or complaints received by the trading facility concerning instances of suspected fraud or manipulation and to forward them to the Commission.

ECMs are also subject to certain limited reporting requirements that require an ECM to identify those transactions conducted on the facility with respect to which the ECM intends to rely on the statutory Section 2(h)(3) exemption, and which averaged five or more trades per day over the most recent calendar quarter. With respect to such transactions, the ECM is required to transmit weekly to the Commission certain basic trade information. Information provided by ECMs can provide Commission surveillance staff with information regarding price spikes or unusual divergence between the price of a commodity traded on an ECM and the price of a related commodity traded on a DCM but do not identify individual traders.

In addition, an ECM must maintain for five years, and make available for inspection upon request by the Commission, records of its activities related to its business as an electronic trading facility, including audit trail information sufficient to enable the Commission to reconstruct trading activity, and the name and address of each participant authorized to enter into transactions on the facility. Should the Commission need further information from an ECM, the Commission has the authority to issue a "special call." A special call to an ECM is simply an indication that the Commission's staff is seeking additional information. A special call, in and of itself, is not evidence of improper or illegal market behavior.

Energy products are eligible to be traded on ECMs by institutional participants. Due primarily to the non-retail nature of these markets and the types of transactions executed, policymakers believed the risks associated with these institutional exchanges were low, thus the lower regulatory requirements for these markets.

Because the energy markets have changed dramatically since ECMs began trading, the Commission's regulation of these markets must evolve in kind. Although these exempt markets have increased competition and lowered costs for derivatives trading, certain energy contracts offered on ECMs now function as virtual substitutes for contracts listed on regulated exchanges, with tight correlation and linking of prices and participants.

With this as a backdrop, in September 2007, the Commission convened a hearing to examine the oversight of trading on DCMs and ECMs. Commission staff, exchanges, ECMs, and industry and consumer groups testified before the Commission in a productive debate of the relevant issues. Based on this hearing, in October, the Commission presented a report to Congress detailing the Commission's findings and recommendations regarding these energy markets.

Price discovery is a key determinant to Commission regulation and oversight, as others outside the marketplace begin to use prices to conduct business, such as farmers, utilities and others. As such, price discovery was the primary focus when the CFTC began its review of the regulation of ECMs.

Although ECMs have been evolving over time, the relatively recent linkage of ECM contract settlement prices to DCM futures contract settlement prices raised the question of whether the CFTC has the necessary authority to police these markets for manipulation and abuse. Linkage of contract settlement prices was not contemplated at the time of the CFMA nor at the time of the Commission's 2004 rulemaking regarding ECMs that perform a significant price discovery function. Nevertheless, the Commission is now concerned that ECM cash-settled "look-alike" contracts may provide an incentive to manipulate the settlement price of the underlying DCM futures contract to benefit positions in the "look-alike" ECM contract.

Testimony from the Commission's hearing and staff analysis on this subject led us to conclude that one ECM contract on the InterContinental Exchange (ICE) is serving a significant price discovery role and that ICE and the New York Mercantile Exchange (NYMEX) function as virtual substitutes for each other in this particular natural gas contract. Not only are the products substantially identical in terms and pricing, but the market participants are also the same, with all of the top 25 natural gas traders on NYMEX also trading significantly on ICE. Moreover, economic analysis by our staff indicates that the trading activity in these products on ICE serves a significant price discovery function on 20 percent of the trading days measured.

That said, many witnesses from the hearing testified that ECMs provide a valuable platform for markets seeking a low-cost, effective "on-ramp" to launch new ideas for contract design and trading methodologies. ECMs serve as incubators for new concepts and provide robust competition with DCMs. This competition has spurred established DCMs to respond to ECM initiatives with innovations of their own, whether it is developing new products or accelerating the pace of automation.

However, the reality that some ECM contracts are serving a significant price discovery function leads the Commission to conclude that changes to the CEA are necessary in order for the

Commission to detect and prevent manipulation in these markets. To that end, the Commission issued a report in October recommending changes to the CEA that would require large trader position reporting; position limits or accountability levels; self-regulatory responsibility; and emergency authority over ECM contracts determined to serve a significant price discovery function. These recommendations, crafted in consultation with the other members of the President's Working Group on Financial Markets, have the support of the entire Commission. I am pleased to report that the House Agriculture Committee, which is the CFTC's authorizing committee, has circulated a discussion draft bill for possible markup that includes, among other things, language to implement the Commission's recommendations.

As another outgrowth of the Commission hearing, the Commission is in the process of establishing an Energy Markets Advisory Committee to conduct periodic public meetings on issues affecting energy producers, distributors, market users and consumers in an attempt to facilitate discussion and policy decisions as these markets evolve. Moreover, the CFTC intends to work with FERC in an effort to jointly develop best practices for utilities and others who use the prices of regulated futures markets as benchmarks in pricing their energy products.

I am confident that the Commission's actions strike the right balance between ensuring that these markets remain free of manipulative conduct and still allowing the markets to grow and innovate on U.S. soil.

CFTC Coordination with FERC

The Energy Policy Act of 2005 (EPAct) marked an important milestone in the on-going debate over the appropriate policy for regulating trading activities in our nation's energy markets. As called for by the EPAct, the CFTC and FERC, in October 2005, entered into a Memorandum of Understanding (MOU) to coordinate information sharing. Accordingly, the respective staffs of the Commission and FERC are authorized to share information concerning various issues in the energy markets without the need for cumbersome access requests for each particular matter. To that end, Commission staff remain in regular contact with counterparts at FERC, and FERC staff is routinely invited to attend Commission enforcement briefings and surveillance meetings. The Commission's Enforcement staff also meets quarterly with FERC counterparts to share information on issues and matters of mutual interest.

The CFTC and FERC share the common goal of ensuring that the energy markets remain free from manipulation. I strongly support the broad grant of enforcement authority provided to FERC in the EPAct of 2005 to prevent manipulation of the physical energy markets as well as the goal of avoiding regulatory gaps in the oversight of these markets.

Since the CFTC and FERC entered into the MOU, our agencies have had a largely positive, collaborative relationship. I am committed to continually developing this cooperation given the inter-relationship between the futures and physical energy markets. As the MOU recognizes, Congress granted the CFTC exclusive jurisdiction over the futures markets in connection with FERC's new anti-manipulation powers. These mandates need not be inconsistent, as evidenced by the working relationship we share with other federal and state enforcement authorities. I am committed to finding a similar balance with FERC. Already, our staffs have met to discuss the current MOU and any possible changes to it that would further coordinate our efforts. We are also discussing ways to improve communication between Commissions to enhance collaboration and ideas to educate users of the markets on best practices for benchmarking against these exchange products. I am hopeful that these efforts will help to align our mandates going forward.

Speculation in the Commodities Markets

The current market environment has brought concern about the role that speculators play in affecting prices in our markets. The proper and efficient functioning of the futures markets requires both speculators and hedgers. While certain targeted controls on speculation are appropriate, speculators, as a class, provide the market liquidity to allow hedgers to manage various commercial risks. Unnecessary limitations on the amount of speculation that an individual or entity may engage in could limit the amount of liquidity in the marketplace, the ability of hedgers to manage risks, and the information flow into the marketplace, which could in turn negatively affect the price discovery process and the hedging function of the marketplace.

Recently, the CFTC's Office of Chief Economist examined the markets and the role that speculators play in them. The staff studied the relationship between futures prices and the positions of managed money traders (MMTs), commonly known as hedge funds, for the natural gas and crude oil futures markets. The staff also examined the relationship between the positions of large speculators such as hedge funds and positions of other categories of traders (*e.g.*, floor traders, merchants, manufacturers, commercial banks, dealers) for the same markets.

The study found that when new information comes to the market and creates some price movement, it is the commercial traders (such as oil companies, utilities, airlines) who react to it first. When they react by buying/selling/changing production, they want to hedge their action and they enter the futures markets to do that. The producers need to hedge and need someone to take the other side – that is where the large speculators play a role. The price changes that prompt large hedgers to alter their positions in the very short run eventually ripple through to large speculator participants who will change their positions in response. The hedgers request liquidity for their risk management and the speculators provide the liquidity.

The results also suggest that, on average, large speculators do not change their positions as frequently as other participants, primarily those who are hedgers. The staff also found no evidence of a link between price changes and MMT positions (conditional on other participants trading) in the natural gas market, and found a significantly negative relationship between MMT position changes and price changes (conditional on other participants trading) in the crude oil market. Hence, the report's conclusions show that speculative buying, as a whole, does not appear to drive prices up.

While speculation is critical to the markets, excessive speculation can be detrimental to the markets. Under the CEA, the concept of "excessive speculation" is based on trading that results in "sudden or unreasonable fluctuations or unwarranted changes in the price" of commodities underlying futures transactions. The CEA specifically makes it a violation of the Act to manipulate the price of a commodity in interstate commerce or for future delivery. The CEA does not make excessive speculation a *per se* violation of the Act, but rather, requires the Commission to enact regulations to address such trading (for example, through speculative position limits).

Pursuant to Section 4a of the Act, the Commission has utilized its authority to set limits on the amount of speculative trading that may occur or speculative positions that may be held in contracts for future delivery. The speculative position limit is the maximum position, either net long or net short, in one commodity future (or option), or in all futures (or options) of one commodity combined, that may be held or controlled by one person (other than a person eligible for a hedge exemption) as prescribed by a DCM and/or by the Commission. Moreover, CEA Section 5(d)(5) requires that an exchange, "[t]o reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month . . . shall adopt position limitations or position accountability for speculators, where necessary and appropriate."

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits – and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than one-fourth of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price.

With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, an exchange may replace position limits with position accountability for contracts on financial instruments, intangible commodities, or certain tangible commodities. If a market has accountability rules, a trader – whether speculating or hedging – is not subject to a specific limit. Once a trader reaches a preset accountability level, however, the trader must provide information about his position upon request by the exchange. In addition, position accountability rules provide an exchange with authority to restrict a trader from increasing his or her position.

Finally, in order to achieve the purposes of the speculative position limits, the Commission and the DCMs treat multiple positions held on a DCM's market that are subject to common ownership or control as if they were held by a single trader. Accounts are considered to be under common ownership if there is a 10 percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts.

Violations of exchange-set or Commission-set limits are subject to disciplinary action, and the Commission, or a DCM, may institute enforcement action against violations of exchange speculative limit rules that have been approved by the Commission. To this end, the Commission approves all position limit rules, including those for contracts that have been self-certified by a DCM.

It is clear that speculation is an important component of the futures markets, but there is a point when excessive speculation can be damaging to the markets. As a result, the CFTC closely monitors the markets and the large players in the markets, in addition to position and accountability limits, to detect potentially damaging excessive speculation and potential manipulative behavior.

CFTC Budget

Sufficient resources for the agency must accompany these legal and regulatory tools described in order for the Commission to adequately protect these markets from wrongful conduct. The budget that funds the CFTC's operating divisions, its technology and surveillance operations, and other support staff, is approximately $98 million for the current fiscal year (FY). The FY 2008 President's Budget request for the CFTC is for an appropriation of $116 million and 475 staff -- an increase of approximately $18 million and 17 staff over the FY 2007 continuing resolution appropriation.

We are grateful for the Administration's recognition of the need for increased funding for our agency. The FY 2008 Budget request is a good down payment in an effort to reverse a recent declination in resources at the Commission, but it is, in perspective, a small recognition of the challenge we face.

Since the CFMA was enacted, there has been a seven-fold increase in the rate of new product listings by U.S. exchanges. Nine new DCMs and nine new DCOs have been approved by the CFTC. Electronic trading has soared to approximately 60 percent of total volume this year, and that percentage is steadily increasing. The competition, product innovation, and increasing use of technology fostered by the CFMA meant exponential growth in the futures and option markets, especially during the last few years. It has also meant a continuing evolution of these markets in the form of new trading venues, new trading strategies, new risk management tools, and new customers.

During this period of unprecedented growth for the futures industry, however, the CFTC's resources have been steadily diminishing. The CFTC needs additional staff in almost every program area and currently operates with a staffing numbers at an historic low. This historic low is contrasted by the increase in trading volume, trading platforms, product numbers and complexity, and cross-border business. To say the least, Commission employees are stretched. We have the resources to carry out the Commission's mission on a daily basis by asking more of staff and deferring critical technological needs and other programs, but the CFTC cannot continue on this path much longer.

Technology is critical to enable our professional staff to adequately oversee the markets. However, budget constraints have required the Commission to put new systems development initiatives and hardware and software purchases on hold. For example, Commission investment in technology, as a percentage of total budget, has fallen from approximately 10 percent to around seven percent. This trend is unsustainable given that so much of the growth in the futures industry is directly attributable to investments in technology. It is important that the Commission not be overwhelmed by the technologically innovative industry we regulate.

Conclusion

In summary, the Commission takes very seriously its Congressional mandate to protect the public and market users from manipulation, fraud, and abusive practices. The proper regulation of the nation's energy markets is one of the most significant issues facing this Commission. Energy prices discovered on these markets greatly impact our economy and every American – ranging from residential consumers to main street businesses to Wall Street firms. The CFTC appreciates the opportunity to assist Congress in examining and appropriately adjusting the Commission's authority in this area. Additionally, the Commission remains committed to collaborating with FERC to ensure that the energy markets are free from manipulation. I am grateful to testify today and look forward to answering any questions Committee members have on these pertinent and important matters.

Mr. STUPAK. Thank you, and thank both of you for appearing here today. Unfortunately, we have four votes on the floor right now. So I think we are going to recess until approximately 1:30, 1:35. We should be back by then, and hopefully we will have a chance to take questions, and more members will be back then.

[Recess.]

Mr. STUPAK. We have had the opening statements. We are going to go on with questions. Mr. Kelliher, if I may start with you, sir. Your testimony says, "legislative proposals intended to enclose the Enron loophole and give the CFTC jurisdiction over ICE and other electronic trading venues could affect FERC's ability to oversee natural gas and electric power markets. Many of the same venues trade physical as well as financial contracts, and any limitations on FERC's access to that information could reduce its ability to oversee jurisdictional market." What specific legislative proposals are you referring to, and what authorities are at risk in terms of FERC jurisdiction over trading in exempt commercial markets?

Mr. KELLIHER. Well, we do currently have ability to get information from ICE. First of all, we get information as a client. We buy information. That was discussed in the first panel. We actually think that information is very important to us, but we also occasionally issue a friendly subpoena to ICE. And we get additional information that is non-public from them, and that information is very important to us to monitor markets and look for possible market manipulation. If we were not able to get that non-public information, it would impair our ability to understand the market.

Mr. STUPAK. Well, if it a friendly subpoena, is the contents of the subpoena negotiated out before it is issued?

Mr. KELLIHER. The subpoena, I won't say they invite, but they—the information we get from them is very detailed market information. But the companies that are engaged in transactions, they are blind. They are Company X, Company Y.

Mr. STUPAK. OK.

Mr. KELLIHER. We sometimes want to know who Company X is, and so that—and it is necessary to issue a subpoena. And then they will identify the company. The information remains nonpublic, but that is what we can do currently. We don't want to lose that ability.

Mr. STUPAK. Well, is there any language you would suggest to us to ensure that there is no limitation on your ability to access information and bring enforcement actions?

Mr. KELLIHER. We can provide that information to you, sir.

Mr. STUPAK. OK, in the Energy Transfer Partners case brought by FERC, FERC alleged that the company used its market power in the Houston Ship Channel to drive down the physical price of natural gas and at the same time took a series of short positions on ICE which bet that the price of natural gas at that location would go down. FERC estimated $67 million in unjust profits in just nine trading periods. What is noteworthy is that FERC was alerted by a call to the enforcement hotline.

So would this case of alleged market manipulation have been detected without your call to the hotline, without a call from the hotline?

Mr. KELLIHER. It might have, and FERC investigations, and probably similar with CFTC, begin a number of different ways. In the case of Amaranth, that investigation began by FERC staff monitoring transactions at NYMEX, and NYMEX is a very transparent market and just seeing some price movements that didn't seem to make sense based on our understanding of market fundamentals.

But hotline calls also are a source of—can begin an investigation. Sometimes it is a FERC audit. Sometimes it is a referral from another Federal agency. There really are about 10 different ways an investigation might begin, but in that case, it was a hotline call from——

Mr. STUPAK. Let me ask this. Has FERC initiated any manipulation cases where prices were manipulated upward?

Mr. KELLIHER. We have a number of nonpublic investigations that I am not at liberty to discuss.

Mr. STUPAK. Do you have a number of investigations going now on the upward——

Mr. KELLIHER. We have a good number of current investigations. Some of them may involve upward manipulation. Some of them may involve downward manipulation, but I actually legally cannot discuss them without authorization from the Commission. But I can offer a private briefing. I would be happy to provide a private briefing to you after getting that authorization.

Mr. STUPAK. I am sure some members would be interested. Mr. Kelliher, in the Amaranth case involving manipulation of futures and derivatives markets during the months of February, March, and April of 2006, which then drove down the prices paid in FERC jurisdiction markets, has FERC investigated price increases for 2006 and 2007 winter season that impacted prices in the spring and summer of 2006, which was connected to Amaranth trading standard strategies?

Mr. KELLIHER. We did look at Amaranth trading activity in other months, not just in those months.

Mr. STUPAK. OK.

Mr. KELLIHER. But we are not looking at manipulation of futures. We are looking at manipulation of futures products that affect physical gas consumers. It is entirely possible Amaranth might have—it is hypothetically possible a company—I want to be careful. A company could engage in manipulation of futures that actually has no effect on physical gas consumers, and we would have no interest in that manipulation.

Mr. STUPAK. OK, has FERC given thought to expanding its jurisdiction to cover enforcement of market manipulation outside its current jurisdictional markets involving pipes and wires such as heating oil, crude oil, propane, ethanol, or other?

Mr. KELLIHER. We have not requested that authority.

Mr. STUPAK. Have you given thought to it? Have you discussed it?

Mr. KELLIHER. I think the question has been raised about propane, and I think we have respectfully declined the request. We have not sought that authority over propane and other petroleum products in part because of the nature of our agency. Our authority, with respect to oil, is we set rates for oil pipelines. That is it, and so we have a fairly modest role in oil pipelines that goes back 100 years actually. And the idea of a dramatic expansion is——

Mr. STUPAK. Well, that is why I asked involving pipes and wires so the heating oil goes through pipes, crude oil, propane, ethanol. It is all going to be going through pipes. So I mean and if you are the agency that is there to protect the consumer, think the consumer would expect that protection to be extended.

Mr. KELLIHER. We do comprehensively regulate natural gas pipelines, and we do look for undo discrimination preference by natural gas pipelines as they provide transportation service.

Mr. STUPAK. Well, I am going to stop questions here. I will have questions for Mr. Lukken. We will probably go a second round, so I will turn to Mr. Barton for questions, please.

Mr. BARTON. Thank you. Mr. Lukken, do you know who the chairman of the Energy and Commerce Committee was in the last Congress?

Mr. LUKKEN. I believe it was you, sir.

Mr. BARTON. OK, do you know who the chairman of the Energy Conference was that passed the Energy Policy Act of 2005 in the last Congress?

Mr. LUKKEN. The same.

Mr. BARTON. OK, do you know who put in section 315 of the Energy Policy Act? What Member specifically wanted that language included in the Law?

Mr. LUKKEN. I don't know.

Mr. BARTON. Well, it was the chairman of the committee and the chairman of the conference. Do you think that when it says, "shall be unlawful for any entity, directly or indirectly, to use or employ in connection with the purchase or sale of natural gas or the purchase or sale of transportation services, subject to the jurisdiction of the Commission, which is the FERC, any manipulative deceptive device or contrivance, as those terms are used in section 10B of the Security Exchange Act of 1934, 15 U.S. Code, 78J/B in contravision of such rules and regulations as the Commission may prescribe as necessary in the public interest or for the protection of natural gas rate payers", do you think that any entity doesn't mean any entity?

Mr. LUKKEN. We certainly support the broad grant of jurisdictional authority given to FERC in the EPACT of 2005. However, our mandate is to uphold the Commodity Exchange Act, which also has an exclusive jurisdiction provision enacted by Congress in 1974 to protect against duplicative regulation and differing legal standards in those markets.

So we have to read those two statutes in context.

Mr. BARTON. Now, you are basically, if I understand your agency's position, is that the Congress didn't know what it was talking about here. I mean, you have no reason to know this, but this was put in specifically because of my concerns about this new exchange, the ICE exchange, and what they were doing. I mean, I wanted to go a lot further, but because of concerns from other committees and some of the stakeholders, we agreed in a bipartisan, bicameral basis on this language.

So we have the FERC who gets this authority. They go out and try to use it, and your agency says they can't do it. I mean, do you think that Amaranth was—don't you believe that Amaranth was trying to manipulate markets?

Mr. LUKKEN. Absolutely. That is why we have brought an action against Amaranth for manipulating the futures markets, and we have worked cooperatively with FERC to bring those actions. And indeed, in our Court order, where the Judge has asked our opinion on exclusive jurisdiction, we supported FERC's ability to go forward with the proceeding, but we felt compelled—it was the opinion of our general counsel and the Commission that we have exclusive jurisdiction over these contracts.

Mr. BARTON. Well, then, there is no way you can have exclusive jurisdiction with this statutory authority on the books, and what I want to inform you of, as the acting Chairman, is that this wasn't something serendipitous or inadvertent. It was put in directly because of what since has transpired, and Mr. Kelliher and his compadres at the FERC are doing exactly or at least attempting to do exactly what we hoped they would do, which is work with your agency but use their own authorities to ferret out the bad actors and try to make our markets more open and transparent and accessible in a non-biased way to any willing participant.

So I don't see how your Agency or the Courts can rule, unless they assume that the members of Congress who passed this didn't know what we were talking about and didn't understand the English language. But I want to put on the record at this oversight hearing that this particular section was done at my express request, because of concerns I had at the time about speculation in the oil and gas markets, so that we could give the FERC some authority, which was ambiguous at that time.

This is not ambiguous, and it is my understanding that the lower Court has ruled that because it is a Federal statute, it has to be decided at the Appellate Court. But I can't imagine the Appellate Court reading this language and saying that FERC can't do what they have been attempting to do. So I would encourage you to work with the FERC, and you all decide how to cooperate together instead of arguing on who should be doing it in the first place.

There is more than enough work to go around. This is not an area that we have too many regulators and too many overseers. One could argue, given the budget problems that both of your agencies have had and the cutbacks, that you should be working much more closely together if the Law allows it to share resources.

With that, Mr. Chairman, I am going to yield back. But thank you again for holding this hearing. And thank both of you gentlemen for participating.

Mr. STUPAK. Thank you. Mr. Whitfield, questions, please.

Mr. WHITFIELD. Thank you, Mr. Chairman. Mr. Lukken, one question I would like to ask you. The American Public Gas Association has called for legislation that would require broad market transparency for larger trading positions throughout the exempt markets, including all over-the-counter and bilateral trading. And your recent legislative proposal does not really quite go that far, I believe.

Do you think that the CFTC should implement a broad market transparency requirement throughout these exempt markets and bilateral trading and over-the-counter as well?

Mr. LUKKEN. Well, what our proposal suggested to Congress was that in these exempt commercial markets, when a contract becomes a price discovery contract, a benchmark that others are utilizing in interstate commerce, that additional regulatory authority should occur in those areas. And we have recommended four things.

One, large trader reporting system reports from that exchange regarding those contracts so that we, as a surveillance agency, can monitor the markets, make sure the positions can't be manipulated by certain positions of traders.

Two, accountability and position limits, meaning that NYMEX, which is a regulated market, now has position limits on trading going into the closing of a contract. ICE will also have to put position limits on those products. They will also have to self-regulate themselves. They have to become their own watchdog with responsibilities to the Commission as well as give us emergency authority of those markets.

Now, you talk about in addition the bilateral markets outside. It is our intention that our section 18.05 rule, 18.05 authority, gives us the ability to go into those bilateral markets on a need-to-know basis to ask for that information. Anything that is traded on an ECM or a DCM are regulated markets and we are recommending those markets would also have to keep records on any things related to those bilateral transactions. So if you are holding a bilateral swap that may affect the futures position, you have to keep those records for 5 years, and we would have the ability to go in and ask for them if we see an anomaly in pricing on the marketplace.

Mr. WHITFIELD. Right, I came in as Joe Barton was asking some questions, and I think he touched on this a little bit. But on this Amaranth case, my impression is that FERC and your agency have worked closely on that case. Is that correct?

Mr. LUKKEN. Correct.

Mr. WHITFIELD. You have shared information, but it is still your agency's position that FERC really does not have legal jurisdiction. Is that true?

Mr. LUKKEN. That is correct.

Mr. WHITFIELD. OK, and now my understanding, Mr. Kelliher, that there has been some initial Court rulings on that very point. Is that correct?

Mr. KELLIHER. Yes, we have had at least three or perhaps four decisions by the Courts. There have been attempts to impose temporary restraining orders, stays, and injunctions on our enforcement action. All of which have been rejected, one as recently as Monday of this week.

Mr. WHITFIELD. Right.

Mr. KELLIHER. And the decision Monday was interesting, because it actually did discuss the statutory interpretation of the anti-manipulation provision.

Mr. WHITFIELD. But the decision on Monday—give me a synopsis of that Decision.

Mr. KELLIHER. It was rejecting a request for an injunction, and it was arguing that, I think in this case, I think it was Amaranth or Mr. Hunter. Was this Amaranth? Hunter was the lead trader at Amaranth, and he was seeking an injunction, and it rejected his petition because it argued that he had failed by quite a lot to demonstrate that there be any kind of irreparable harm.

Mr. WHITFIELD. Right.

Mr. KELLIHER. But they also went a little bit further, and for them to grant an injunction, he would have to prove the likelihood of success on the merits. The Court actually discussed that to some extent and said, that would mean he would have to prove that FERC has no authority under the anti-manipulation provision of the Energy Policy Act. Now, the Court had a brief discussion of that, suggesting that they thought that he had no basis for that argument.

Mr. WHITFIELD. Well, I mean, I certainly agree with the Court, and I think it has been very clear that this committee feels like FERC does have jurisdiction. And certainly want to commend FERC for the aggressive action they took in this case and with that, Mr. Chairman, I will yield back the balance of my time.

Mr. STUPAK. Thank you. Mr. Lukken, let me follow up with something Mr. Whitfield asked you. You were talking about the bilaterals in rule 1805. That is sort of after the fact though, isn't it? I mean, you can't look at it while these things are going on. You get the information after the fact, correct?

Mr. LUKKEN. Well, we would be able to find out—in order for a manipulation to occur, you need the means to manipulate but also the profit motive.

Mr. STUPAK. Right.

Mr. LUKKEN. So you need the means being the benchmark, the pricing benchmark that we are looking at, and the profit center being maybe these bilateral trades that are occurring. And so what we have said is, if you are involved in the benchmark markets, if you are looking at significant price discovery markets and there is a pricing concern of ours, we have the ability to go ask for that information in the bilateral marketplace.

Mr. STUPAK. Well, let me ask you this, do bilateral markets, using standardized contracts, have an impact on the discovery or the price discovery process for energy commodities?

Mr. LUKKEN. We did not find a strong correlation in the bilateral market as far as becoming a price discovery mechanism in the exempt commercial markets. I would say, though, that it is in our rule or the proposal we sent up to Congress, it does not limit these potential price discovery contracts to only clear trades. These could potentially go into bilateral contracts as well that are traded on ECM.

Mr. STUPAK. Yes, but our last panel, Mr. Cota, Professor Greenberger, and Ms. Campbell of the American Gas, they all thought that they do, in fact, have an impact, and they do have an impact on the price discovery process.

Mr. LUKKEN. I believe they were referring to the ECM product, bilateral products being traded on the ECMs. I was not here for their entire testimony, but there are certainly bilateral contracts trading on an exempt commercial market that we will begin to see if those contracts become significant price discovery contracts.

Mr. STUPAK. In the book right there, go to tab No. 18, if you would, please. Let me ask you a question. Tab 18 should be the NYMEX large trader disclosure form. "A NYMEX rule requires traders who want to hold more than 1,000 contracts in a final day of a trading of the prompt month to disclose all over-the-counter and forward contract positions including those executed through bilateral trades." Since disclosure is required in this instance, is there a reason that large positions executed in bilateral markets cannot be routinely reported to the CFTC?

Mr. LUKKEN. So this is them opening up their books? Well, I think——

Mr. STUPAK. Right, couldn't they do the same thing to you so you could really look at it? Do you have real-time numbers or at least a prompt month?

Mr. LUKKEN. I think the focus of our report was to really look at where price discovery was occurring, which is on the electronic marketplace. You know, this would be a lot of information coming into our markets, and our surveillance economists. You know, the marginal beneficial nature of these bilateral contracts, we would be overwhelmed as far as an agency in trying to monitor and put them into systems that would be relevant for us. So I think for us the tailored focus concern was going to be the ECMs and making sure we got that information on an ad hoc basis to go into the bilateral markets and ask for that information. But certainly we would be overwhelmed if we were asked to receive information from the entire bilateral market.

Mr. STUPAK. Well, what is the size of the bilateral market?

Mr. LUKKEN. It dwarfs the exchange rated market. It is very large.

Mr. STUPAK. Well, isn't that room for more speculation and more profit taking in the larger market as opposed to a small one, which you are looking at?

Mr. LUKKEN. Well, again, if it starts to bleed into the price discovery contracts, that is when the public interests arise in our concerns and regulations.

Mr. STUPAK. But you wouldn't know that until after the fact. Wouldn't you have more current information if they were required to disclose this form as they do at NYMEX?

Mr. LUKKEN. Well, they would be on our market's trading that we would see. It wouldn't be after the fact. We would see pricing anomalies on our marketplace.

Mr. STUPAK. Let me ask you this question. Has the CFTC assessed the risk of whether traders will move from ICE to bilateral trading on overseas markets once a discovery regime is imposed on trading of price discovery contracts? Do you think they will move to foreign bilaterals?

Mr. LUKKEN. Well, in testimony at our hearing in September, this was one of the listed points we asked witnesses to address—the U.S. competitiveness issue, where the markets would move. It seemed to be the consensus that this tailored approach to regulation would be a way to get at the information, make sure that manipulation was not occurring on these ECM markets, but also ensure that markets didn't move overseas. So that was the balance that we tried to strike.

Mr. STUPAK. We heard concerns from the previous panel about foreign boards of trade. Do you consider the UK Financial Service

Authority to have equivalent market rules as those imposed by the CFTC in its designated contract markets?

Mr. LUKKEN. Equivalent may be too strong of a word, but comparable. Certainly, in the international regulatory community, they are one of the strongest regulators around, the Financial Services Authority. In fact, they are quoted by many in our Government and in the private sector as the model we should be going towards.

Mr. STUPAK. Does FSA, the Financial Services Authority in the UK, do they require position limits on financially settled contracts to prevent excessive speculation?

Mr. LUKKEN. They do not, but they also have different requirements that our agency does not require. So again, this is how these regulatory authorities have grown up and the history of all with that.

Mr. STUPAK. Then why would the CFTC then approve no-action letters allowing foreign boards of trade to operate in the U.S.? You said they are not equivalent. They are comparable. I guess that is sort of a subjective standard. If they don't require position limits on financially settled contracts, then why would we give them these no-action letters, as you call it?

Mr. LUKKEN. The no-action letter, this is something we debated at length at the Commission last year—we held hearings on this. We looked into this, and no action, you must understand, is almost the registration of these exchanges. They have to come in, show us how these rules are comparable in the UK to our rule books here at the exchanges. We go through a broad analysis of the regulatory system in the United Kingdom in making our——

Mr. STUPAK. But isn't it sort of like, hold us to what we say, not what we do?

Mr. LUKKEN. No, we condition the no-action arrangement with receiving large trader information from these markets. So it is not that these are outside of our view. In fact, one could argue they have two regulators looking at these markets, both the United Kingdom and our surveillance staff because we are getting large trader reporting on a weekly basis, leading up to the final week of expiration, and then on a daily basis.

Mr. STUPAK. Well, you have a memorandum of agreement, don't you, with the financial services in England?

Mr. LUKKEN. Yes.

Mr. STUPAK. So what information is specifically shared between you and the CFTC and FSA?

Mr. LUKKEN. It is large trader reporting information, similar to what we get from market participants and exchanges here in the United States. We also hold quarterly meetings with them to discuss enforcement cases. Our surveillance economists talk to them all the time on these issues.

Mr. STUPAK. Let me ask you this, because Professor Greenberger brought it up—has the CFTC assessed whether trading on ICE futures for financial energy commodities, such as the New York Harbor Reformulated Gasoline, New York Harbor Heating Oil, or West Texas Intermediate Crude Oil, has an impact on the price discovery on the NYMEX?

Mr. LUKKEN. ICE futures in Atlanta or ICE futures——

Mr. STUPAK. In Atlanta.

Mr. LUKKEN. In Atlanta. What we looked at, and this is what our rulemaking will go to and what the House Agriculture Committee today marked up, is that if any of these products become a significant price discovery contract traded on ICE on the exempt market, we would be able to get this information from them, once that occurs. So certainly we understand that there can be an influence from these exempt markets on regulated markets. And once that price discovery threshold is met, regulation would occur.

Mr. STUPAK. Would that same answer hold true if it was the futures in the UK, ICE futures in UK, being closed out in UK?

Mr. LUKKEN. Well, they are a fully regulated exchange, so they are being regulated by the United Kingdom.

Mr. STUPAK. Can trading on ICE futures be used as part of a strategy to manipulate energy prices?

Mr. LUKKEN. Sure, and we have brought cases on that.

Mr. STUPAK. And why is the CFTC's approving no-action letters, which allow U.S. traders to trade financial energy commodities such as New York Harbor Gasoline, Heating Oil, or West Texas Intermediate Crude Oil without requiring the trading platform to become a designated contract market and subject to your jurisdiction, the CFTC's jurisdiction?

Mr. LUKKEN. Well, it is a very good question, but these are global commodities. Even though West Texas is in the name, the oil is traded as a global commodity. It is relied on around the world, and so we want to make sure that, as a world product, that other nations around the world are also being open to our markets. So by allowing access to the UK of our traders, with conditions and full review by our staff, we also ensure that our markets have access to other overseas so that our markets here in the United States can grow.

Mr. STUPAK. And without requiring the trading platform to become a designated contract market, aren't you sort of only hurting the integrity of the market?

Mr. LUKKEN. Well, this is the mutual recognition concept that is currently being debated on the securities side right now. In fact, the Securities and Exchange Commission is looking into whether to adopt a similar, comparable, but not identical, type of mutual recognition system that would most likely recognize the UK FSA. So this is something that is the global standard of how regulators talk to each other around the world and interact. And we are certainly a leader in this area.

Mr. STUPAK. My time has expired. Mr. Walden, for questions, please.

Mr. WALDEN. Thank you, Mr. Chairman. Appreciate that. I wanted to follow up with Mr. Lukken, with you. You heard me ask Professor Greenberger about your report, and he said that your report really was done before the collapse of Amaranth. Is that accurate, and do you still stand by the conclusions of your report that this speculative market isn't substantively driving up the price of oil gas?

Mr. LUKKEN. Our report was done on crude oil. It was not done on natural gas, which is the subject matter of the Amaranth investigation. But it was dealing with a similar commodity and how hedge funds and other speculative interests behave in those markets. And it was the conclusion of our chief economist and his staff that published the paper, that these were really price followers more than price makers in those markets. It has been updated. We have updated it up until most recently, I think, through November I believe. Is that correct? So it is updated to even account for the recent run-up in oil prices as well.

Mr. WALDEN. And the conclusion remains the same?

Mr. LUKKEN. I think the conclusions have remained exactly the same. Is that correct?

Mr. WALDEN. All right, Mr. Kelliher.

Mr. LUKKEN. Having said that, we do have controls in place on speculation. We recognize it can be excessive, and we do have certain things that we put into place to control against that excessive speculation.

Mr. WALDEN. So I just want to clarify. You don't think it is a $20 to $30 a barrel part of the margin in oil right now then, speculation?

Mr. LUKKEN. I could only speculate. Sorry.

Mr. WALDEN. Have you had experience, or that is what I want to know. And is there somebody making money through a derivative through the—never mind. Go ahead.

Mr. LUKKEN. But we have looked into that claim that there is a $30 premium. We don't know any economic basis on which we are trying to figure out who said that. I think some of this might be sort of gut feels of traders involved and analysts. And those are real feelings that should be brought to light, but we have based our findings on economic data that we have through the positions of traders. And we feel more comfortable talking about those positions.

Mr. WALDEN. All right. Yes, it is Professor Greenberger who said in his testimony $20 to $30 a barrel. Mr. Kelliher, do you have any comment on that?

Mr. KELLIHER. No, I am not familiar with the CFTC analysis, but I don't have any reason to dispute Chairman Lukken.

Mr. WALDEN. But from your own agency's perspective?

Mr. KELLIHER. No, our authority in oil is just limited to oil pipeline rates.

Mr. WALDEN. What about natural gas?

Mr. KELLIHER. Natural gas, we have jurisdiction over wholesale gas markets, pipelines, LNG projects.

Mr. WALDEN. But do you see speculation in that market as described by some of the other witnesses today?

Mr. KELLIHER. There is speculation, and there is risk management. And I think similar to CFTC we view use speculation by itself as harmful.

Mr. WALDEN. Right.

Mr. KELLIHER. It is a necessary part of markets.

Mr. WALDEN. And so you don't see evidence of harmful speculation then? Is that what you are saying?

Mr. KELLIHER. We look for manipulation. Manipulation is what we look for. We look for undo discrimination and preference. Those are the evils that we are focused on. So we are not looking for excessive speculation per se.

Mr. WALDEN. OK, so let me get the term right then. Let us use manipulation of the market. You do see some of that happening, has happened?

Mr. KELLIHER. Yes.

Mr. WALDEN. And that more regulation is needed over ICE?

Mr. KELLIHER. I will defer to CFTC on regulation of futures. We think we have the authority we need at FERC to regulate in our jurisdiction. We think you gave us the right tools 2 years ago, and I defer to CFTC on what authority they need.

Mr. WALDEN. And you think, Mr. Lukken, that the legislation that came out of the Ag Committee today while we were holding this hearing just coincidentally gave you the authority you need?

Mr. LUKKEN. We believe, yes.

Mr. WALDEN. OK, I don't think I have any other questions, Mr. Chairman. I again want to thank you for holding this hearing. It is a very important issue. Thank you.

Mr. STUPAK. Thank you. Mr. Green, for questions.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Kelliher, the CFTC has said it is exclusive regulator over futures markets. Frankly, this is for both of you because our interest on the committee is to see—we want the regulation, and we just happen to have jurisdiction over FERC and obviously the Agriculture Committee, I guess, has it over CFTC.

But the exclusive regulator of the futures market, do you believe FERC's exercise of the anti-manipulation authority weakens the CFTC's role? And adding into that, I have a question about the memorandum of understanding. Is there some way that—because energy is easier understood in FERC whereas CFTC has so many other commodities they deal with other than energy? And just appreciate an answer from both of you.

Mr. KELLIHER. Go ahead.

Mr. LUKKEN. OK.

Mr. GREEN. Has it weakened CFTC's role if FERC exercises the anti-manipulation authority under EPACT 2005?

Mr. LUKKEN. You know, one of our mandates is to make sure that the markets are open, competitive, and transparent to ensure the integrity of the market. And any time there is confusion on differing legal standards, duplicative regulators in the space, I think there is cause for concern that these markets may choose other alternatives that they may have to trade. So that is what we try to minimize.

I completely agree with Joe. We share the goal of preventing manipulation no matter where it occurs. We hope that there are no gaps, try to minimize duplication when we can. But we think that these markets deserve legal certainty, and certainly the exclusive jurisdiction provides that for these markets.

Mr. KELLIHER. And we don't think that our enforcement action interferes with CFTC regulation. We don't think there is a dual regulation here because there is one regulator. It is the CFTC. There are two investigations that really have been announced in recent months that are—they are not joint investigations strictly speaking, but they are coordinated and parallel investigations.

The other one, as I mentioned in my testimony, was the Energy Transfer Partners investigation. In that case, that involved, we believe, involved manipulation in FERC jurisdictional markets, physical gas sales that affected other physical gas products as well as financial products. So manipulation occurred in our space, if you will, we think and then extended to CFTC space.

Now they are conducting enforcement action of their own that involves an area where FERC has exclusive jurisdiction. We don't view that their enforcement action undermines or threatens or impairs FERC's exclusive jurisdiction over physical natural gas because they are not regulating in the sense that we regulate that market. They are not setting a rate. They are not revoking a blanket certificate. They are not doing the things that are regulation under the Natural Gas Act. So we don't see that their enforcement action undermines our authority, and we similarly don't see why our enforcement action undermines their authority. But it is an honest disagreement.

Mr. GREEN. Well, how does MOU working if we can, we ought to have the two agencies who complement each other really in the energy markets that there can be—can there be a joint effort? I mean I have never heard of agencies, Federal agencies doing that. But it would seem like it would be needed in this, particularly the sensitivity of the price fluctuations for my industrial consumers but also for my constituents.

Mr. LUKKEN. Well, I think the original intent of the MOU was on information sharing, making sure each of us could uphold the mandate of their act. We have different legal interpretations of what our acts require of us, so it is difficult for an MOU to try to change what we believe the Law to be, each of us respectively. So it is something, I think, we are looking at. Our staff have talked about ideas of trying to approach this to coordinate better, going forward to try to avoid, as best we can, these situations in the future. But again this is an honest legal dispute between the two agencies that the Courts are currently and actively considering.

Mr. GREEN. Well, and that is my next question. Energy Transfer Partners, CFTC is prosecuting alleged manipulation of physical markets which was under FERC's jurisdiction because of their effect on the futures market, which are under CFTC's. How is that going to balance out? Because I guess I have an interest because Energy Transfer Partners is doing things in my area. I mean sure, nationwide, but at home.

Mr. LUKKEN. Our statutory mandate on manipulation covers the futures markets, but Congress granted us also cash market action. And up until 2005, we were the only people in that space, so we brought lots of cash market authorities in light of the western energy crisis and Enron debacle. So this is something we are still trying to work out, how to best divide the authority between the two agencies. But you raise a good point, that maybe we should think about where the expertise of each regulator lies and how that might help us to guide where we divide jurisdiction.

Mr. KELLIHER. And I would just like to comment. I really don't think it is unusual that more than one Federal agency might prosecute the same underlying offense. I mean it happened a few years ago where CFTC was prosecuting false reporting with respect to natural gas sales, and the Justice Department also was taking fraud actions against the same companies and individuals. So I don't think it is unusual that the same activity might violate two different Laws that are administered by two different agencies.

And we are not, for example, charging anyone with violating the Commodity Exchange Act. CFTC is not charging anyone with violating the Natural Gas Act. We both are given these different duties by Congress, different responsibilities. Sometimes the same behavior violates more than one Federal Law.

Mr. GREEN. Mr. Chairman, I know my time is up, but I don't know what the bill is doing that has come out. It was just was reported out today in Ag Committee, but I would hope it would foster that relationship so, again, the beneficiary are the citizens and whether it be corporate citizens or individuals ones. And I know we don't have jurisdiction over that, but we definitely have it on the floor and to be able to have an interest in it, particularly when you come from energy-producing areas or chemical-producing areas. So thank you, Mr. Chairman.

Mr. STUPAK. Thank you. Mr. Lukken, you indicate that, besides Professor Greenberger, you don't know of anyone else who agreed with the idea it is $20 to $30 more per barrel of oil in the price that we are paying right now. Do you know a Mr. Gatt of Oppenheimer and Company? Are you familiar with him?

Mr. LUKKEN. I understood he testified yesterday before the Senate.

Mr. STUPAK. He has indicated in a couple of articles, LA Times, New York Times, it is $20 to $30 excess speculation brings to the price of a barrel of oil. Are you familiar with Ms. Foss, the chief energy economist at the Center for Energy Economics at the University of Texas?

Mr. LUKKEN. I am not. I am sorry.

Mr. STUPAK. OK, in the ENE News, Energy Environment News, she also indicates $20 to $30. So there is a lot of support out there. Kyle Cooper from the IAAF advisor out of Houston, Texas, and Miami Herald they report the same things. So there is a lot of authority besides Professor Greenberger. But let me ask you this. Do you agree with Professor Greenberger's testimony that the CFTC proposal will lead to further regulatory arbitrage because once subject to CFTC regulation traders will simply move their trading to other contracts which are exempt from regulation?

Mr. LUKKEN. I don't agree with that. I think our proposal is trying to get at the electronic exchange like facility, which is the exempt markets. Now, people go to those markets because of the benefits that these type of multilateral trading facilities provide. Clearing, creditworthiness that those markets provide, transparency of what the pricing might be provided in the bilateral marketplace.

Mr. STUPAK. Yes, but didn't NYMEX provide the same thing?

Mr. LUKKEN. Correct.

Mr. STUPAK. So why did people move to ICE?

Mr. LUKKEN. Well, I am talking once our proposal is put into place. Then we will have the ability to see these markets to get the information——

Mr. STUPAK. So you don't think they will move to bilaterals either, through the phone or electronics?

Mr. LUKKEN. It is a different trading environment in the multilateral space. I think those markets are beneficial, and people come to them for a reason not purely regulation.

Mr. STUPAK. Well, they go there to avoid regulation.

Mr. LUKKEN. Again, this is something we discussed as part of our hearing in September, and these are the recommendations we made.

Mr. STUPAK. Mr. Kelliher, let me ask you this. In your testimony, and we are talking about the exclusive jurisdiction on future markets and your testimony, CFTC contends that FERC lacks legal authority to prosecute Amaranth, you know, been all through that. But in your testimony, you state, and I am quoting now, "it is much harder for CFTC to prove manipulation than FERC." Why is this the case? Could you explain that a little bit further? The way I look at it, why would the futures industry rather have CFTC prosecuting their case as opposed to FERC other than fines?

Mr. KELLIHER. Well, there is a difference in penalty authority, which you——

Mr. STUPAK. Right.

Mr. KELLIHER. I think our penalty authority is something like eight times larger than CFTC. The one proposed change in the Commodity Exchange Act, I will express an opinion, is in the penalty provisions, and CFTC has proposed to have the same kind of penalty authority we have, and I think that is completely appropriate.

Mr. LUKKEN. And that was passed this morning.

Mr. STUPAK. Congratulations.

Mr. KELLIHER. So I think that is one reason why some participants in the futures industry might prefer that FERC not have any authority to pursue manipulation, the difference in penalty authority, which may soon be eliminated. But we each have an intent standard on manipulation. They have a specific intent standard, which is my understanding. We have a lower intent standard, and reckless disregard can constitute intent for purposes of a FERC manipulation.

Mr. STUPAK. So you have a broader standard?

Mr. KELLIHER. Excuse me?

Mr. STUPAK. A broader standard?

Mr. KELLIHER. We have, I think it is fair to say, a lower standard, where reckless disregard is sufficient to constitute intent for a FERC manipulation case. That is because Congress 2 years ago gave us securities Laws to model, not commodities Law.

Mr. STUPAK. OK. Mr. Walden, anything further?

Mr. WALDEN. I do, Mr. Chairman. I think we are all trying to figure out how much speculators may or may not—manipulation. I will get the term correct here. How much manipulation may or may add to the price of natural gas or oil. And these Energy Information Administration testified recently, I guess it was yesterday, and said they believe supply and demand fundamentals, including strong world economic growth driving and increasing consumption, moderate non-organization of petroleum-exporting countries, OPEC supply growth, OPEC members' production decisions, low OPEC spare production capacity, tightness in global commercial inventories, worldwide refining bottlenecks, and ongoing geopolitical risk, and concerns about supply availability have been the main drivers of oil price movements over the past several years. Do you concur with that statement?

Mr. LUKKEN. Well, our staff that look at these markets agree that fundamentals are very tight right now in these markets. You look at supply, storage, geopolitical risk where those production facilities are, demand from India and China. There are lots of reasons fundamentally why those markets are tight and why prices are high. Having said that, we still make sure that controls are in place to look for excessive speculation by any individual that tries to take advantage of this tightness and move the markets, try to manipulate them.

That is why we have position limits. That is why we get position trader data on a daily, real-time basis from these folks, to see if this is occurring. So, yes, the fundamentals are tight. We follow speculation closely, and we have controls in place to make sure manipulation does not occur.

Mr. WALDEN. Let me ask you this, because I believe it was Mr. Cota, is that right, who testified earlier, said that we were at 5-year highs in supply. Is that accurate, and is it that demand is also still exceeding even that 5-year estimate? I may have gotten the data wrong. Maybe it is 5-year supply in storage.

Mr. LUKKEN. I have just been informed by our chief surveillance economist that crude oil storage is actually going down. I think Mr.—was it Kato?

Mr. WALDEN. Cota.

Mr. LUKKEN. Cota, I am sorry.

Mr. WALDEN. I am sorry. My apologies.

Mr. LUKKEN. I should know that. I think he was talking about heating oil. But as far as crude oil, storage has been going down.

Mr. WALDEN. And natural gas? Where are we in terms of the supply/demand curve on that?

Mr. LUKKEN. We actually have lots of natural gas right now. We are at record highs, predictions of a warmer winter, no hurricanes activity coming into last year has allowed supplies to increase. So, it's a much more comfortable situation on the natural gas.

Mr. WALDEN. So is the price going down then?

Mr. LUKKEN. Prices are at a lower level than historically for natural gas.

Mr. WALDEN. Do you know what they are at right now in the U.S.?

Mr. KELLIHER. Seven-dollar range.

Mr. WALDEN. That is still a lot higher than it used to be, right? I mean it seemed to me we ran a $2 to $3 natural gas for a long time. I mean, I am glad it is down, but I hate to think we are cheering at $7.

Mr. KELLIHER. It is lower than what it was before the hurricanes. Before Hurricanes Katrina and Rita, natural gas prices had climbed significantly, and then they went very high after the hurricanes. But they haven't quite retreated to where they were a number of months before the hurricanes.

Mr. WALDEN. And when do we think that might happen, if even?

Mr. KELLIHER. It may not happen.

Mr. WALDEN. And the reason for that?

Mr. KELLIHER. North American natural gas supply is no longer sufficient to meet North American gas demand.

Mr. WALDEN. And what happens if Congress enacts some sort of cap and trade system on especially coal? Do you see a shift then to natural gas as a replacement source of power for coal? I read a story recently that the number of coal plants that have been put on hold that were planned to be constructed. Are you seeing that trend?

Mr. KELLIHER. We are seeing that as well. Some coal plants are still being considered. Some are being approved, but there has been very wide scale cancellation of coal plants. And the Commission looked at this actually fairly recently, and we have looked at under any scenario, any climate change scenario. Well, under any climate change scenario, natural gas use will go up in the United States. And it——

Mr. WALDEN. And that is because the pressure will be to reduce coal as a fuel source for electricity?

Mr. KELLIHER. For a number of reasons. First of all, if you look at nuclear plants, they have a long lead time, for example. Coal plants, some of the technology is not yet available. Some of, you know, the sequestration.

Mr. WALDEN. Compression.

Mr. KELLIHER. Some of the technologies are not available now.

Mr. WALDEN. Right.

Mr. KELLIHER. Wind, a lot of the wind potential is tied to transmission expansions.

Mr. WALDEN. Right.

Mr. KELLIHER. If you want to see wind expansion in this country, we need to build a lot more transmission.

Mr. WALDEN. Thank you.

Mr. KELLIHER. And transmission has a long lead time. So if you add it all up, it really means we are placing a very big bet on natural gas prices for the next 10 years, the availability of supply as well as the price of supply, and that is something that is important to understand as Congress——

Mr. WALDEN. And have your economists projected, given us some models about what we can anticipate natural gas prices to be based on different scenarios of cap-and-trade.

Mr. KELLIHER. We have not. I think there probably are other estimates, but we have not estimated that.

Mr. WALDEN. OK, I think that is something eventually we are going to need, especially if Congress is going to mark up some sort of cap and trade climate change legislation, whether it is the straight carbon tax like Mr. Dingell, our Chairman, proposed at 50 cents per gallon of gasoline, or whether it is some other shift.

And then I think we have to remember—I understand that electricity produced from natural gas still emits about two-thirds the amount of carbon that coal-produced electricity emits. So I mean you are reducing a third, but you are really shifting the market to a commodity that is in great demand now. And its resource is far more limited than coal, correct?

Mr. KELLIHER. Yes, sir, I think that is true.

Mr. WALDEN. All right, are you starting to see in the market any speculation, the good speculation—I won't go to manipulation—but using your terms, to begin to hedge for what may happen either globally or nationally when it comes to carbon and carbon emissions and some sort of restrictions on them?

Mr. LUKKEN. Well, I think part of the carbon gets to the energy question, which is what you are referring to. And we are seeing greater liquidity in out months of exchanges so that people are now trading further into the future to hedge that risk, which is beneficial for the marketplace. They can lock down prices in order to manage their risk.

We also regulate an exempt market in this space, the Chicago Climate Exchange, which is a voluntary exchange organization. It gets participants who produce carbon to sign up and to trade that carbon on a volunteer contractual basis. And certainly that is a working example going forward that Congress should study when they are looking at these type of cap-and-trade systems.

Mr. WALDEN. All right. Thank you, Mr. Chairman. You have been most generous with the excess time.

Mr. STUPAK. One more, if I may. Mr. Lukken, CFTC's principles include position limits for look-alike contracts on ICE, such as natural gas swaps. And that is what was marked up today, you said, in the Ag Committee?

Mr. LUKKEN. It is product neutral, so whatever the contract might be.

Mr. STUPAK. OK, explain the economic rationale for including position limits then on financially settled contracts. Is that so you don't have excess speculation?

Mr. LUKKEN. Well, because they can influence the physical contract, they are based somewhat on the price of the physical contract, that is why we require accountability limits, I think, on the financials actually and position limits on the physical contracts in New York. So this would treat these contracts comparable to how they are treated on a regulated exchange currently.

Mr. STUPAK. OK. Go to tab 16 there in the book there. So we talked about ICE, and it is basically a UK trading there. It is foreign boards of trade receiving staff no-action letters permitting direct access from the U.S. And there is a number of them. Like the first one, Montreal. Do they have position limits?

Mr. LUKKEN. I might have the wrong tab here.

Mr. STUPAK. 16.

Mr. LUKKEN. I have the——

Mr. STUPAK. You got the wrong one.

Mr. LUKKEN. Report on enforcement. I will double check here.

Mr. STUPAK. Hang on. We may have the wrong one for you. We will have someone bring it down to you. We will have Kyle bring it down to you, Mr. Lukken.

Mr. LUKKEN. OK.

Mr. STUPAK. I am not sure you have the right one. We have two binders up here, investigative binder and exhibit binder. So all these have no-action letters. So I think we pretty much established that ICE, probably about the eighth one down, ICE Futures Europe, they have—that is UK—they have similar as us.

But what about the other ones, like Montreal here, Dubai, Frankfort, Zurich, Amsterdam, Paris, Leipzig, Hong Kong. You go to the next page. You go Sydney, Australia, Singapore, Tokyo, Alberta, Mexico City, Barcelona. Do they have position limits?

Mr. LUKKEN. I think some do, some don't. This is again, these have been issued over a series of over 10 years since 1996, I think was the first one. Again, we go through a full-blown analysis by our staff looking at the regulatory regime that is requesting this as well as the exchange itself, whether it has rules in place to prevent manipulation and look for this type of activity. Many of these are conditioned on certain authorities that we receive, most recently the FSA document. We require them to give us large trader information.

So we can tailor these to make sure that they are based on risk that we are getting the information we need to conduct our mandate.

Mr. STUPAK. Well, I started to say that if they are large traders and there is no position limits, it opens it up for possibly more speculation, correct?

Mr. LUKKEN. Well, even though there are no position limits, we still see the positions. So we have the ability, if we see a large position that concerns us—it may not be a per se violation, more than 500 contracts, but if it is above a level that may draw concern by our economists, we are willing to call these people up, talk to the UK authorities about it. We are looking at this. It is just that the position limits, the hard limits that some of our exchanges have in place aren't in place in the UK.

Mr. STUPAK. Well, how do you set that? How do you determine under section 6A that we talked about earlier in the first panel, speculation if you don't have the jurisdiction over them? You see what I am trying to say? If they have the letters, then you really don't have a lot of jurisdiction over it. Then how do you know if you get to that excessive speculation?

Mr. LUKKEN. We do have jurisdiction over these entities. We are able to go in and take enforcement action against a U.S. trader, performing a manipulation on a different market that may affect our markets. That is within the reach of our jurisdiction.

Mr. STUPAK. Even on the foreign boards of trade?

Mr. LUKKEN. Yes.

Mr. STUPAK. But they have to have some kind of action in the U.S., do they not?

Mr. LUKKEN. Well, normally that is when our interests arise, yes. If there is a U.S. customer trader——

Mr. STUPAK. Or use a computer terminal in United States?

Mr. LUKKEN. Well, the computer terminal in this case, I mean it is mostly U.S. access so it is U.S. participants. We have not been given a situation where it is only a U.S. computer terminal.

Mr. STUPAK. So the access of the U.S. would be if it was intended to reach the U.S. shores, the product?

Mr. LUKKEN. If it had an impact on our markets, we work closely with the United Kingdom to try to go after that activity.

Mr. STUPAK. Well, I know UK, but I am talking about the other ones like Dubai or Singapore.

Mr. LUKKEN. We just sent a couple of employees from our enforcement staff to Dubai to investigate some dealings there. So it certainly is something that we closely correlate with all these jurisdictions.

Mr. STUPAK. So any trade, future trade, as long as it has some nexus to the United States would be subject to your jurisdiction and enforcement?

Mr. LUKKEN. I am not sure legally how far we have tested this. But certainly if we have a nexus to our markets or U.S. customers, we will try to pursue that. And if not, we will work closely with our foreign regulatory counterparts to go after that activity.

Mr. STUPAK. I was thinking more if this committee wrote something that gave you very, very broad nexus, computer terminal and intended shipment started for U.S., to give as much jurisdiction as we can to have enforcement action to take the excessive speculation out of these prices.

Mr. LUKKEN. I would be cautious. I mean, you have to understand that many of the products traded here in the United States, the largest product traded in the United States is the Chicago Mercantile Exchange Euro Dollar contract, a product that is based on the London, the Libor rate of interest rate. Certainly any action that we try to impose—jurisdictional authorities over things traded elsewhere, there may be the possibility of reciprocal action by foreign authorities limiting access to those products.

Mr. STUPAK. Understood. Mr. Walden, anything further?

Mr. WALDEN. No.

Mr. STUPAK. With that, let me thank both of you for your time and your patience today with us. And thank you for your testimony.

That concludes our questions. I want to thank all of our witnesses for coming today and for your testimony. I ask unanimous consent that our hearing record remain open for 30 days for additional questions for the record.

Without objection the record will remain open. I ask unanimous consent that the contents of our document binder be entered into the record. Without objection, they will be entered.

That concludes our hearing. This meeting of the subcommittee is adjourned.

[Whereupon, at 2:38 p.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs
Norm Coleman, Chairman
Carl Levin, Ranking Minority Member

THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT

STAFF REPORT

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

UNITED STATES SENATE

JUNE 27, 2006

SENATOR NORM COLEMAN
Chairman
SENATOR CARL LEVIN
Ranking Minority Member
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

RAYMOND V. SHEPHERD, III
Staff Director & Chief Counsel

ELISE J. BEAN
Staff Director & Chief Counsel to the Minority

LELAND B. ERICKSON
Counsel

DAN M. BERKOVITZ
Counsel to the Minority

Permanent Subcommittee on Investigations
199 Russell Senate Office Building – Washington, D.C. 20510
Main Number: 202/224-3721; 202/224-7042 (fax) ★ Minority Office: 202/224-9505; 202/224-1972 (fax)
Web Address: www.hsgac.senate.gov [Follow Link to "*Subcommittees*," to "*Investigations*"]

THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT

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THE ROLE OF MARKET SPECULATION IN RISING OIL AND GAS PRICES: A NEED TO PUT THE COP BACK ON THE BEAT

June 27, 2006

I. EXECUTIVE SUMMARY

For the past five years, the United States Senate Permanent Subcommittee on Investigations has conducted a number of investigations into the pricing of energy commodities, including gasoline, crude oil, and natural gas.[1] These investigations reflect a continuing concern over the sustained increases in the price and price volatility of these essential commodities, and, in light of these increases, the adequacy of governmental oversight of the markets that set these prices.

Over the past six years crude oil, gasoline, and natural gas prices have risen significantly. Crude oil has risen from a range of $25-$30 per barrel in 2000, to a range of $60-$75 per barrel in 2006. High crude oil prices are a major reason for the record or near-record highs of the prices of a variety of petroleum products, including gasoline, heating oil, diesel fuel, and jet fuel. The average price for a gallon of regular unleaded gasoline has jumped from $1.46 per gallon in 2000 to $2.36 per gallon over the past 12 months, with peaks at $3.14 per gallon in September 2005, and $2.93 per gallon in May 2006. Rising crude oil prices have helped push up natural gas prices as well: the price of natural gas has risen from $2-$3 per million BTU (British Thermal Unit) in 2000 to a typical range of $6-$8 per million BTU during the past year.

The traditional forces of supply and demand cannot fully account for these increases. While global demand for oil has been increasing – led by the rapid industrialization of China, growth in India, and a continued increase in appetite for refined petroleum products, particularly gasoline, in the United States – global oil supplies have increased by an even greater amount. As a result, global inventories have increased as well. Today, U.S. oil inventories are at an eight-year high, and OECD oil inventories are at a 20-year high. Accordingly, factors other than basic supply and demand must be examined. For example, political instability and hostility to the United States in key producer countries, such as Nigeria, Venezuela, Iraq, and Iran, threaten the security and reliability of these supplies. Furthermore, in each of the past two years hurricanes have disrupted U.S. oil and gas production in the Gulf of Mexico. As Saudi Arabia has increased its rate of production to meet increasing demand, its ability to pump additional oil in

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[1] See, e.g., Minority Staff, U.S. Senate Permanent Subcommittee on Investigations, *U.S. Strategic Petroleum Reserve: Recent Policy Has Increased Costs to Consumers But Not Overall U.S. Energy Security*, S. Prt. 108-18, 108th Cong., 1st Sess. (March 5, 2003); Majority Staff, Senate Permanent Subcommittee on Investigations, *Gas Prices: How Are They Really Set?*, reprinted in *Gas Prices: How Are They Really Set*, Hearings Before the Senate Permanent Subcommittee on Investigations, 107th Cong., 2nd Sess. (April 30 and May 2, 2002), at p. 322; U.S. General Accounting Office, *Effects of Mergers and Market Concentration in the U.S. Petroleum Industry*, Report to the Ranking Minority Member, Senate Permanent Subcommittee on Investigations, GAO-04-96 (May 2004); *Volatility in the Natural Gas Market: The Impact of High Natural Gas Prices on American Consumers*, Hearing Before the Senate Permanent Subcommittee on Investigations, 109th Cong., 2nd Sess. (February 13, 2006).

the event of a shortfall has declined, thereby providing less of a cushion in the event of a supply disruption. It is often asserted that these fears over the adequacy of supply have built a "risk premium" into crude oil prices.[2]

In addition, over the past few years, large financial institutions, hedge funds, pension funds, and other investment funds have been pouring billions of dollars into the energy commodities markets – perhaps as much as $60 billion in the regulated U.S. oil futures market alone – to try to take advantage of price changes or to hedge against them. Because much of this additional investment has come from financial institutions and investment funds that do not use the commodity as part of their business, it is defined as "speculation" by the Commodity Futures Trading Commission (CFTC). According to the CFTC, a speculator "does not produce or use the commodity, but risks his or her own capital trading futures in that commodity in hopes of making a profit on price changes." Reports indicate that, in the past couple of years, some speculators have made tens and perhaps hundreds of millions of dollars in profits trading in energy commodities. This speculative trading has occurred both on the regulated New York Mercantile Exchange (NYMEX) and on the over-the-counter (OTC) markets.

The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil to be delivered in the future in the same manner that additional demand for the immediate delivery of a physical barrel of oil drives up the price on the spot market. As far as the market is concerned, the demand for a barrel of oil that results from the purchase of a futures contract by a speculator is just as real as the demand for a barrel that results from the purchase of a futures contract by a refiner or other user of petroleum.

Although it is difficult to quantify the effect of speculation on prices, there is substantial evidence that the large amount of speculation in the current market has significantly increased prices. Several analysts have estimated that speculative purchases of oil futures have added as much as $20-$25 per barrel to the current price of crude oil, thereby pushing up the price of oil from $50 to approximately $70 per barrel. Additionally, by purchasing large numbers of futures contracts, and thereby pushing up futures prices to even higher levels than current prices, speculators have provided a financial incentive for oil companies to buy even more oil and place it in storage. A refiner will purchase extra oil today, even if it costs $70 per barrel, if the futures price is even higher.

As a result, over the past two years crude oil inventories have been steadily growing, resulting in U.S. crude oil inventories that are now higher than at any time in the previous eight years. The last time crude oil inventories were this high, in May 1998 – at about 347 million barrels – the price of crude oil was about $15 per barrel. By contrast, the price of crude oil is now about $70 per barrel. The large influx of speculative investment into oil futures has led to a situation where we have high crude oil prices despite high levels of oil in inventory.

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[2] *See, e.g.*, Daniel Yergin, Testimony Before the U.S. House of Representatives Committee on Energy and Commerce, May 4, 2006.

As former Federal Reserve Chairman Alan Greenspan recently explained in testimony before the Congress, over the past few years "there has been a major upsurge in over-the-counter trading of oil futures and other commodity derivatives."[3] Hedge funds and other institutional investors have accumulated "substantial net long positions in crude oil futures, largely in the over-the-counter market."[4] According to Mr. Greenspan, these futures positions have created an additional demand for oil for future delivery, and "with the demand from the investment community, oil prices have moved up sooner than they would have otherwise." Mr. Greenspan states these price increases have stimulated additional oil production, a large increase in oil inventories, and a partial scale-back of consumption.[5]

In general, speculative trading brings greater liquidity to the futures market, so that companies seeking to hedge their exposure to commodity prices can find counterparties willing to take on those price risks. Speculative purchases of futures contracts can also, in effect, finance the production and storage of the underlying commodity to meet future demand. On the other hand, large speculative buying or selling of futures contracts can distort the market signals regarding supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the overall economy.

A key responsibility of the CFTC is to ensure that prices on the futures market reflect the laws of supply and demand rather than manipulative practices[6] or excessive speculation.[7] The Commodity Exchange Act (CEA) states, "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity."[8] The CEA directs the CFTC to establish such trading limits "as the Commission finds are necessary to diminish, eliminate, or prevent such burden."[9]

At the same time that there has been a huge influx of speculative dollars in energy commodities, the CFTC's ability to monitor the nature, extent, and effect of this speculation has been diminishing. Most significantly, there has been an explosion of trading of U.S. energy

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[3] Statement of Alan Greenspan before the Committee on Foreign Relations, United States Senate, June 7, 2006.

[4] *Id.*

[5] *Id.*

[6] 7 U.S.C. Sec. 5(b),

[7] 7 U.S.C. Sec. 6a(a).

[8] *Id.*

[9] *Id.*

commodities on exchanges that are not regulated by the CFTC. Available data on the nature and extent of this speculation is limited, so it is not possible for anyone, including the CFTC, to make a final determination about the current level of speculation.

In *Irrational Exuberance*, which forecast of the collapse of stock market prices in 2000-2001, Professor Robert Shiller wrote of the importance of understanding the role of speculation in setting market prices. "We need to know confidently whether the increase that brought us here is indeed a *speculative bubble* – an unsustainable increase in prices brought on by investors' buying behavior rather than by genuine, fundamental information about value. In short, we need to know if the value investors have imputed to the market is not really there, so that we can readjust our planning and thinking."[10]

To a certain extent, whether any level of speculation is "excessive" lies within the eye of the beholder. In the absence of data, however, it is impossible to begin the analysis or engage in an informed debate over whether our energy markets are functioning properly or are in the midst of a speculative bubble. Again, Professor Shiller has warned, "It is a serious mistake for public figures to acquiesce in the stock market valuations we have seen recently, to remain silent about the implications of such high valuations, and to leave all commentary to the market analysts. . . . The valuation of the stock market is an important national – indeed international issue."[11] This advice would appear to be as relevant to the energy markets as to the stock market.

Until recently, U.S. energy futures were traded exclusively on regulated exchanges within the United States, like the NYMEX, which are subject to extensive oversight by the CFTC, including ongoing monitoring to detect and prevent price manipulation or fraud. In recent years, however, there has been a tremendous growth in the trading of contracts that look and are structured just like futures contracts, but which are traded on unregulated OTC electronic markets. Because of their similarity to futures contracts they are often called "futures look-alikes." The only practical difference between futures look-alike contracts and futures contracts is that the look-alikes are traded in unregulated markets whereas futures are traded on regulated exchanges. The trading of energy commodities by large firms on OTC electronic exchanges was exempted from CFTC oversight by a provision inserted at the behest of Enron and other large energy traders into the Commodity Futures Modernization Act of 2000 in the waning hours of the 106th Congress.

The impact on market oversight has been substantial. NYMEX traders, for example, are required to keep records of all trades and report large trades to the CFTC. These Large Trader Reports, together with daily trading data providing price and volume information, are the CFTC's primary tools to gauge the extent of speculation in the markets and to detect, prevent, and prosecute price manipulation. CFTC Chairman Reuben Jeffrey recently stated: "The Commission's Large Trader information system is one of the cornerstones of our surveillance

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[10] Robert J. Shiller, *Irrational Exuberance* (Princeton University Press, 2000), at p. 5.

[11] *Id.*, at pp. 203-204.

program and enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation."[12]

In contrast to trades conducted on the NYMEX, traders on unregulated OTC electronic exchanges are not required to keep records or file Large Trader Reports with the CFTC, and these trades are exempt from routine CFTC oversight. In contrast to trades conducted on regulated futures exchanges, there is no limit on the number of contracts a speculator may hold on an unregulated OTC electronic exchange, no monitoring of trading by the exchange itself, and no reporting of the amount of outstanding contracts ("open interest") at the end of each day.

The CFTC's ability to monitor the U.S. energy commodity markets was further eroded when, in January of this year, the CFTC permitted the Intercontinental Exchange (ICE), the leading operator of electronic energy exchanges, to use its trading terminals in the United States for the trading of U.S. crude oil futures on the ICE futures exchange in London – called "ICE Futures." Previously, the ICE Futures exchange in London had traded only in European energy commodities – Brent crude oil and United Kingdom natural gas. As a United Kingdom futures market, the ICE Futures exchange is regulated solely by the United Kingdom Financial Services Authority. In 1999, the London exchange obtained the CFTC's permission to install computer terminals in the United States to permit traders here to trade European energy commodities through that exchange.

Then, in January of this year, ICE Futures in London began trading a futures contract for West Texas Intermediate (WTI) crude oil, a type of crude oil that is produced and delivered in the United States. ICE Futures also notified the CFTC that it would be permitting traders in the United States to use ICE terminals in the United States to trade its new WTI contract on the ICE Futures London exchange. Beginning in April, ICE Futures similarly allowed traders in the United States to trade U.S. gasoline and heating oil futures on the ICE Futures exchange in London.

Despite the use by U.S. traders of trading terminals within the United States to trade U.S. oil, gasoline, and heating oil futures contracts, the CFTC has not asserted any jurisdiction over the trading of these contracts. Persons within the United States seeking to trade key U.S. energy commodities – U.S. crude oil, gasoline, and heating oil futures – now can avoid all U.S. market oversight or reporting requirements by routing their trades through the ICE Futures exchange in London instead of the NYMEX in New York.

As an increasing number of U.S. energy trades occurs on unregulated, OTC electronic exchanges or through foreign exchanges, the CFTC's large trading reporting system becomes less and less accurate, the trading data becomes less and less useful, and its market oversight program becomes less comprehensive. The absence of large trader information from the electronic exchanges makes it more difficult for the CFTC to monitor speculative activity and to

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[12] Letter from Reuben Jeffery III, Chairman, Commodity Futures Trading Commission, to Governor Jennifer Granholm, August 22, 2005.

detect and prevent price manipulation.[13] The absence of this information not only obscures the CFTC's view of that portion of the energy commodity markets, but it also degrades the quality of information that is reported. A trader may take a position on an unregulated electronic exchange or on a foreign exchange that is either in addition to or opposite from the positions the trader has taken on the NYMEX, and thereby avoid and distort the large trader reporting system. Not only can the CFTC be misled by these trading practices, but these trading practices could render the CFTC weekly publication of energy market trading data, intended to be used by the public, as incomplete and misleading.

It is critical for U.S. policy makers, analysts, regulators, investors and the public to understand the true reasons for skyrocketing energy prices. If price increases are due to supply and demand imbalances, economic policies can be developed to encourage investments in new energy sources and conservation of existing supplies. If price increases are due to geopolitical factors in producer countries, foreign policies can be developed to mitigate those factors. If price increases are due to hurricane damage, investments to protect producing and refining facilities from natural disasters may become a priority. To the extent that energy prices are the result of market manipulation or excessive speculation, only a cop on the beat with both oversight and enforcement authority will be effective.

Extending the CFTC's large trader reporting system to require all U.S. traders of energy futures or futures-like contracts to keep records and report large trades to the CFTC, regardless of where the trade takes place – on the NYMEX, on an unregulated OTC electronic exchange, or on a foreign exchange – will eliminate the gaps in large trader reporting requirements. This action is necessary to preserve the CFTC's ability to oversee energy futures markets in order to detect and prevent price manipulation and excessive speculation.

[13] Enron's manipulation of prices on its unregulated electronic trading platform demonstrates the widespread economic harm that may result from abuses in unregulated markets. In 2002, for example, the Federal Energy Regulatory Commission (FERC) found that 174 trades between Enron and one other party in the last hour of trading in Enron's electronic market on January 31, 2001, resulted in a steep increase in the price of natural gas on that date. The report tentatively concluded that Enron OnLine price data was susceptible to price manipulation and may have affected not only Enron trades, but also increased natural gas prices industrywide. See, e.g., August 2002 report prepared by the FERC staff, Docket No. PA-02-000.

II. FINDINGS AND RECOMMENDATIONS

Based upon its investigation into the role of market speculation in rising oil and gas prices, the Subcommittee staff makes the following findings and recommendations.

A. Findings

1. Rise in Speculation. Over the past few years speculators have expended tens of billions of dollars in U.S. energy commodity markets.

2. Speculation Has Increased Prices. Speculation has contributed to rising U.S. energy prices, but gaps in available market data currently impede analysis of the specific amount of speculation, the commodity trades involved, the markets affected, and the extent of price impacts.

3. Price-Inventory Relationship Altered. With respect to crude oil, the influx of speculative dollars appears to have altered the historical relationship between price and inventory, leading the current oil market to be characterized by both large inventories and high prices.

4. Large Trader Reports Essential. CFTC access to daily reports of large trades of energy commodities is essential to its ability to detect and deter price manipulation. The CFTC's ability to detect and deter energy price manipulation is suffering from critical information gaps, because traders on OTC electronic exchanges and the London ICE Futures are currently exempt from CFTC reporting requirements. Large trader reporting is also essential to analyze the effect of speculation on energy prices.

5. ICE Impact on Energy Prices. ICE's filings with the Securities and Exchange Commission and other evidence indicate that its over-the-counter electronic exchange performs a price discovery function – and thereby affects U.S. energy prices – in the cash market for the energy commodities traded on that exchange.

B. Recommendations

1. Eliminate Enron Loophole. Congress should eliminate the Enron loophole that currently limits CFTC oversight of key U.S. energy commodity markets and put the CFTC back on the beat policing these markets.

2. Require Large Trader Reports. Congress should enact legislation to provide that persons trading energy futures "look-alike" contracts on over-the-counter electronic exchanges are subject to the CFTC's large trader reporting requirements.

3. Monitor U.S. Energy Trades on Foreign Exchanges. Congress should enact legislation to ensure that U.S. persons trading U.S. energy commodities on foreign exchanges are subject to the CFTC's large trader reporting requirements.

4. Increase U.S.-U.K. Cooperation. The CFTC should work with the United Kingdom Financial Services Authority to ensure it has information about all large trades in U.S. energy commodities on the ICE Futures exchange in London.

5. Make ICE Determination. The CFTC should immediately conduct the hearing required by its regulations to examine the price discovery function of the ICE OTC electronic exchange and the need for ICE to publish daily trading data as required by the Commodity Exchange Act.

III. RECENT TRENDS IN ENERGY MARKETS

"There has been no shortage and inventories of crude oil and products have continued to rise. The increase in prices has not been driven by supply and demand."

–Lord Browne, Group Chief Executive of BP[14]

"Senator, the facts are – and I've said this publicly for a long time – the oil prices have been moving steadily up for the last two years. And I think I have been very clear in saying that I don't think that the fundamentals of supply and demand – at least as we have traditionally looked at it – have supported the price structure that's there."

–Lee Raymond, Chairman and CEO, ExxonMobil[15]

A. Increasing Prices

In what has become an all-too-familiar refrain over the past several years, energy prices have recently reached record highs. Oil prices in the spring of 2006 surpassed the record highs reached last summer in the days after Hurricane Katrina rampaged through the Gulf of Mexico and shut down over a million barrels per day of U.S. oil production. Figure 1 shows the steep climb and recent record highs in crude oil prices.

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[14] Melanie Feisst, *"Joseph was a speculator too," Hedge funds draw on the Bible to defend themselves against accusations that they have destablised the markets*, The Daily Telegraph, May 6, 2006.

[15] Joint Hearing Before the Senate Committee on Commerce, Science and Transportation and the Senate Committee and Energy and Natural Resources, November 9, 2005.

Figure 1
Crude Oil Prices
January 2000 - May 2006

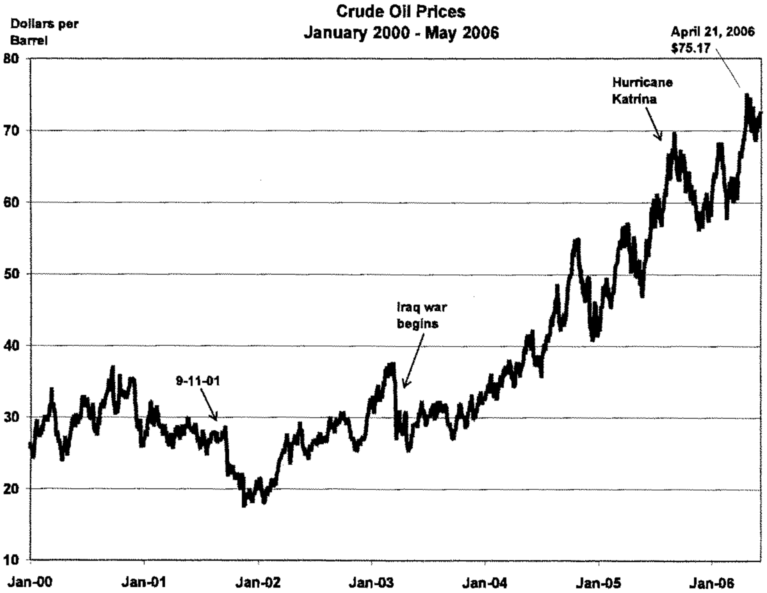

Figure 1. Since January 2002, crude oil prices have steadily risen; oil prices reached record high levels in spring, 2006. Prices reflect spot month NYMEX futures contract prices. Data source: U.S. Department of Energy, Energy Information Administration (EIA), NYMEX data.

Because gasoline and other petroleum-based energy commodities are produced by refining crude oil, the rising price of crude oil has been a major cause of rising gasoline and petroleum product prices. Figure 2 illustrates how U.S. gasoline prices have increased in recent years.

Figure 2
U.S. Retail Gasoline Prices
January 1998 - May 2006

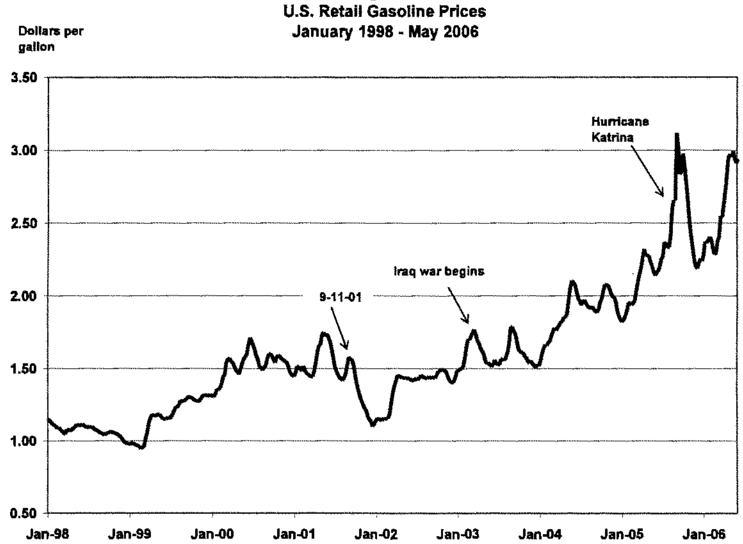

Figure 2. The average price of gasoline in the United States has risen from an average of \$1.10 cents per gallon in the late 1990s to an average of over \$2.20 per gallon over the past twelve months, and nearly \$3 per gallon in the spring of 2006. Prices reflect the weekly average retail price for all grades of gasoline. Data source: EIA.

Natural gas prices also have jumped higher over the past several years. Because several industries, such as electric power generation, can use natural gas as a substitute for crude oil, and vice versa, natural gas prices are significantly affected by crude oil prices. Natural gas prices also are highly correlated with the prices of several petroleum products, such as diesel fuel and heating oil. Figure 3 illustrates the recent rise in natural gas prices.

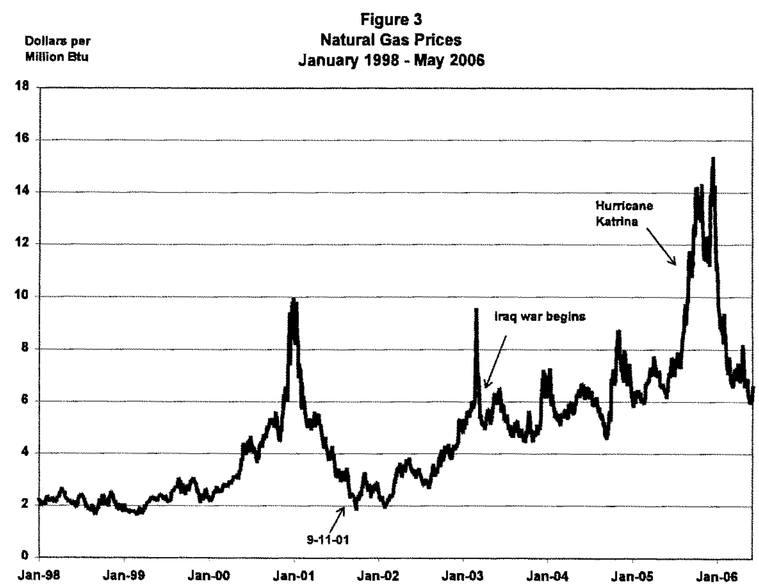

Figure 3. Natural gas prices have risen from an average of $2 per million BTU in the late 1990s to a current range of $6-$8 per million BTU in spring 2006. At times, price spikes have doubled the price of natural gas. Prices reflect spot month NYMEX futures contract prices. Data source: EIA, NYMEX data.

A number of factors are often cited as contributing to these increasing prices.[16] Generally, the rising prices are attributed to an increasingly precarious balance between supply and demand. Global demand for oil has been increasing, led by the rapid industrialization of China, growth in India, and a continued increase in appetite for refined products, particularly gasoline, in the United States.[17] Although supplies have been increasing to keep pace with this increased demand,[18] these supplies are perceived to be increasingly vulnerable to disruption. Political instability and hostility to United States interests in the key producer countries of Iran, Iraq, Venezuela,[19] and Nigeria[20] are among the most frequently cited threats to supplies. Additionally, in each of the past two years hurricanes have disrupted U.S. oil and gas production in the Gulf of Mexico.[21] As Saudi Arabia has increased its rate of production to meet increasing demand, its

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[16] See, e.g., U.S. Department of Energy, Energy Information Administration (EIA), *Short-Term Energy Outlook and Summer Fuels Outlook*, April 2006 ("*2006 Summer Fuels Outlook*"), at pp. 2-3; Jeffrey H. Birnbaum and Steven Mufson, *Cost of Gas Puts Pressure on GOP*, Washington Post, April 25, 2006; BBC News, What is driving oil prices so high?, http://news.bbc.co.uk/go/pr/fr/-/1/hi/business/4922172.stm (April 20, 2006); Peg Mackey and Janet McBride, Reuters, *Oil's top brass talk prices at summit*, Saturday, April 22, 2006, 9:33 a.m.; Steven Mufson, *The Battle Over the Blame for Gas Prices*, Washington Post, Friday, April 21, 2006, at p. A01.

[17] See, e.g., Philip K. Verleger, Jr., *A Primer on Oil Prices: I*, The Petroleum Economics Monthly, December 2005; International Energy Agency (IEA), *Oil Market Report*, May 12, 2006, at p. 3.

[18] For example, from 2002 through 2005 global demand increased from 77.8 to 83.6 million barrels per day (bpd), while global supply increased from 76.9 to 84 million bpd. This represents an increase in demand of 5.8 million bpd, and an increase in supply of 7.1 million bpd. As a result, OECD inventories grew by 300,000 bpd in 2003 and 200,000 bpd in 2004 and 2005. *Id.*, at p. 43.

[19] Monte Reel, *Chavez Stokes Confrontation Over U.S. Role in Venezuela*, Washington Post, July 19, 2005.

[20] See, e.g., Matt Piotrowski, *Nigerian Shut-Ins Fail to Stimulate Oversupplied US Cash Crude Market*, Oil Daily, March 6, 2006. This spring, however, despite several well-publicized disruptions to Nigerian supplies, no shortfalls resulted. "'Physical traders have taken the Nigerian outage totally in stride,' [one trader] said. 'Without the Nigerian troubles, there would be even more oversupply.'" *Id.*

[21] Between August 26, 2005, and April 19, 2006, the cumulative loss of production in the Gulf of Mexico due to Hurricane Katrina was approximately 149 million barrels, or approximately 1 million barrels per day (bpd). U.S. Department of Interior Materials and Management Service (MMS), Hurricane Katrina/Hurricane Rita, Evacuation and Production shut-in Statistics Report, Wednesday, April 19, 2006, at http://www.mms.gov/ooc/press0419.htm. Nearly 90 percent of total Gulf of Mexico oil production, which normally is about 1.5 million bpd, was shut down in the first few days after landfall on August 29; nearly 56 percent, or about 840,000 bpd, was still shut-in (i.e., unable to be produced) on September 15, two weeks after landfall. U.S. Department of Energy, Office of Electricity Delivery and Energy Reliability, Energy Assurance Daily, September 15, 2005, at pp. 2-3.

In the six-month period between September 11, 2004 and February 14, 2005, Hurricane Ivan caused a cumulative loss of nearly 44 million barrels of crude oil production in the Gulf of Mexico, which was equivalent to about 7.2 percent of the annual production of oil in the Gulf. MMS, Hurricane Ivan Evacuation and Production shut-in Statistics as of Monday, February 14, 2005, Final Report, at http://www.mms.gov/ooc/press/2005/press0214.htm.

The International Energy Agency (IEA) states that "random events," such as accidents, labor unrest, "guerilla activity," unplanned maintenance, and weather-related events, including hurricanes in North America, ability to pump additional oil in the event of a shortfall elsewhere has declined, thereby providing less of a cushion in the event of such a supply disruption.[22] It is often asserted that these and other fears over the adequacy of supply have built a "risk premium" into crude oil prices.[23]

These factors, however, do not tell the whole story. Concurrent with the most recent sustained run-up in energy prices, large financial institutions, hedge funds, pension funds, and other investors have been pouring billions of dollars into the energy commodities markets to try to take advantage of price changes or hedge against them. Most of this additional investment has not come from producers or consumers of these commodities, but from speculators seeking to take advantage of these price changes. The CFTC defines a speculator as a person who "does not produce or use the commodity, but risks his or her own capital trading futures in that commodity in hopes of making a profit on price changes."[24] Reports indicate that in the past year a few speculators have made tens and perhaps hundreds of millions of dollars trading in oil and gas.[25]

The large purchases of crude oil futures contracts by speculators have, in effect, created an additional demand for oil, driving up the price of oil for future delivery in the same manner that additional demand for contracts for the delivery of a physical barrel today drives up the price for oil on the spot market. As far as the market is concerned, the demand for a barrel of oil that results from the purchase of a futures contract by a speculator is just as real as the demand for a barrel that results from the purchase of a futures contract by a refiner or other user of petroleum.

"may cause supply losses of between 300 kb/d [thousand barrels per day] and 400 kb/d for non-OPEC supply each year." IEA, *Oil Market Report*, May 12, 2006, at p. 14.

[22] *2006 Summer Fuels Outlook*, at p. 3. On the other hand, government-controlled strategic stocks, including the U.S. Strategic Petroleum Reserve, are at historically high levels. *2006 Summer Fuels Outlook*, Summer Fuel Charts, at p.3 and at Summer Fuel Charts, p. 9; IEA, *Oil Market Report*, March 14, 2006, at p. 59. In the event of a disruption in supply, these strategic stocks can be just as effective as using spare production capacity to make up for production shortfalls. For example, in 2005, the United States released 30 million barrels of oil from the U.S. Strategic Petroleum Reserve, and other IEA members released another 30 million barrels to compensate for the loss of production caused by Hurricanes Katrina and Rita. H. Josef Hebert, *Nations to Release 60M Barrels of Oil, Gas*, Associated Press Financial Wire, September 2, 2005, 10:51 p.m. GMT. In 2003, Saudi Arabia and other OPEC members increased their production to compensate for the temporary loss of about 1.7 million barrels per day of Iraq oil due to the American invasion. David Ivanovich, *OPEC strives to prevent world oil-supply shortage*, Houston Chronicle, March 10, 2003; *Producers Expect Minimal War Diruption*, Oil Daily, March 19, 2003.

[23] *See, e.g.*, Daniel Yergin, Testimony Before the U.S. House of Representatives Committee on Energy and Commerce, May 4, 2006, at www.cera.com/news (last visited May 22, 2006).

[24] CFTC, The Economic Purpose of Futures Markets, at http://www.cftc.gov/opa/brochures/opaeconpurp. htm.

[25] See Section III.C.3 in this report, below.

Although it is difficult to quantify the effect of speculation on prices, there is substantial evidence supporting the conclusion that the large amount of speculation in the current market has significantly increased prices; several analysts have estimated that speculative purchases of oil futures have added as much as \$20-\$25 per barrel to the current price of crude oil. Additionally, by purchasing large numbers of futures contracts, and thereby pushing up futures prices to even higher levels than current prices, speculators have provided a financial incentive for oil companies to buy even more oil and place it in storage. A refiner will purchase extra oil today, even if it costs \$70 per barrel, if the futures price is even higher.

As a result, over the past two years crude oil inventories have been steadily growing, resulting in U.S. crude oil inventories that are now higher than at any time in the previous eight years. The last time crude oil inventories were this high, in May 1998 – at about 347 million barrels – the price of crude oil was about \$15 per barrel. By contrast, the price of crude oil today is about \$70 per barrel. The large influx of speculative investment into oil futures has led to a situation where we have both high supplies of crude oil and high crude oil prices.

High crude oil prices are a major reason for the record or near-record highs of the prices of a variety of petroleum products, including gasoline, heating oil, diesel fuel, and jet fuel.[26] There also is evidence that the skyrocketing prices of metal commodities can partially be attributed to these skyrocketing oil prices.[27]

B. Increasing Amounts of Crude Oil in Storage

What's been happening since 2004 is very high prices without record-low stocks. The relationship between U.S. [oil] inventory levels and prices has been shredded, has become irrelevant."

–Jan Stuart, Global Oil Economist, UBS Securities[28]

Compelling evidence that the oft-cited geopolitical, economic, and natural factors do not fully explain the recent rise in energy prices can be seen in the actual data on crude oil supply and demand. Although demand has significantly increased over the past few years, so have

[26] As explained in two previous reports issued by the Subcommittee staff, U.S. gasoline prices are also influenced by the overall gasoline supply and demand balance within the U.S. gasoline market, which in turn depends on a variety of other factors, including the profitability of refinery operations, domestic refinery capacity and availability, the level of imports, competition within the industry at the national and local level, and fuel specifications resulting from environmental requirements that affect the fungibility of gasoline supplies. This year, uncertainty within the market regarding whether there would be an adequate supply of gasoline blended with ethanol to replace the supply of gasoline blended with MTBE also contributed to some of the increases in gasoline prices.

[27] *See, e.g., Falling oil prices would help stem rise in copper prices: trader*, Platts Metals Week, May 19, 2006, at http://www.platts.com/Metals/highlights/2006/mp_mw_051906.xml (last visited May 26, 2006).

[28] Bhusan Bahree and Ann Davis, *Oil Settles Above \$70 a Barrel, Despite Inventories at 8-Year High*, The Wall Street Journal, April 18, 2006.

supplies. As Figure 4 indicates, over the past couple of years global crude oil production has increased along with the increases in demand; in fact, during this period global supplies have exceeded demand.[29]

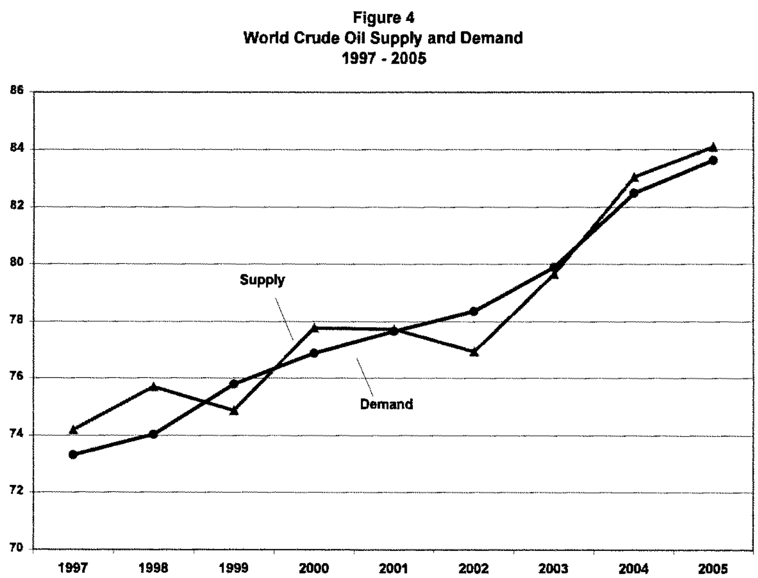

Figure 4. In 2004 and 2005 the supply of crude oil exceeded demand. Data source: EIA, *International Petroleum Monthly, March 2006.*

Projections for the future indicate that, for the near term, supply will continue to keep pace with demand. In its monthly report for March 2006, the International Energy Agency (IEA), stated, "Additions to OPEC and non-OPEC capacity are forecast to keep global supply trends broadly in line with global demand in 2007 and 2008."[30] The U.S. Department of Energy's Energy Information Administration (EIA) recently forecast that in the next few years

[29] *2006 Summer Fuels Outlook,* at p. 3.

[30] IEA, *Oil Market Report,* March 14, 2006, at p. 3. See also, *2006 Summer Fuels Outlook,* at p. 3.

global surplus production capacity will continue to grow to between 3 and 5 million barrels per day by 2010, thereby "substantially thickening the surplus capacity cushion."[31]

Because supplies have been rising along with demand, commercial crude oil inventories have been rising as well. As can be seen in Figure 5, the amount of crude oil in U.S. commercial inventories is higher today than at any other time in the current decade. The EIA forecasts that U.S. inventories will increase again in 2006.[32]

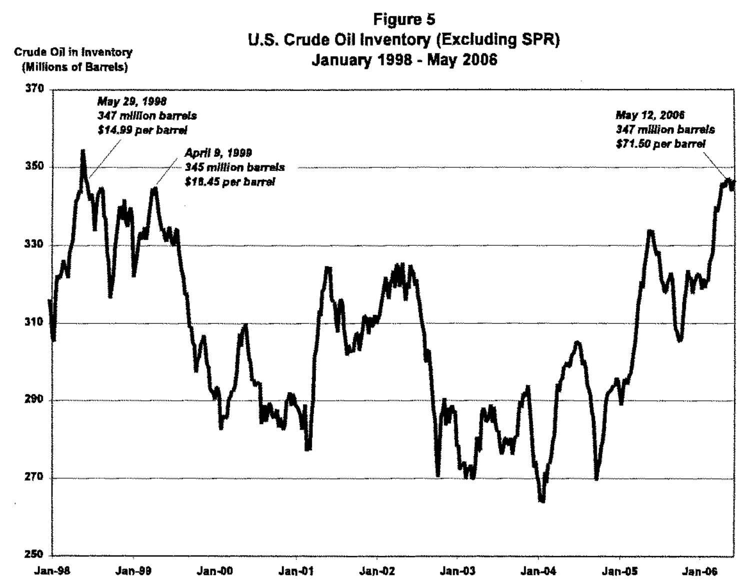

Figure 5. The amount of crude oil in storage in commercial inventories has risen to higher-than-average levels over the past year. Data source: EIA.

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[31] EIA, *Energy Assurance Daily*, May 4, 2006. The EIA reported the current spare capacity to be between 1 and 1.5 million barrels per day (bpd). *Id.* The International Energy Agency reports the spare capacity at 1.7 million bpd. IEA, *Oil Market Report*, May 12, 2006, at p. 14.

[32] *2006 Summer Fuels Outlook*, at Table 3. In Europe, crude oil in inventories also were higher in 2005 than in either 2003 or 2004. IEA, *Oil Market Report*, March 14, 2006, at p. 29. Not only are the absolute levels of U.S. and European inventories above average, inventories are also higher when measured by days-of-supply those inventories could provide at current consumption levels. *Id.* In June, the IEA reported that OECD crude stocks had risen to their highest level in 20 years. IEA, *Oil Market Report Highlights*, June 13, 2006.

The amount of natural gas in storage also has been increasing over the past couple of years. From mid-2004 to the present, except for the period shortly following the landfall of Hurricane Katrina, the amount of natural gas in storage has exceeded the previous 5-year average.[33] Yet during this entire period natural gas prices were higher than the previous 5-year average. These trends are expected to continue. Despite a projected increase in the amount of natural gas available in storage for next winter, the EIA states that "concerns about potential future supply tightness and continuing pressure from high oil markets are keeping expected spot natural gas prices for the next heating season at high levels."[34]

Figure 6 shows the relationship between U.S. crude oil inventories and prices over the past 8 years, and how the relationship between physical supply and price has fundamentally changed since 2004. For the period from 1998 through 2003, the chart shows that the price-inventory relationship generally centered around a line sloping from the middle-left of the chart down to the lower right, meaning that low inventories were accompanied by high prices, and high inventories were accompanied by low prices. For 2004, 2005, and through May 2006, which is the most recently available data, the inventory-price relationships fall nowhere near this downward sloping line; if anything, the points seem to go in the opposite direction, such that higher inventories seem to be correlated with higher prices. Figure 6 clearly indicates that there has been a fundamental change in the oil industry, such that the previous relationship between price and inventory no longer applies.

[33] EIA, *Short-Term Energy Outlook and Summer Fuels Outlook*, April 2006, Summer Fuel Charts, at p.11.

[34] *2006 Summer Fuels Outlook*, at Table 3. In mid-May of this year, however, natural gas spot month futures fell below $6 per million BTU.

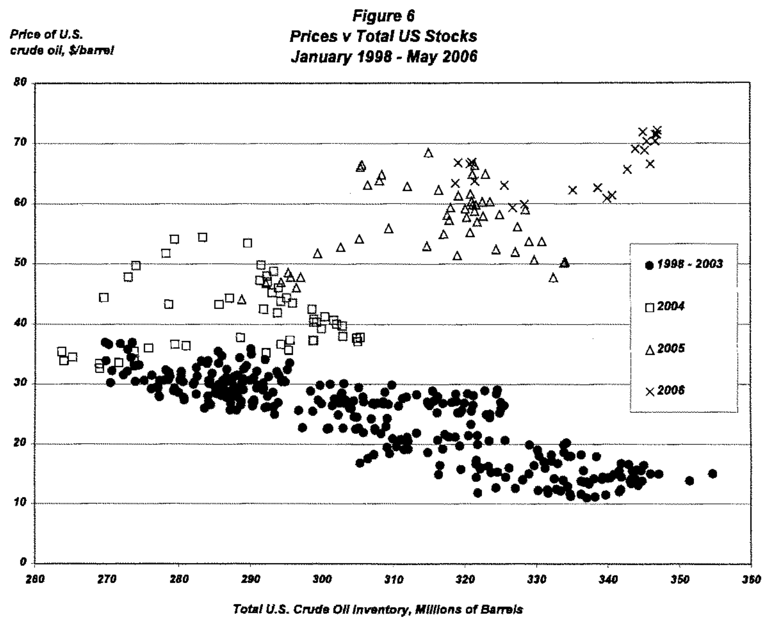

Figure 6. Since 2004, crude oil prices have risen as inventories have risen. Data source: EIA.

As will be discussed in the next section, one reason underlying this change is the influx of billions of dollars of speculative investment in the crude oil and natural gas futures markets. As energy prices have not only increased but become more volatile, energy commodities have become an attractive investment for financial institutions, hedge funds, pension funds, commodity pools, and other large investors. One oil economist has calculated that over the past few years more than $60 billion has been spent on oil futures in the NYMEX market alone.[35] As explained below, this frenzy of speculative buying has created additional demand for oil futures, thereby pushing up the price of those futures. The increases in the price of oil futures

[35] Philip Verleger, *Commodity Investors: A Stabilizing Force?*, The Petroleum Economics Monthly, March 2006.

have provided financial incentives for companies to buy even more oil and put it into storage for future use, resulting in high prices despite ample inventories.[36]

C. Increased Speculation in Energy Commodities

"Ironically, hedge funds trading oil are not doing anything very different than the large investment banks such as Goldman Sachs, Bank of America, or Morgan Stanley already do. The proprietary trading desks of these and other large investment banks are actually 'hedge funds in drag,' just as Enron was."
–Peter C. Fusaro and Gary M. Vasey, Hedge Funds Change Energy Trading[37]

1. Increased Investments in Energy Commodities

At the same time energy commodity prices have been increasing, there has been a large increase in the amount of money expended on energy commodities futures and other derivative instruments. "Volatile energy markets and record-high commodity prices are prompting renewed interest from investors eager to play in the sector," *The New York Times* reported earlier this year. "That has pushed banks and a growing number of hedge funds to hire more energy traders and brainy quantitative minds to back their bets on energy prices."[38] Recent academic

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[36] Some traders contend that the high inventories have lowered spot prices. "The physical market is pretty relaxed," one trader said this spring, as prices rose over $60 per barrel. "There's been downward pressure on WTI [West Texas Intermediate] because of inventories." Matt Piotrowski, *Nigerian Shut-Ins Fail to Stimulate Oversupplied US Cash Crude Market*, Oil Daily, March 6, 2006. "What the high stock levels are doing, along with unsold spot cargoes and storage capacity constraints, is driving down the spot and front month prices relative to the outer months. In effect, a chunk of the fear premium is being taken out of the market." *Receding Fear Premium*, Petroleum Intelligence Weekly, March 13, 2006.

On the other hand, by creating a financial incentive to purchase oil for storage, the steep rise in futures prices may also have stimulated current demand, thereby pushing up current prices. Although some of this increased demand for oil – for present consumption plus for future consumption – has been met by increase in supply, any increase in production necessary to meet this additional demand has come at a time of low excess global excess production capacity. The recent decline in global excess production capacity has been one of the major factors supporting current price levels. See, e.g., Verleger, *A Primer on Oil Prices: I*, at p. 22. ("This process of inventory building [due to speculative purchases of futures contracts] reduces the supply of certain crudes and products available to the current spot market when current supply cannot be increased, as has been the case in 2005. Ths promotion of inventory holding raises current spot prices.").

Using the IEA estimate of 1.7 million bpd for OPEC's surplus production capacity, an amount of oil equivalent to between 10 and 15 percent of OPEC's surplus capacity has been placed into commercial inventories. It is not apparent why these increases in commercial inventories, together with the high level of strategic reserves in OECD countries, including the U.S. Strategic Petroleum Reserve, have not had a greater effect in alleviating the "fear premium" regarding potential supply disruptions.

[37] International Research Center for Energy and Economic Development, 2005.

[38] Alexei Barrionuevo and Simon Romero, *Energy Trading, Without a Certain "E"*, The New York Times, January 15, 2006.

research indicating that commodity futures have performed as well as stocks and better than bonds, with less risk, also has boosted expenditures on energy commodity futures.[39]

Because the over-the-counter energy markets are unregulated, there are no precise or reliable figures as to the total dollar value of recent spending on investments in energy commodities, but the estimates are consistently in the range of tens of billions of dollars. Last fall, the International Monetary Fund reported, "Industry estimates suggest that approximately $100-$120 billion of new investment in the past three years has been in active and passive energy investment vehicles."[40] *The New York Times* cited an estimate that there were "at least 450 hedge funds with an estimated $60 billion in assets focused on energy and the environment, including 200 devoted exclusively to various energy strategies."[41]

The increased speculative interest in commodities is also seen in the increasing popularity of commodity index funds, which are funds whose price is tied to the price of a basket of various commodity futures. Goldman Sachs estimates that pension funds and mutual funds have invested a total of approximately $85 billion in commodity index funds, and that investments in its own index, the Goldman Sachs Commodity Index (GSCI), has tripled over the past few years to $55 billion.[42] In March of this year, petroleum economist Philip Verleger calculated that the amount of money invested in commodity index funds "jumped from $15 billion in 2003 to $56 billion in 2004 and on to $80 billion today."[43]

With respect to crude oil in particular, Verleger estimates that, during 2005, $25 billion was "injected" into the West Texas Intermediate (WTI) crude oil futures contract traded on the NYMEX, mostly coming from pension funds and other managed money. Verleger states "another $20 billion or so" was invested in NYMEX WTI contracts in the first few months of

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[39] Michael R. Sesit, *Commodities Enter Investment Mainstream, Pension Funds, Universities Jump Into the Asset Class; High Returns, Low Risk*, Wall Street Journal, September 9, 2004; Philip Verleger, *Commodity Investors: A Stabilizing Force?*, The Petroleum Economics Monthly, March 2006. The most frequently cited research papers are Thomas Schneeweis, Georgi Georgiev, *The Benefits of Managed Futures*, June 10, 2002; and Gary Gorton and K. Geert Rouwenhorst, *Facts and Fantasies about Commodity Futures*, Yale International Center for Finance, Working Paper No. 04-20, June 14, 2004.

[40] Pelin Berkma, Sam Ouliaris, and Hossein Samiei, *The Structure of the Oil Market and Causes of High Prices*, International Monetary Fund, September 21, 2005.

[41] Alexei Barrionuevo, *Energy Trading, Without a Certain "E"*, The New York Times, January 15, 2006 (citing Mr. Peter Fusaro of the Energy Hedge Fund Center).

[42] Jad Mouawad and Heather Timmons, *Trading Frenzy Adding to Rise in Price of Oil*, The New York Times, April 29, 2006.

[43] Philip Verleger, *Commodity Investors: A Stabilizing Force?*, The Petroleum Economics Monthly, March 2006.

this year.[44] Overall, Verleger estimates that between July 2004 and mid-March 2006, a total of approximately $60 billion has been invested in the NYMEX WTI contract.[45]

The increase in speculative trading is directly observable in the CFTC weekly reports on trading activity in the CFTC-regulated futures markets. Over the past two years, the CFTC data shows more than a doubling in the "open interest" in both crude oil and natural gas contracts – essentially the number of outstanding futures contracts at the end of a trading day.[46] The CFTC data indicates that much of the increase is due to "non-commercial" trading – namely, trading by speculators.[47]

2. The Effect of Speculation on Prices

"There is little doubt that Katrina only exacerbated a troubling trend in energy prices that already seemed to ignore basic fundamental drivers to thrive instead on hype."
–A futures trader, September 2005.[48]

One of the benefits of speculative trading is that it brings needed liquidity to the futures market so that companies seeking to hedge their exposure to commodity prices can find counterparties willing to take on those price risks. Also, as previously discussed, speculation can help finance the build-up of inventories when prices are expected to increase. On the other hand, large speculative buying or selling of futures contracts can distort the price signals influencing supply and demand in the physical market or lead to excessive price volatility, either of which can cause a cascade of consequences detrimental to the supply and price of the commodity and the overall economy.

A key responsibility of the CFTC is to ensure that prices on the futures market reflect the laws of supply and demand rather than manipulative practices[49] or excessive speculation.[50] The Commodity Exchange Act (CEA) states, "Excessive speculation in any commodity under contracts of sale of such commodity for future delivery . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and

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[44] Philip Verleger, *A Primer on Oil Prices II: The Role of Inventories*, The Petroleum Economics Monthly, February 2006, at p. 20.

[45] Verleger, March 2006.

[46] See the Appendix to this Report for a more detailed discussion of open interest.

[47] See the Appendix to this Report for a more detailed discussion of this CFTC data.

[48] *Behind Runaway Prices: Supply Issues are Real, But Hype Sets Bar*, Natural Gas Week, September 5, 2005.

[49] 7 U.S.C. Sec. 5(b),

[50] 7 U.S.C. Sec. 6a(a).

unnecessary burden on interstate commerce in such commodity."[51] The CEA directs the CFTC to establish such trading limits "as the Commission finds are necessary to diminish, eliminate, or prevent such burden."[52]

A number of energy industry participants and analysts have noted the divergence between the ample supplies of crude oil and natural gas, and record-high prices for those commodities, and have attributed some of this disconnect to the presence of speculators in the market. "Gold prices don't go up just because jewelers need more gold, they go up because gold is an investment," one consultant said. "The same has happened to oil."[53]

"The answer to the puzzle posed by rising prices and inventories, industry analysts say, lies not only in supply constraints such as the war in Iraq and civil unrest in Nigeria and the broad upswing in demand caused by industrialization of China and India. Increasingly, they say, prices also are being guided by a continuing rush of investor funds in commodities investments."[54] Another gas trader said: "It's all about futures speculators shooting for irrational price objectives, as well as trying to out-think other players – sort of like a twisted game of chess." "[T]he basic facts are clear," he added, "this market is purely and simply being controlled by over-speculation."[55] Tim Evans, senior analyst at IFR Energy Services, stated, "What you have on the financial side is a bunch of money being thrown at the energy futures market. It's just pulling in more and more cash. That's the side of the market where we have runaway demand, not on the physical side."[56]

Some traders charge that certain hedge fund managers have purposefully contributed to a misperception that there is a shortage of supply. "There's a few hedge fund managers out there who are masters at knowing how to exploit the peak theories [that the world is running out of oil] and hot buttons of supply and demand, (and) by making bold predictions of shocking price advancements to come (they) only add more fuel to the bullish fire in a sort of self-fulfilling prophecy."[57]

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[51] *Id.*

[52] *Id.*

[53] Jad Mouawad and Heather Timmons, *Trading Frenzy Adding to Rise in Price of Oil*, The New York Times, April 29, 2006 (quoting Roger Diwan, partner, PFC Energy).

[54] Bhusan Bahree and Ann Davis, *Oil Settles Above $70 a Barrel, Despite Inventories at 8-Year High*, The Wall Street Journal, April 18, 2006.

[55] *Behind Runaway Prices: Supply Issues are Real, But Hype Sets Bar*, Natural Gas Week, September 5, 2005.

[56] *Oil: A Bubble, not a Spike?* BusinessWeek online, April 27, 2005.

[57] Natural Gas Week, September 5, 2005.

Several analysts have estimated that the influx of speculative money has tacked on anywhere from about $7 to about $30 per barrel to the price of crude oil.[58] Even OPEC officials are concerned that a shift in the market from high futures prices relative to current prices, to lower futures prices relative to current prices (i.e. from contango to backwardation) could precipitate a "quick drop of $20 a barrel or more."[59] Noting that "fundamentals are in balance and stock levels are comfortable," the president of the OPEC cartel, Edmund Daukoru, recently attributed the current price levels to "refinery tightness, geopolitical developments and speculative activity."[60] Other traders have pointed out the possibility of a sharp drop in price. "At some point, this oversupplied market has to begin to break down this house of cards which is dominated by speculative entities," one futures trader noted, "and when those entities decide to start liquidating their futures positions in crude and gas, look out below."[61]

Generally, economists struggle to quantify the effect of speculators on market prices. Part of the difficulty is due to the absence of specific data about the strategies of particular traders or classes of traders. The CFTC's weekly Commitment of Trader reports are not specific or precise enough to provide the basis for rigorous quantitative analysis,[62] and commodity traders are, as a rule, reluctant to distribute their data for such purposes. Another difficulty is separating cause from effect: are high prices caused by an increase in speculation, or do more speculators enter the market when prices become more volatile because that is when the profit opportunities arise?

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[58] See, e.g., Jad Mouawad and Heather Timmons, *Trading Frenzy Adding to Rise in Price of Oil*, The New York Times, April 29, 2006 ("by some estimates 10 percent to 20 percent" of current prices); Goldman Sachs, *Natural Gas Weekly*, December 10, 2004 ($7 per barrel in spring, 2004); John M. Berry, *Speculation plays a role in high oil prices*, Alexander's Gas & Oil Connections, August 17, 2005 ("'Current US oil inventory levels suggest WTI crude prices should be around $25 a barrel,' [oil analyst Mike Rothman of International Strategy and Investment] calculated. 'Given underlying issues and concerns about OPEC capacity and demand growth, we certainly are not prepared to argue that the price spread between the $25 model value and near $60 actual is all speculation, but we do feel that a portion is."); *Oil Pricing: Don't Underestimate the Fear Factor*, BusinessWeek online, March 13, 2006 (Sarah Emerson, director of petroleum market analysis and research at Energy Security Analysis estimates an additional $15 per barrel is due to "fear;" Tim Evans, senior energy analyst for IFR Markets, estimates $25-$30 per barrel.).

[59] Bhusan Bahree and Ann Davis, *Oil Settles Above $70 a Barrel, Despite Inventories at 8-Year High*, The Wall Street Journal, April 18, 2006.

[60] Platts, *OPEC has no option but to maintain output at current prices: Libya*, June 15, 2006. Similarly, Saudi Arabian Oil Minister Ali Naimi has stated, "World oil supply is currently exceeding demand, and there is no lack of spare capacity." Kate Dourian, *Naimi says producers can't be assured robust demand will continue*, Platts Oilgram News, May 16, 2006. U.S. Energy Secretary Samuel Bodman agreed with Minister Naimi's assessment: "[Secretary] Bodman, meeting with reporters after a speech at an electricity forum, suggested that there seems to be plenty of oil available." H. Josef Hebert, *Energy secretary says U.S. can weather Iranian oil disruption*, Associated Press Worldstream, June 6, 2006.

[61] *Bears Predict Bullish Crude, Gas Bubble to Burst Sooner Than Later*, Natural Gas Week, June 27, 2005.

[62] See the Appendix for an explanation of these reports.

Several recent analyses have concluded that speculation has significantly increased energy prices; others have concluded otherwise.

Former Federal Reserve Chairman Alan Greenspan. In testimony before the Senate Committee on Foreign Relations, former Chairman Greenspan stated that, in the last couple of years, "increasing numbers of hedge funds and other institutional investors began bidding for oil [and] accumulated it in substantial net long positions in crude oil futures, largely in the over-the-counter market. These net long futures contracts, in effect, constituted a bet that oil prices would rise."[63] The former Chairman observed that these purchases of oil futures have had a cascade of effects on prices, production, inventories, and consumption:

> With the demand from the investment community, oil prices have moved up sooner than they would have otherwise. In addition, there has been a large increase in oil inventories. In response to higher prices, producers have increased production dramatically and some consumption has been scaled back. Even though crude oil productive capacity is still inadequate, it too has risen significantly over the past two years in response to price.[64]

Citgroup. In a May 5, 2006, report on prices of U.S. commodities, Citigroup reported that the monthly average value of speculative positions held in all U.S. commodity markets rose to over $120 billion, just under the record of $128 billion set the previous October. Of the 36 agricultural, energy, and metal commodities analyzed, Citigroup found the largest speculative positions were in natural gas ($30.3 billion) and crude oil ($30.1 billion), followed by gold ($13.3 billion). The report stated, "We believe the hike in speculative positions has been a key driver for the latest surge in commodity prices."

Goldman Sachs. In a report on the natural gas markets issued in late 2004, Goldman Sachs determined that the rising natural gas prices – which were then near $7 per million BTU – were "rooted in tightening fundamentals."[65] Goldman Sachs also stated, "Our analysis indicates that speculative money does have some impact on natural gas prices and the shape of the forward curve." Goldman Sachs reported that the net-speculative positions had depressed the next-month natural gas futures contract price by $0.28 per million BTU in early December 2004, but the previous spring it had increased the "prompt" NYMEX natural gas futures contract (i.e., the futures contract that is next to expire) by $0.60 per million BTU – an increase of slightly greater than 10 percent.

The Goldman Sachs report also noted that natural gas prices were directly affected by crude oil prices, and "we believe that speculators also impact the price of crude oil and petroleum products, with the impact of speculators peaking at roughly $7 [per barrel] in the

[63] Statement of Alan Greenspan before the Senate Committee on Foreign Relations, June 7, 2006.

[64] *Id.*

[65] Goldman Sachs, *Natural Gas Weekly*, December 10, 2004.

spring of 2004." At that time, crude oil prices ranged from $35-$40 per barrel; hence, according to the Goldman Sachs analysis, speculators at that time were boosting the price of oil by about twenty percent. "Unlike natural gas," Goldman Sachs wrote, "we estimate that the impact of speculators on oil prices is roughly equivalent in magnitude to the impact of shifts in supply and demand fundamentals (as reflected in stocks)." In other words, shifts in speculative positions could affect crude oil to the same degree as actual changes in the supply of or demand for crude oil.

Philip Verleger: A New Era for Energy. In a series of analyses in his publication, *The Petroleum Economics Monthly*, Philip Verleger contends that the recent increase in speculative activity has altered the nature of the crude oil markets and boosted futures prices. Verleger believes that the recent infusion of tens of billions of dollars from pension funds, speculators, and other investors into crude oil and natural gas futures markets has ushered in a "new era" for energy producers and refiners. "The current new era is marked by the entry of long-term investors, who have pushed forward crude prices to record levels," Verleger writes. "Consumers, no doubt, will have another term for it."[66] During this era "prices will likely be quite high for several years," but "will be followed by a period of very low prices."[67]

A key indicator of this new era, according to Verleger, is the emergence of a "'disconnect' between the cash price behavior and the fundamentals, as measured by supply-and-demand balances or stocks."[68] The reason for this divergence, in Verleger's analysis, is that purchases of long-term crude oil futures contracts have pushed up the longer-term futures prices by so much that it is more profitable for oil companies to store the oil and then sell it at a later date than sell it today, even at record-high spot prices. Even if oil is at $70 per barrel today, suppliers will hold their inventories if they can sell it for $75 for delivery a year from now.

Since 2001 there has been a dramatic growth in the open interest in very long-term futures contracts (30 months or longer). At the end of July 2001, there was an open interest of 19,624 in very long-term contracts, representing about 4.5 percent of all open interest; at the end of July 2005, there was an open interest of 125,546 in very long-term contracts, representing about 15 percent of all open interest. According to Verleger, nearly all of the buying of these very long-term crude oil futures contracts reflects speculative buying, since commercial firms typically don't enter into contracts for delivery so far into the future, and therefore have no need to use such long-term futures contracts for hedging purposes.[69]

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[66] Philip K. Verleger, Jr., *The Petroleum Economics Monthly*, July 2005, at p. 1.

[67] *Id.*, at p. 2.

[68] *Id.*, at p. 10.

[69] *Id.*, at p. 12.

"In summary," Verleger writes, "increased purchases of long-dated crude lift the forward price curve. The rise in prices is reflected back to contracts maturing in a few months."[70] Quantitatively, "the impact of increasing stocks has been overwhelmed by the strong demand for forward crude, which has added as much as $24 per barrel to prices."[71]

CFTC staff study. In contrast to the studies that have found a relationship between speculative activity and price, a CFTC staff study released in April 2005 found, in general, "no evidence of a link between price changes and MMT [managed money trader] positions" in the natural gas markets and "a significantly negative relationship between MMT positions and price changes (conditional on other participants trading) in the crude oil market."[72] The CFTC staff found, generally, that these managed money funds tended to follow what the commercial participants in the market were doing, and tended to trade less frequently than commercial traders.

NYMEX study. A second study that found no relationship between hedge fund activity and volatility was conducted by the NYMEX. Overall, the NYMEX found that during 2004, "hedge fund trading activity comprised a modest share of trading volume in both crude oil and natural gas futures markets," and comprised "a relatively modest share of open interest." It also found that hedge fund participation during this period tended to decrease volatility. "In short," the NYMEX stated, "it appears that Hedge Funds have been unfairly maligned by certain quarters who are seeking simple answers to the problem of substantial price volatility in energy markets, simple answers that are not supported by the available evidence."[73]

A number of industry participants have expressed skepticism about the accuracy of the NYMEX and CFTC analyses. Neither the NYMEX study nor the CFTC study addressed the effects of hedge fund and other speculative investments on the price of longer-term futures contracts. Rather, both the CFTC study and the NYMEX focused on the near-term effects of trading by hedge funds, particularly with respect to volatility. "[D]espite those [NYMEX and CFTC] reports," one trade publication reported, "a majority of industry professionals still contend that there are too many large speculative entities actively engaged in the market – with fund accounts taking on massive equity positions in the commodities."[74] Another article

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[70] *Id.*, at p. 15.

[71] *Id.*, at p. 19.

[72] Michael S. Haigh, Jana Hranaiova and James A. Overdahl, Office of the Chief Economist, U.S. Commodity Futures Trading Commission, *Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex*, Working Paper, First Draft: April 28, 2005.

[73] New York Mercantile Exchange, *A Review of Recent Hedge Fund Participation in NYMEX Natural Gas and Crude Oil Futures Markets*, March 1, 2005.

[74] *Bears Predict Bullish Crude, Gas Bubble to Burst Sooner Than Later*, Natural Gas Week, June 27, 2005. *See, e.g., Oil Market Control Passes From OPEC to Speculators*, Jet Fuel Intelligence, August 29, 2005 ("'The amount of paper barrels being traded is extraordinary and this has had an extraordinary effect on prices,' said one industry veteran."); *Commodity Strategists: Oil to Fall, Toronto Bank Says*, Bloomberg.com, April 25, 2005 (the

reported that many traders have "scoffed" at these two studies, "saying that they focused only on certain months, missing price run-ups."[75]

In sum, while industry and regulatory economists and analysts do not agree on the extent to which market speculation has affected energy prices, it is beyond dispute that speculation has increased. CFTC data as well as numerous industry reports indicate that speculators have injected tens of billions of dollars into the energy commodities markets. Although the absence of data makes it impossible to precisely quantify the effect of these speculative investments on prices, it appears from the CFTC data, market data, and the comments of a number of well-respected analysts that this increased speculation has fundamentally altered the relationship between crude oil inventories and prices. The purchase of long-term futures by speculators has provided a financial incentive for oil purchasers to build inventories and store oil for future use; this has resulted in a market characterized both by large amounts of oil in inventory and high prices.

Whether the current level of speculation has provided needed liquidity, encouraged the building of inventories, or created a speculative bubble in energy prices is impossible to determine without additional data. It is clear that better tools are needed to understand how much is being spent, by whom, in which markets and instruments, and the effect of increasing speculation on the price and affordability of energy in the United States.

The importance of understanding the effect of speculation on market prices cannot be understated. Professor Robert Shiller, in his prescient book *Irrational Exuberance*, which warned that the U.S. stock market was in the midst of a speculative bubble just prior to the price collapse of 2000-2001, wrote as follows:

> The extraordinary recent levels of U.S. stock prices, and associated expectations that these levels will be sustained or surpassed in the near future, present some important questions. We need to know whether the current period of high stock market pricing is like the other historical periods of high pricing, that is, whether it will be followed by poor or negative performance in coming years. We need to know confidently whether the increase that brought us here is indeed a *speculative bubble* – an unsustainable increase in prices brought on by investors' buying behavior rather than by genuine, fundamental information about value. In short, we need to know if the value investors have imputed to the market is not really there, so that we can readjust our planning and thinking.[76]

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speculative rally has "'decoupled' prices from the reality of supply and demand.") .

[75] Alexei Barrionuevo, *Energy Trading, Without a Certain "E"*, The New York Times, January 15, 2006.

[76] Robert J. Shiller, *Irrational Exuberance* (Princeton University Press, 2000), at p. 5.

In light of the vital importance of energy to our national economy and security, the need to better understand the role of speculation in price formation appears is just as important for the energy market as for the stock market.

3. Large Profits from Speculation in Energy Commodities

Accurate information about the profits and losses of market participants is difficult to obtain. Nonetheless, reports indicate that a number of firms, funds, and traders have reaped enormous profits from the recent increases in energy prices, energy price volatility, and trading volume. These large profits provide an indication of one of the incentives for speculation in today's energy commodity markets.

For example, it has been reported that in 2004, Goldman Sachs and Morgan Stanley, the two leading energy trading firms in the United States, earned a total of about $2.6 billion in net revenues from commodities trading, mostly from energy commodities.[77] For 2005, Goldman Sachs and Morgan Stanley each reportedly earned about $1.5 billion in net revenue from energy transactions.[78]

A recent article in *Trader Monthly* magazine included short profiles of the "100 Highest Earning Traders" for 2005, as ranked by the magazine. Overall, *Trader Monthly* reported, "On Wall Street, some of the scores were gargantuan, as bulge-bracket banks enjoyed one of the most profitable years in the history of the markets, from asset-backed to credit and crude to crack spreads."[79] Although the rankings are based on estimates and anecdotal information, and the article does not explain how the profiled traders generated their income, it nonetheless provides some information regarding the magnitude of some of the earnings of leading energy commodity traders in 2005.[80] The *Trader Monthly* rankings group these traders into several categories: hedge fund managers, Wall Street Traders, and "the rest," which includes traders working for brokerage firms that own seats on the NYMEX.

At the top of the *Trader Monthly* list, T. Boone Pickens was reported to have earned between one and one-and-a-half billion dollars in energy trading in 2005. The magazine reports that Mr. Pickens's main commodities fund earned a return of approximately 700 percent in 2005, which it "believes is the largest one-year sum ever earned."[81] Another hedge fund magazine,

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[77] Alexei Barrionuevo, *Energy Trading, Without a Certain "E"*, The New York Times, January 15, 2006.

[78] *Wall Street firms reshape power trading, add liquidity in physical and paper markets*, Platts Power Markets Week, January 16, 2006; see also Ann Davis, *Morgan Stanley trades energy in barrels*, Pittsburgh post-gazette.com, March 3, 2005.

[79] Rich Blake and Andrew Barber with Robert LaFranco, *The Trader Monthly 100; Earn, Baby, Earn*, Trader Monthly, April/May 2006 (hereinafter cited as "*The Trader Monthly 100*"), at p. 69.

[80] The Subcommittee staff has not verified the information contained in the *Trader Monthly* article.

[81] *The Trader Monthly 100* at p. 71.

Alpha, estimated that Mr. Pickens's trading strategies earned $1.4 billion in 2005, largely due to his bets on crude oil.[82]

Following an interview with Mr. Pickens, the *Associated Press* reported, "Oil tycoon Boone Pickens' bet that energy prices would rise made him more money in the past five years than he earned in the preceding half century hunting for riches in petroleum deposits and companies."[83] During this interview, which occurred in mid-2005, when the price of oil was approaching a then-record $60 per barrel, Mr. Pickens stated, "I can't tell for sure where [prices are] going, other than up."[84] Mr. Pickens's success in predicting price increases may have even created its own momentum for further price increases – according to *Natural Gas Week,* "[Mr. Pickens] regularly talks up crude oil and natural gas prices on financial market cable TV. Traders and futures brokers report that each time this happens, more speculative interest is drawn to energy futures markets."[85]

Also at the top of the list of energy traders is John Arnold, a former Enron trader who left Enron in 2002 to start his own hedge fund, Centaurus Energy, with three employees and $8 million of his own money.[86] As of January of this year, Centaurus employed 36 people and had about $1.5 billion in assets.[87] At a recent energy conference, Mr. Arnold said he "looks to place

[82] Stephen Taub, *Really Big Bucks*, Alpha, May 2006, at p. 19. Mr. Pickens ranked second on the *Alpha* list. Mr. James Simons, who *Trader Monthly* ranked third with an estimated $900 million - $1 billion in earnings, was ranked first by *Alpha*, with an estimated $1.5 billion in earnings. The two rankings identify many of the same individuals as the top hedge fund traders, although the estimates of earnings vary by significant amounts – hundreds of millions of dollars in some instances. The *Alpha* rankings only list the top 25 traders; with the exception of Mr. Pickens, the energy traders identified in the *Trader Monthly* rankings did not earn enough to qualify for this list. *See also* Alistair Barr, *Hedge-fund giants Simon, Pickens made more than $1 bln in 2005*, MarketWatch, May 26, 2006, at http://www.marketwatch.com (last visited May 26, 2006).

[83] Brad Foss, *AP Interview; Riding high on oil prices, Boone Pickens sees prices going even higher*, Associated Press, June 22, 2005.

[84] *Id.* It was long before this 2005 interview, however, that Mr. Pickens began betting that the price of oil would rise, based on a belief that the rapid increase in demand had used up all of the global spare production capacity. In May, 2004, for example, when oil was trading at about $40 per barrel, and most analysts were predicting prices would fall, Mr. Pickens publicly predicted prices would keep increasing: "I think you'll see $50 before you see $30 again." Darrell Preston, Bloomberg News, *T. Boone is Back; The Corporate Raider Who Brought Down Gulf Oil is Cashing in on Oil Price Spike*, Pittsburgh Post-Gazette, October 10, 2004. Opinions vary as to the reason for Mr. Pickens has been so successful recently. "He understands the industry and business like no one else," commented billionaire Harold Simmons, one of the original investors in Mr. Pickens's hedge funds. *Id.* On the other hand, Peter Fusaro, chairman of Global Change Associates, a consulting firm, commented, "He just got lucky." *Id.*

[85] *Behind Runaway Prices: Supply Issues are Real, But Hype Sets Bar*, Natural Gas Week, September 5, 2005.

[86] *See* Barrionuevo, *Energy Trading, Without a Certain "E"*, The New York Times, January 15 2006.

[87] *Id.; see also* Peter Elkind, Bethany McLean, *The Luckiest People in Houston*, Fortune, April 17, 2006. Among those now working for Mr. Arnold is Greg Whalley, who, as head of wholesale trading at Enron, once was Mr. Arnold's boss. In August 2001, following the resignation of Jeffrey Skilling, Mr. Whalley was appointed

bets on a market that he determines is 'biased,'" meaning that the market is not reflecting the fair value for a product.[88] "We ask ourselves can we identify what is forcing a market to price a product at an unfair value, and then, what will push it back to fair value."[89] Mr. Arnold also stated how a significant amount of speculative trading was taking place on the unregulated over-the-counter Intercontinental exchange (ICE). "'Trading never went away,' Arnold said, 'What has changed is the non-commercial type of interest.' Intercontinental Exchange, he said, has provided huge new opportunities, as has NYMEX's Clearport trading. 'Because of this, there has never been as much investor interest . . . as there is today.'"[90]

Table 1 lists the traders who *Trader Monthly* reported to have obtained a significant portion of their profits from trading energy commodities. Inclusion on this list is not meant to imply that any of the traders derived their profits from any improper trading activity.

Table 1
Selected Top Energy Traders in 2005

Trader	Firm Type of Trader	2005 Estimated Earnings	*Trader Monthly* Comments
T. Boone Pickens	BP Capital (hedge fund)	$1.5 billion +	"'Long Crude' doesn't even begin to describe T. Boone Pickens's position. With $5 billion and growing in assets under management, his fund company, BP Capital, is throwing off a small national economy via an unshakable bet that the world's oil supply can't keep up with demand. . . . Returns on Pickens's main commodities pool were over 700 percent in 2005. . . . [This] translates into what *Trader Monthly* believes is the largest one-year sum ever earned. . . ."
Brian Hunter	Amaranth Advisors (hedge fund)	$75-$100 million	"In 2005, Hunter was certainly among the top natural gas traders in the world. . . . Rumor is that Hunter made Amaranth an estimated $800 million off his book, mainly [natural] gas derivatives positions but also some other energy dabblings."

Enron's president. *Id.*

[88] *Two former Enron trading experts share dais and ideas on energy market evolution*, Platts Power Markets Week, February 13, 2006.

[89] *Id.*

[90] *Id.*

John Arnold	Centaurus Energy (hedge fund)	$75-$100 million	"Starting 4 years ago with $8 million of his own dough, John D. Arnold, former star Enron energy trader, has since amassed more than $1 billion in assets. Most of the 16 other traders at his Centaurus Energy fund operation came from Enron."
Jim Pulaski	Tudor Investment (hedge fund)	$50-$75 million	"[T]his Tudor energy trader is commander in chief when it comes to natural gas."
Steven Berkson	Trader (NYMEX)	$25-$30 million	"Readers of *Trader Monthly* will remember the legend of natural-gas-futures stalwart Steve Berkson and Hurricane Katrina. One of the tallest versions of the tale has Berkson making $40 million off the opening bell the day Katrina made landfall (we heard he ended up tallying around $20 million for the week). Lesser known is how much of that score Berky ultimately slid to relief efforts (reportedly a sizable portion)."
Mark Fisher	MBF Clearing operator (NYMEX)	$25-$30 million	"Few people have more at stake in the future of the NYMEX than Fisher, who runs MBF Clearing, the primary market-making operation for the exchange's top-grossing crude-oil futures contract."
Simon Greenshields	Morgan Stanley	$20-$25 million	"Morgan Stanley's head of gas and power, Greenshields is part of the bank's elite energy crew. His specialties are natural gas and electricity. . . ."
Olav Refvik	Morgan Stanley	$20-$25 million	"Refvik is a key part of one of the most profitable energy-trading operations in the world. He has helped the bank dominate the heating oil market by locking up New Jersey storage-tank farms adjacent to New York Harbor. . . ."
John Shapiro	Morgan Stanley	$20-$25 million	"Shapiro has been a vital part of Morgan's energy effort, working [to help] oversee the 200-plus-person profit center."
John Bertuzzi	Goldman Sachs	$15-$20 million	"A star trader on one of the most powerful energy desks on earth. . . ."
George "Beau" Taylor	J.P. Morgan	$15-$20 million	"[Taylor] . . . switched over to J.P. Morgan, where he now helps oversee the firm's 80-person energy-trading unit."
Jeffrey Wolfson	Trader (NYMEX)	$15-$20 million	"Crude oil traders don't come much bigger than the man whose badge reads GEOF. A one-man volume-generation machine. . . ."
Vincent Kaminski	Citigroup	$10-$15 million	"Kaminski is a revered energy trader considered among the foremost authorities on measuring and analyzing market risk. . . ."

Todd Applebaum	Trader (NYMEX)	$10-$15 million	"Applebaum is another natural gas guy who lit it up in 2005. 'Great trader, huge volume,' says one NYMEX insider."
Eric Bolling	Trader (NYMEX)	$10-$15 million	"Among the most famous natural gas traders on the floor today . . . [Bolling] is said to account for as much as 5 percent of total volume in [natural gas]. . . ."
Sandy Goldfarb	Trader (NYMEX)	$10-$15 million	" . . . [Goldfarb] knocked his [natural gas] book out of the ozone layer last year amid one hurricane after another and some of the most treacherous volatility ever recorded in the decade and a half since natural gas futures were created. . . ."
Robert Halper	Trader (NYMEX)	$10-$15 million	"When it comes to [arbitraging] crude oil against gasoline, Bob Halper wrote the book. According to some, he will go down as one of the biggest crack-spread traders the NYMEX has ever seen."
Daniel Lirtzman	Trader (NYMEX)	$10-$15 million	"A natural gas 'natural'. . . ."
Kevin McDonnell	Trader (NYMEX)	$10-$15 million	"Chalk up yet another blowout year. . . ."
Simon Posen	Trader (NYMEX)	$10-$15 million	"Last year's natural gas swings produced a significant surge in Posen's trading profits."
Mitchell Stern	Trader (NYMEX)	$10-$15 million	"Stern had a huge year, sources say."

Table 1. Large trader profits are an indicator of increased speculation in energy commodity markets. Data source: *Trader Monthly*, April/May 2006.

Not only are the top traders for investment banks and funds earning record incomes, but in-house corporate traders are earning record amounts as well. According to a recent article in Bloomberg news, at Sempra Energy, the owner of the biggest U.S. natural gas utility, "as many as 30 commodity traders [make] more than the $2 million earned last year by Chief Executive Officer Don Felsinger. 'That's what it costs to be in this business,' Felsinger [said] in a May 17 interview."[91] Bloomberg also reported that division managers for commodities trading were also the mostly highly paid employees at Constellation Energy, earning approximately $5 million in bonuses, compared to a total compensation package of about $4 million for the Chief Executive Officer.[92]

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[91] *What's a Top Commodity Trader Worth? Quintuple 2000 Salaries*, Bloomberg.com, June 1, 2006.

[92] *Id.*

IV. NO COP ON THE BEAT FOR OVER-THE-COUNTER ENERGY MARKETS

Until recently, the trading of U.S. energy futures was conducted exclusively on regulated exchanges within the United States, like the NYMEX, and subject to extensive oversight by the CFTC and the exchanges themselves in order to detect and prevent price manipulation. Under the Commodity Exchange Act, the purpose of CFTC regulation is to deter and prevent price manipulation, ensure the "financial integrity" of transactions, maintain market integrity, prevent fraud, and promote fair competition.[93] This regulation and the resulting transparency has bolstered investor confidence in the integrity of the regulated U.S. commodity markets and helped propel U.S. exchanges into the leading marketplace for many commodities.

Pursuant to its statutory mandate to detect and prevent price manipulation, the CFTC has imposed a variety of reporting requirements and regulations on the trading of commodity futures and options. NYMEX traders, for example, are required to keep records of all trades and report large trades to the CFTC. The CFTC uses these Large Trader Reports, together with daily trading data providing price and volume information, to monitor exchange activity and detect unusual price movements or trading.

None of this oversight to prevent price manipulation, however, applies to any of the energy trading conducted on OTC electronic exchanges. As a result of a provision inserted by House and Senate negotiators during the waning hours of the 106th Congress into legislation that became the Commodity Futures Modernization Act of 2000 (CFMA),[94] the Commodity Exchange Act exempts from CFTC oversight all trading of energy commodities by large firms on OTC electronic exchanges.[95]

In recent years, there has been a tremendous growth in the trading of energy commodity contracts that are virtually identical to futures contracts, but which are traded on OTC electronic exchanges rather than the regulated futures exchanges. These contracts are so similar to futures contracts that they are often called "futures look-alike contracts." Although the trading of

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[93] 7 U.S.C. Sec. 5.

[94] The provisions of the CFMA that provide exclusions and exemptions for energy and metal commodities were included in the version of the legislation that passed the House on October 19, 2000 (H.R. 4541, 106th Cong., 2nd Sess.), but were omitted from the version placed on the Senate calendar after passage by the Senate Committee on Agriculture in late August (S. Rpt. No. 106-390, 106th Cong., 2nd Sess.). Following negotiations between members of the House and Senate Agriculture committees, the legislation that became the Commodity Futures Modernization Act – with the exclusions for energy and metal commodities – was introduced in the House on December 14 and in the Senate on December 15, 2000. The CFMA was passed by both the House and Senate on December 15, the last day of the 106th Congress, as part of an omnibus legislative package involving 13 appropriations bills and several authorization bills. There was no opportunity for debate on any of the specific provisions in the CFMA; the Senate passed this entire omnibus package by unanimous consent. A history of the regulation of the trading of energy commodities is presented in Appendix 2 of the Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations, *U.S. Strategic Petroleum Reserve: Recent Policy Has Increased Costs to Consumers But Not Overall U.S. Energy Security*, S. Prt. 108-18, 108th Cong., 1st Sess. (March 5, 2003).

[95] 7 U.S.C. 2(h)(3).

futures contracts on futures markets is subject to extensive oversight, as a result of the CFMA exemptions the trading of futures look-alikes on an OTC electronic exchange is not subject to any CFTC oversight. The growth of these OTC electronic markets, therefore, has been creating an increasing "blind spot" in the CFTC's oversight of the trading of energy commodity futures. This increasing blind spot significantly impairs the CFTC's ability to carry out its statutory mandate to detect and prevent price manipulation.

A. Development of OTC Electronic Markets

"Enron did two things for us. It validated our model, and in 2000, 13 big market makers agreed to support the ICE's efforts."
–Jeffrey Sprecher, Chairman and CEO, Intercontinental Exchange[96]

Initially, the OTC market was not an actual place or facility where trading occurred, but rather a general term that referred to instances in which two parties would come together to reach agreement on a contract between them to protect against or assume price risks that could not be adequately addressed by the trading of standardized futures contracts on the regulated futures exchanges. Until the advent of electronic trading in the late 1990s, the terms of most OTC contracts were customized through negotiations between the two parties, either face-to-face or through brokers over the telephone. Because the terms of these customized, bilateral deals were unique, and the contracts generally could not be traded or assigned to third parties, these OTC contracts were considered simply as bilateral contracts, outside the CFTC's jurisdiction.

In the 1990s, as energy deregulation gained momentum, and energy was increasingly being considered as another commodity priced on an open market, energy producers and suppliers desired additional protections against market price risks. OTC contracts became more popular, and the increasing number of energy providers, merchants and traders holding these contracts desired to trade these OTC instruments to third parties to help reduce, diversify or spread the risks they had assumed. In response, the OTC market began to develop standardized OTC contracts that could be traded to multiple parties. Following rapid developments in computer and internet technology in the 1990s, a number of companies and groups developed electronic exchanges to facilitate these OTC trades.[97]

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[96] Gerelyn Terzo, *A Battle Royal; A sleek upstart and an entrenched giant are waging all-out war for the soul of the energy trading market*, Investment Dealers Digest, May 1, 2006.

[97] Initially, the most prominent of these electronic exchanges was operated by Enron. On Enron's electronic trading platform, called "Enron OnLine," Enron became the counterparty to all of the trades. Enron's position as a party to all trades provided Enron with superior market information and created a non-level playing field. Following Enron's collapse and the subsequent revelations of how Enron abused its superior knowledge and market position, *see, e.g.*, note 117, the Enron "one-to-many" trading model was discredited. Today, all of the electronic exchanges are "many-to-many" exchanges, meaning that the parties trade with each other rather than the operator of the exchange.

In 2000, a half dozen investment banks and oil companies formed the Intercontinental Exchange ("ICE") for OTC electronic trading in energy and metals commodities.[98] The Atlanta-based ICE is an electronic exchange open only to large commercial traders that meet the definition of an "eligible commercial entity" under the Commodity Exchange Act.[99] According to ICE, its market participants "must satisfy certain asset-holding and other criteria and included entities that, in connection with their business, incur risks relating to a particular commodity or have a demonstrable ability to make or take delivery of that commodity, as well as financial institutions that provide risk-management or hedging services to those entities."[100]

Today, ICE operates the leading OTC electronic exchange for energy commodities. ICE describes its participants as "some of the world's largest energy companies, financial institutions and other active contributors to trading volume in global commodity markets. They include oil and gas producers and refiners, power stations and utilities, chemical companies, transportation companies, banks, hedge funds and other energy industry participants."[101] According to ICE, its electronic markets now constitute "a significant global presence with over 9,300 active screens at over 1,000 OTC participant firms and over 440 futures participant firms as of December 31, 2005."[102]

Unlike NYMEX, ICE does not require its participants to become formal members of its exchange or to join a clearinghouse.[103] Any large commercial company qualifying as an eligible

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[98] The founding partners of ICE are BP Amoco, Deutsche Bank AG, Goldman Sachs, Dean Witter, Royal Dutch/Shell Group, SG Investment Bank, and Totalfina Elf Group. In November, 2005, ICE became a publicly traded corporation. Many of these original founders are major shareholders: Morgan Stanley owns nearly 15 percent of ICE shares, Goldman Sachs owns about 14 percent, Total owns about 9.5 percent, and BP owns about 9 percent. *Market Forces: Big Oil increases market reach*, Energy Compass, March 24, 2006.

[99] Participation is restricted to parties that quality as an "eligible commercial entity" under Sec. 1a(11) of the CEA. Generally, these entities are large financial institutions, insurance companies, investment companies, corporations and individuals with significant assets, employee benefit plans, government agencies, and registered securities brokers and futures commission merchants.

[100] Intercontinental Exchange Inc, Form 10-K, filed March 10, 2006 ("ICE 10-K"), at p. 14. There does not appear to be any mechanism to ensure that only eligible commercial entities actually trade on ICE. The CFTC does not monitor or oversee participation; ICE declined to answer the Subcommittee staff's questions as to whether or how it monitors trader qualifications.

[101] ICE 10-K, at p. 14.

[102] ICE 10-K, at p. 6. As explained in Section V, in 2001, ICE purchased the International Petroleum Exchange, a London-based futures exchange that traded North Sea Brent crude oil and natural gas delivered in Europe. In 2005, ICE renamed the London exchange as "ICE Futures" and converted its open-outcry pit trading system into an all-electronic exchange. Hence, ICE now operates two major electronic markets: ICE Futures and ICE OTC. ICE Futures is a futures market in London, regulated by the U.K. Financial Services Authority, and ICE OTC operates as an "exempt commercial market" under section 2(h)(3) of the U.S. Commodity Exchange Act. Both markets operate outside of the CFTC's oversight.

[103] In contrast, on NYMEX and other regulated futures exchanges, the exchange clearinghouse acts as the buyer for all sellers and the seller for all buyers. Persons that are not members of the exchange must trade through a clearing member. Clearing members accept all financial responsibility for the trades tbey conduct on behalf of the customer initiating the trade.

commercial entity can trade through ICE's OTC electronic exchange without having to employ a broker or pay a fee to a member of the Exchange.

Although ICE's OTC exchange does not operate its own clearinghouse, ICE has contracted with a third party, the LCH.Clearnet, to offer clearing services for traders who desire to trade only with other cleared traders. By trading only with other cleared traders, a party trading on ICE can eliminate the risk of default by the other party just as if he or she were trading on a futures exchange, thereby avoiding one of the traditional disadvantages of OTC trading.[104] ICE describes the advantages of OTC trading through a clearinghouse:

> The use of OTC clearing serves to reduce the credit risk associated with bilateral OTC trading by interposing an independent clearinghouse as a counterparty to trades in these contracts. The use of a central clearinghouse rather than the reliance on bilateral trading agreements [has] resulted in more participants becoming active in the OTC markets. In addition, clearing through a central clearinghouse typically offers market participants the ability to reduce the amount of capital required to trade as well as the ability to cross-margin positions in various commodities.[105]

ICE states that its OTC markets "offer trading in hundreds of natural gas, power and refined oil products on a bilateral basis. At the end of first quarter 2006, we also offered over 50 cleared OTC contracts, which account for the majority of our commission revenue. In March 2006, we began the introduction of more than 50 planned additional cleared OTC contracts, with the first 34 cleared contracts launched through the end of April this year."[106] According to ICE, its natural gas contracts are its most heavily traded contracts. ICE represents it traded nearly 43 million cleared OTC Henry Hub natural gas contracts in 2005, "compared to 10.4 million cleared OTC Henry Hub natural gas contracts traded by our nearest competitor during the same period."[107]

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[104] NYMEX also offers an electronic trading platform for the trading of standardized OTC instruments, and provides clearinghouse services, called "NYMEX ClearPort," for traders using the NYMEX OTC electronic trading platform. NYMEX states that its OTC clearing service "lets market participants take advantage of the financial depth and security of the Exchange clearinghouse along with round-the-clock access to more than 60 energy futures contracts including natural gas location differentials; electricity, crude oil spreads and outright transactions; refined product crack and location spreads and outright transactions; and coal." NYMEX, NYMEX ClearPort Services, on NYMEX website, at http://www.nymex.com/cp_overview.aspx (last visited May 19, 2006).

[105] Intercontinental Exchange Inc., Form 10-Q, filed May 2, 2006 ("ICE 10-Q"), at p. 16. In 2005, ICE also contracted with North American Energy Credit and Clearing, LLC, to provide clearing for trades in physically-settled OTC natural gas and power contracts. *Id.*

[106] ICE 10-Q, at p. 17.

[107] ICE 10-K, at p. 5.

ICE claims that its "introduction of cleared OTC products has enabled us to attract significant liquidity in the OTC markets we operate."[108] Others agree. "[C]learing is paving the way for greater growth of the energy market as a whole," one futures industry publication reported. "Clearing not only helped restore liquidity post-Enron, it opened the door to an influx of hedge funds and other professional traders, many of whom come from the financial world." Moreover, OTC clearing has "created a new linkage" between the futures markets and the OTC markets. "On one level this is simple arbitrage between two sets of similar contracts. On another level it is a cross-fertilization of people and ideas, as each side seeks out better opportunities in newly accessible markets."[109] "If you want to participate in all the information of the market," said Bo Collins, former President of NYMEX, and now the operator of his own hedge fund, "you have to participate electronically and OTC."[110]

Today, there are few, if any, practical differences between the energy commodities traded on the regulated futures markets and the standardized, cleared contracts traded on the unregulated OTC electronic exchanges. From an economic perspective, there is no distinction between trading a standardized, cleared OTC contract for future delivery on ICE and trading a standardized, cleared futures contract on NYMEX.[111] Both types of contracts allow buyers and sellers to hedge against price risks and to speculate on price changes. In each market counterparty risk is eliminated by use of a clearinghouse. In each market, contracts are put on the market and bought and sold many times.

From a practical perspective, the only real difference between the two markets is the degree of regulation. ICE itself distinguishes its OTC market from the regulated futures exchanges primarily by the absence of regulation.[112] Trading on the futures market is subject to CFTC oversight, while trading on the unregulated OTC exchanges is not.

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[108] ICE 10-K, at p. 5. ICE states, "both physically-delivered and cash-settled gas products can be traded at a fixed price or differential to recognized published indices." ICE website, at https://www.theice.com/naturalgas.jhtml. *See also, e.g.*, ICE, OTC Natural Gas Clearing and Credit, Product Specifications, March 24, 2006; ICE, OTC Natural Gas and Financial Power Clearing and Credit, Product Specifications for products to be launched on April 7, 2006. ICE further amplifies: "A substantial portion of the trading volume in our OTC markets relates to approximately 15-20 highly liquid contracts in natural gas, power, and oil. For these contracts, the highest degree of market liquidity resides in the prompt, or front month, whereas that liquidity is reduced for contracts with settlement dates further out, or in the back months." ICE 10-K, at p. 9.

[109] Will Acworth, *The Tipping Point: OTC Energy Clearing Takes Off*, Futures Industry Magazine, January/February 2005.

[110] *Id.* Although NYMEX's ClearPort offers a similar OTC trading opportunities, ICE currently has approximately 80 percent of the market for cleared OTC Henry Hub natural gas contracts and 85 percent of the cleared OTC PJM financial power contracts. ICE 10-Q, at p. 28.

[111] Generally, futures contracts for key energy commodities can be settled through physical delivery of the commodity, whereas but OTC futures look-alikes are financially settled. Since only a small percentage of futures contracts actually result in physical delivery of the commodity, this distinction does not make a practical difference in the economic function or utility of the two types of contracts. Moreover, many of the financially-settled OTC contracts reference the NYMEX price for settlement; in this respect the two markets are intertwined.

[112] ICE 10-K, at p. 25.

B. No Oversight of OTC Electronic Markets

Section 2(h)(3) of the Commodity Exchange Act, which became law as part of the CFMA, exempts from CFTC oversight all agreements, contracts, and transactions in energy and metals ("exempt commodities") that are traded on electronic trading facilities between "eligible commercial entities."[113] Generally, an eligible commercial entity must be either a large financial institution, insurance company, investment company, corporation or individuals with significant assets, employee benefit plan, government agency, registered securities broker, or futures commission merchant. Markets operating under Section 2(h)(3) are referred to as "exempt commercial markets."[114]

An exempt commercial market (ECM) is subject to the CEA's statutory prohibitions on fraud and price manipulation and, if the CFTC determines that the market performs a significant price discovery function, the ECM must provide pricing information to the public, but otherwise it is fully exempt from the CFTC's regulatory oversight. The CFTC describes its authority over these ECMs as follows:

> In contrast to its authority over designated contract markets and registered derivatives transaction facilities, the CFTC does not have general oversight authority over exempt commercial markets. Exempt commercial markets are not registered with, or designated, recognized, licensed or approved by the CFTC.[115]

Today, the CFTC does not apply to exempt commercial markets like ICE any of the oversight and surveillance measures it currently uses to oversee regulated futures markets like the NYMEX. Table 2 provides a comparison of the oversight mechanisms used to police trading on the two markets and prevent price manipulation and fraud.

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[113] 7 U.S.C. Sec. 2(h)(3).

[114] 7 U.S.C. Sec. 1a(11).

[115] Cite to 2(h)(3). CFTC, Exempt Commercial Markets That Have File Notice with the CFTC, at CFTC website at http://www.cftc.gov/dea/dea_ecm_table.htm (last visited May 19, 2006).

Table 2
Futures and Exempt Commercial Markets:
Differences in Oversight to Prevent Price Manipulation

Measure to Prevent Price Manipulation	Does the Measure Apply to the:	
	Futures Market	**Exempt Commercial Market**
CFTC Market Surveillance Program		
• CFTC staff monitoring of daily trading reports	Yes	No
• Weekly reports and reviews for expiring contracts	Yes	No
• Option of special data call by CFTC	Yes	Yes
Large Trader Reporting		
• Large trader reporting by clearing members	Yes	No
• Large trader reporting by exchanges	Yes	No
• Filing of information about trading accounts by traders	Yes	No
Core Principles for Exchange Operations		
• Exchange is responsible for monitoring compliance with market rules	Yes	No
• Exchange can only list contracts for trading that are not readily susceptible to manipulation	Yes	No
• Exchange must monitor trading to prevent manipulation, price distortion, and disruption of the delivery or cash-settlement process	Yes	No
• Position limits for speculators to reduce the potential threat of manipulation or congestion	Yes	No
• Emergency authority, in consultation with the CFTC, to liquidate positions, suspend trading, or impose special margin requirements	Yes	No
• Daily submission of trading information to CFTC	Yes	Limited
• Daily publication of trading information	Yes	*
• Exchange must keep records of trading	Yes	Yes

* Section 2(h)(4) of the Commodity Exchange Act requires daily publication of trading information if the market performs a price discovery function. The CFTC has not made any determination as to whether any of the exempt commercial markets performs a price discovery function. See Section IV.D. in this report.

These differences are substantial. For example, unlike the regulated exchanges, on OTC electronic exchanges, neither the CFTC nor the OTC trading facility itself monitors trading activity to detect and deter fraud and price manipulation. Key trading information is not disclosed to the CFTC or the public. Although ICE discloses to the CFTC and subscribers of its data services certain information about posted bids, offers, and completed trades, other critical data routinely reported by the regulated exchanges to the CFTC and the public, such as open interest, is not reported by ICE. Large trader reports do not have to be filed with the CFTC. Unlike trading on the NYMEX, there are no position limits or price change limits.

The most frequently asserted justification for this disparity in regulatory coverage is that only large institutions that are sophisticated traders with less need for governmental protection are permitted to trade on these electronic trading facilities. But federal regulation of commodity markets is not designed solely to protect commodity traders; it is also intended to protect commodity purchasers and the public at large, including consumers who ultimately bear the costs of energy products such as gasoline, heating oil, diesel fuel, and natural gas.

The Commodity Exchange Act articulates the national interest in preventing price manipulation and excessive speculation:

> The transactions and prices of commodities on such boards of trades are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, rendering regulation imperative for the protection of such commerce and the national public interest therein.[116]

The history of commodity markets demonstrates it is unrealistic to rely on the self-interest of a few large traders as a substitute for dedicated, independent oversight to protect the public interest. Commodity traders have no responsibility or obligation to look out for public rather than private interests. In some cases, it could be a breach of fiduciary duty for officers of a private corporation to look out for interests other than those of the corporation's shareholders. Most recently, the Enron scandal, which involved misconduct by a number of traders at large energy and trading companies active in OTC trading, is clear evidence of how a few sophisticated, unscrupulous traders can harm not only other market participants, but also the public at large by artificially increasing prices.[117] Consumers paying artificially high energy

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[116] 7 U.S.C. Sec. 5. This statement of purpose in the CEA was revised to read in its current form as part of the CFMA of 2000.

[117] *See, e.g.*, August 2002 report prepared by the Federal Energy Regulatory Commission (FERC) staff, Docket No. PA-02-000, which found significant evidence of price manipulation and deceptive practices by Enron in connection with its OTC electronic trading platform, known as Enron OnLine. The report includes a detailed analysis of natural gas trades made on Enron OnLine for next-day delivery into California over the course of a single day, January 31, 2001. The report found that of a total of 227 trades on that day, 174 involved Enron and a single unnamed party; these 174 trades took place primarily during the last hour of trading, and by using "higher prices," these trades resulted in a steep price increase over the last hour of trading. The report also noted that price information displayed electronically on Enron OnLine was a "significant, even dominant" source of price

prices suffer the same harm regardless of whether the price was manipulated on an OTC electronic exchange or on a regulated futures market.

C. No Large Trader Reporting in OTC Electronic Markets

As indicated Table 2, Large Trader Reports are not required in OTC electronic markets. The absence of information about large trades increases the vulnerability of these markets to price manipulation and excessive speculation.

CFTC Chairman Reuben Jeffery III, recently stated, "One of the core themes of the Commodity Exchange Act . . . is that the commodity markets operate free of manipulation and the Commission's most basic responsibility is to detect and deter such behavior so that markets operate in an open and competitive manner, free of price distortions."[118] To fulfill this responsibility, the Commission has established a market surveillance program, whose primary mission is "to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions."[119] "[T]he Commission attempts to proactively combat potential manipulation," Chairman Jeffery explains, "rather than simply waiting until someone has attempted to manipulate prices."[120] The CFTC staff monitors the daily trading on the regulated exchanges, with particular focus on "the daily activities of large traders, key price relationships, and relevant supply and demand factors."[121]

The "cornerstone" of the surveillance program is the Commission's Large Trader Reporting (LTR) system.[122] Chairman Jeffery states the LTR system "enables detection of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation. This transparency is also well known to market participants, providing yet another element of deterrence."[123] The CFTC's Chief Economist, Dr. James Overdahl, recently told Congress the LTR system "is a powerful tool for detecting the types of concentrated and

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information used by reporting firms publishing natural gas pricing data. The report tentatively concluded that Enron OnLine price data was susceptible to price manipulation and may have affected not only Enron trades, but also increased natural gas prices industrywide.

[118] Letter from Reuben Jeffery III, Chairman, Commodity Futures Trading Commission, to Governor Jennifer Granholm, August 22, 2005.

[119] CFTC Backgrounder, *The CFTC Market Surveillance Program*, June 2001, at CFTC website, at http://www.cftc.gov/opa/backgrounder/opasurveill.htm?from=home&page=mktsurveilcontent.

[120] Letter from Reuben Jeffery III, Chairman, Commodity Futures Trading Commission, to Governor Jennifer Granholm, August 22, 2005.

[121] CFTC, *The CFTC Market Surveillance Program*.

[122] Letter from Reuben Jeffery III, Chairman, Commodity Futures Trading Commission, to Governor Jennifer Granholm, August 22, 2005.

[123] *Id.*

coordinated positions required by a trader or group of traders attempting to manipulate the market."[124]

Under the LTR system, clearing members of futures exchanges (the entities that actually do the trading on behalf of customers) must file daily reports with the CFTC identifying the futures and options positions held by its customers above specific threshholds established by the Commission. To enable the CFTC to aggregate a trader's positions that may have been established through more than one clearing member, traders themselves are required to inform the CFTC of each account that acquires a reportable position. "Only by properly identifying and aggregating accounts can the surveillance staff make a thorough assessment of a trader's potential market impact and a trader's compliance with speculative position limits."[125] The exchanges themselves are required to report similar data to the CFTC. According to the CFTC, "The aggregate of all large-traders' positions reported to the Commission usually represents 70 to 90 percent of the total open interest in any given market."[126]

The Commission describes how it uses this data to take appropriate action to detect and deter price manipulation:

> Surveillance economists prepare weekly summary reports for futures and options contracts that are approaching their critical expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advise the Commission and senior staff of potential problems and significant market developments at weekly surveillance meetings so that they will be prepared to take prompt action when necessary.[127]

The LTR system also provides critical information for the weekly Commitment of Traders reports that the CFTC provides to the public. The CFTC's Chief Economist stated, "Data from the CFTC's Large Trader Reporting System can help answer questions about the role of non-commercial traders in U.S. energy futures markets." This data can be used to help determine the relative participation of commercial participants (firms that buy or sell the traded commodity as part of their business and use the futures markets for hedging) and of speculators (who are not using the market for hedging physical commodities). Without a large trader reporting system, it is impossible to determine the composition of the futures markets and analyze the influence of speculation on market prices.[128]

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[124] Statement of Dr. James Overdahl, Hearing on *Global Oil Demand/Gasoline Prices*, before the Senate Committee on Energy and Natural Resources, September 6, 2005.

[125] CFTC Backgrounder, *The CFTC's Large-Trader Reporting System*, at CFTC website, at http://www.cftc.gov/opa/backgrounder/opa-ltrs.htm.

[126] *Id.*

[127] CFTC, *The CFTC Market Surveillance Program*.

[128] There are anecdotal reports that some traders prefer trading on the OTC energy markets in the United States because of the lack of regulation. *Natural Gas Week* recently quoted one trader:

> When volumes all of a sudden begin to increase in one market and begin to erode in another, you

D. No Public Dissemination of Trading Data by OTC Electronic Markets

Under the Commodity Exchange Act, regulated markets are required to publish daily information about settlement prices, volume, open interest, and opening and closing price ranges for all actively traded contracts.[129] Under the Commodity Futures Modernization Act, OTC electronic markets must publish similar information if the CFTC determines that the market "performs a significant price discovery function" for the underlying cash market.[130] Although there is substantial evidence that the ICE OTC electronic exchange performs such a price discovery function, the CFTC has not undertaken any effort to make this determination. The failure to even attempt to make this determination ignores the Congressional mandate expressed in the law that the OTC electronic exchanges that perform a price discovery function be as transparent to the public as the regulated futures exchanges.

In 2004, the CFTC issued a rule setting forth the process and criteria it would use to determine whether an electronic exchange performed a price discovery function.[131] However, the CFTC has not taken any action in the two years since that rule was issued to actually

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> have to ask yourself where the real market is? Since there's not the same sort of mandatory reporting requirements in the OTC world, it's very likely the funds have had their fill of being scrutinized and spot-lighted as the culprits, so they are moving into another market area that is not so easily tracked and doesn't have as much attention drawn to it.

Funds Increasing OTC Volumes, Sidestepping Nymex Oversight, Natural Gas Week, April 25, 2005. *Natural Gas Week* also reported that hedge funds "benefit from the OTC traded futures market because they are not as transparent as NYMEX traded futures, and the non-commercial reporting requirements such as the CFTC mandated Commitment of Traders report is not as stringent." *Id.* The article explained how speculators can influence the futures markets through their activity in the OTC market, or vice versa, and capture a profit through the difference in price between the two markets that may result from trading in one of the markets.

> "Last week, there was a lot of arbitrage going on between the OTC gas futures markets and the NYMEX futures markets, because at times the OTC markets were as much as 5 cents in back of the futures screen," another gas futures trader said. "The OTC futures markets usually trade nearly in tandem with the NYMEX futures screen, but it's not uncommon to be able to capture a spread between the two markets. Still, it's amazing that the speculative entities in the OTC market can move the NYMEX down by 5 cents or more in about 30 seconds. But they could just as easily position themselves in the OTC market to influence the NYMEX futures market to the upside as well," the trader added.

Id. The article also noted that funds can take large positions in the OTC market without having to report those positions to any regulatory agency, thereby circumventing any position limits that apply to their trading on the futures market.

[129] 7 U.S.C. Sec. 7(d).

[130] Under the CEA, electronic trading facilities that trade energy commodities are subject to "such rules and regulations as the Commission may prescribe if necessary to ensure timely dissemination by the electronic trading facility of price, trading, volume, and other trading data to the extent appropriate, if the Commission determines that the electronic trading facility performs a significant price discovery function for transactions in the cash market for the commodity underlying any agreement, contract, or transaction executed or traded on the electronic trading facility." 7 U.S.C. Sec. 2(h)(4)(D).

[131] 69 Fed. Reg. 43285 (July 20, 2004).

determine whether ICE or any other OTC electronic market meets these criteria. Under the 2004 rule, an ECM performs a price discovery function when it meets one of two specified criteria:

(A) Cash market bids, offers or transaction are directly based on, or quoted at a differential to, the prices generated on the market on a more than occasional basis; or

(B) The market's prices are routinely disseminated in a widely distributed industry publication and are routinely consulted by industry participants in pricing cash market transactions.[132]

An ECM operating under the Sec. 2(h)(3) exemption must notify the CFTC when "it has reason to believe" either of these criteria are met, or if the "market holds itself out to the public as performing a price discovery function for the cash market for the commodity."[133]

If an ECM notifies the CFTC that it has reason to believe that it meets any of these criteria for performing a price discovery function, or the CFTC itself determines that an ECM appears to meet one of these criterion, then the CFTC must provide the ECM "with an opportunity for a hearing through the submission of written data, views and arguments."[134] After conducting such a hearing, and "consideration of all relevant matters," the Commission "shall issue an order containing its determination whether the electronic trading facility performs a significant price discovery function" under this section.[135]

If the CFTC determines that an electronic trading facility performs a significant price discovery function, then the regulations require the facility to disseminate to the public, on a daily basis, the following information:

(1) Contract terms and conditions, or a product description, and trading conventions, mechanisms and practices;
(2) Trading volume by commodity and, if available open interest; [and]
(3) The opening and closing prices or price ranges, the daily high and low prices, a volume-weighted price . . . or such other daily price information as proposed by the facility and approved by the Commission.[136]

[132] 17 C.F.R. Sec. 36.3(c)(2).

[133] 17 C.F.R. Sec. 36.3(c)(2)(C).

[134] 17 C.F.R. Sec. 36.3(c)(2)(C)(iii).

[135] *Id.*

[136] 17 C.F.R. Sec. 36.3(c)(2)(C)(iv)(A). The information must be publicly disseminated no later than the business day following the day to which the information applies. *Id.* at Sec. 36.3(c)(2)(C)(iv)(B).

The 2004 rule also requires an exempt commercial market to inform the CFTC of those commodity contracts it is trading in reliance on the exemption set forth in Sec. 2(h)(3). *Id.* at Sec. 36.3(b)(1)(ii). The ECM must provide the CFTC with a description of the contract and weekly reports on the price, quantity, and other information the CFTC determines is appropriate for each trade in that commodity contract during the previous week. The facility may either provide this information in weekly reports or provide the CFTC with electronic access to the same

Despite the 2004 regulations, to date, neither ICE – nor any other ECM – has informed the CFTC that it has reason to believe that its electronic exchange performs a price discovery function. Yet at the same time, ICE appears to have made that very claim to the Securities and Exchange Commission (SEC). In the Form 10-K that ICE filed with the SEC on March 10, 2006, ICE identified price discovery as a core function of its over-the-counter markets: "Our participants, representing many of the world's largest energy companies, leading financial institutions and proprietary trading firms, as well as natural gas distribution companies and utilities, rely on our platform for price discovery, hedging and risk management."[137]

ICE's 10-K filing also describes its sale of a daily report containing price data about OTC transactions as a core business activity. ICE described its "OTC End of Day Report" as follows:

> The OTC ICE Data end of day report is a comprehensive electronic summary of trading activity in our OTC markets. The report is published daily at 3:00 p.m. Eastern time and features indicative price statistics, such as last price, high price, low price, total volume-weighted average price, best bid, best offer, closing bid and closing offer, for all natural gas and power contracts that are traded or quoted on our platform. The end of day report also provides a summary of every transaction, which includes the price [and] the time stamp . . . .[138]

It is not apparent why traders and energy firms would pay for ICE Data's end-of-day trader reports if those reports did not provide valuable information about the data that is most useful to market participants – prices. Such price reports would appear to be useless or not worth the cost if the ICE trades did not perform a price discovery function. By generating valuable daily price data to industry participants, trading on ICE now performs a price discovery function.

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information. *Id.* at Sec. 36.3(b)(1)(ii)(A) and (B). Additionally, the ECM must maintain records of complaints or allegations of fraud or manipulation, and forward any such complaints to the CFTC. *Id.* at Sec. 36.3(b)(1)(iii) and (iv). There is no requirement that the CFTC or an ECM provide this data to the public.

In comments filed on the proposed rule, ICE contended that the CFMA did not give the CFTC authority to conduct regulatory oversight of trading on electronic trading facilities or to require electronic trading facilities to submit reports. The CFTC rejected this argument, noting that Congress expressly stated ECMs were still subject to the anti-fraud and anti-manipulation provisions of the CEA. "If the Commission is to have the ability to enforce those provisions, it must have access to meaningful information concerning transactions on ECMs." 69 Fed. Reg. at 43287. The CFTC also dismissed the contention that allowing the CFTC staff to monitor trading through the installation of a view-only trading screen at the CFTC was sufficient to enable the CFTC to monitor those markets for fraud and manipulation. "The Commission has found that the information provided under the current electronic access option is neither as relevant, nor as useful, as anticipated." *Id.* Fed. Reg. at 43286. It stated that the view-only access to computer screens provided to the CFTC by ICE "is not, in fact, equivalent to the large trader information received with respect to designated contract markets." *Id.* The CFTC, however, has not used this section to require information on open interest or large trades. Hence, the information that is provided to the CFTC under this section does not serve to provide the CFTC with the type of large trader information necessary to detect and prevent manipulation.

[137] ICE 10-K, at p. 4.

[138] ICE 10-K, at p. 13.

It is difficult to reconcile ICE's daily trading report and its statements to the SEC with its failure to notify the CFTC that its natural gas and electricity markets perform a price discovery function. As ICE states, most of the natural gas and power contracts traded in its OTC markets relate to "the prompt, or front month," – meaning the futures contract that is closest to the spot or cash market. Hence, the prices of these contracts as traded on ICE have a direct influence on the prices of these commodities in the cash market.

Although the CFTC's 2004 rulemaking requires an ECM that has reason to believe it is performing a price discovery function to notify the CFTC, the CFTC has retained authority to initiate a hearing to determine whether an ECM meets the criteria for performing a price discovery function. Despite numerous unqualified statements by ICE on its website,[139] in press releases,[140] and in filings with the SEC that its OTC electronic trading facility performs a price discovery function, the CFTC has failed to initiate any type of inquiry to evaluate this issue. In light of the substantial evidence that the ICE electronic exchange is performing a price discovery function, the CFTC appears to have failed to carry out its statutory mandate to require ICE to publicly disseminate trading data.

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[139] *See, e.g.*, ICE. The Energy Marketplace, https://www.theice.com/profile.jhtml (last visited June 9, 2006) ("IntercontinentalExchange is the world's leading electronic marketplace for energy trading and price discovery. . . . ICE's electronic trading platform offers direct, centralized access to trade execution and real-time price discovery through over 7,000 active screens at more than 1000 OTC and futures participant firms."); A Global Community of Energy Market Participants, at https://www.theice.com/customers.jhtml (last visited June 9, 2006) ("Through ICE's markets, participants have direct access to trade execution, real-time price information, market activity and unparallelled transparency in both futures and OTC energy markets. From the world's leading oil majors, to funds, utilities and financial institutions, energy market participants rely on ICE."); Clearing, at https://www.theice.com/futures_clearing.jhtml (last visited June 9, 2006) ("As the world's leading electronic energy exchange, ICE provides an unsurpassed forum for price discovery and risk management."); ICE Platform, https://www.theice.com/ice_platform.jhtml (last visited June 9, 2006) (ICE's electronic platform is the gateway to an open marketplace – one in which each participant has access to real-time price discovery and trading functionality.").

[140] *See, e.g.*, Statement of Jeffrey Sprecher, ICE Chairman and Chief Executive Officer, Intercontinental Announces 2003 Results, March 4, 2004, ("ICE's investment in the development of cleared OTC products was beneficial to a growing number of market participants who relied on clearing to ease credit constraints while managing risk. As a result, Intercontinental is well positioned to participate in the stabilizing OTC energy markets, and to facilitate the migration to electronic price discovery."), at https://www.theice.com/showpr.jhtml?id=558; Statement of Jeffrey Sprecher, Trading Technologies to Connect to ICE Energy Markets, March 17, 2004 ("We look forward to together delivering alternatives to the markeplace for electronic price discovery and expanded market access to a diverse group of participants."), at https://www.theice.com/showpr.jhtml?id=557.

V. THE COP'S BLIND EYE: U.S. ENERGY TRADES ON FOREIGN EXCHANGES

"Growth in our industry is certainly exceeding the ability of the regulators to get their heads around it."
–Jeffrey Sprecher, ICE Chairman and CEO[141]

ICE now operates two types of electronic energy exchanges. One is the ICE OTC exchange, which is registered in the United States. The other is ICE Futures, which is a futures exchange registered in London and regulated by the United Kingdom Financial Services Authority (FSA). Until January of this year, ICE Futures traded solely in European-based energy commodities. Within the past few months, however, the CFTC has permitted ICE Futures in London to use its trading terminals within the United States for the trading of U.S. energy commodities, including U.S. crude oil, U.S. gasoline, and U.S. home heating oil. The result is that persons located in the United States seeking to trade key U.S. energy commodities now can avoid all U.S. market oversight and reporting requirements simply by routing their trades through the ICE Futures exchange in London instead of the NYMEX in New York.

A. U.S. Energy Commodities Traded on Foreign Exchanges

In May 1999, the London International Petroleum Exchange ("IPE") petitioned the CFTC to permit the IPE to make its electronic trading system available to IPE members in the United States. Specifically, the IPE desired that its members who were registered with the CFTC be able to electronically place orders from within the United States, or to electronically submit the orders of customers within the United States, to the IPE in London, without requiring the IPE to be fully regulated as a U.S. futures market under the CEA. The IPE's petition contained general information about the IPE's operations, the contracts traded on the IPE, its floor and trading procedures, a description of the United Kingdom regulatory structure applicable to the IPE, the IPE's procedures for compliance with the U.K. regulations, and procedures for sharing information with the CFTC.[142]

In November 1999, the CFTC granted the IPE's request by releasing a "no-action" determination, permitting the IPE to allow its members to electronically trade from within the United States without having to designate the IPE as a U.S. futures exchange under the CEA. The CFTC wrote that its position was "restricted to providing relief from the requirement that IPE obtain contract market designation pursuant to [the CEA] and regulatory requirements that flow specifically from the contract market designation requirement in the event that the above-reference contracts are made available in the United States." The CFTC stated its "no-action position does not affect the Commission's ability to bring appropriate action for fraud or manipulation." It also stated that it retained the authority to "condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion."

[141] Comments at a conference, May 9, 2006. An audio replay of Mr. Sprecher's presentation can be downloaded from the ICE website, at https://www.theice.com/showpr.jhtml?id=2321 (last visited June 9, 2006).

[142] Letter from IPE to CFTC, May 14, 1999.

The initial no-action letter permitted the trading of IPE's natural gas, fuel oil, gas oil, and Brent crude oil contracts through IPE terminals in the United States. Subsequently, in 2002 and 2003, following the purchase of the IPE by ICE, the IPE received permission from the CFTC, through several amendments to the initial no-action letter, to trade U.K. natural gas, gas oil, and Brent crude oil contracts through the ICE electronic trading platform.

B. ICE Futures Trading of U.S. Energy Commodities

In mid-January 2006, ICE notified the CFTC that on February 3, 2006, it would begin trading a U.S. energy commodity – West Texas Intermediate crude oil, a crude oil that is produced in the United States – on its ICE Futures exchange in London, and that it would offer this contract for trading on its electronic trading devices that were operating in the United States under the no-action letters the CFTC had previously issued. Under CFTC policy in effect at the time, ICE Futures did not need an additional no-action letter to make this new contract available for trading in the United States; rather, ICE Futures needed only to provide prior notice to the CFTC.[143] This marked the first time that futures contracts for crude oil produced in the United States was traded on an exchange outside of the United States.

Since ICE began trading WTI crude oil futures on its London exchange, it has steadily increased its share of the WTI crude oil furtures market.[144] According to CFTC data, as of the end of April 2006, nearly 30 percent of WTI crude oil futures were traded on ICE Futures.[145] According to one energy trade publication, several of the large ICE stakeholders – BP, Total, and

[143] Notice of Statement of Commission Policy Regarding the Listing of New Futures and Options Contracts by Foreign Boards of Trade that Have Received Staff No-Action Relief to Place Electronic Trading Devices in the United States, 65 Fed. Reg. 41641 (July 6, 2000). On April 14, 2006, the CFTC revised its policy to require a foreign board of trade to provide the CFTC with at least ten days' notice prior to the commencement of trading from within the United States of any product on such board of trade. 71 Fed. Reg. 19877 (April 18, 2006).

[144] Prior to the listing of a WTI contract on the ICE Futures exchange, ICE offered a WTI contract for trading on its OTC electronic exchange. In a recent interview, ICE Chairman and CEO Jeffrey Sprecher described how ICE's development of a successful OTC contract for WTI paved the way for the introduction of the WTI contract on ICE Futures:

> To the outside world, we launched WTI and it came out with a very high adoption rate. But the reality is ICE was working on that contract for a year and a half prior to its launch. One unique thing about ICE is that we can take a product and launch it as a bilateral OTC contract allowing the energy trading community to trade it. While they trade it we can work out many of the details, such as the size of the contract, delivery aspects, tick size and those things. Then we can add clearing to it and bring in more of the funds and speculators – if we get that going, then we can make it a futures contract. That's the process we went through with the WTI contract. It went from a bilateral swap to a cleared OTC contract to a futures contract.
>
> And we're bringing other contracts through that conveyor belt process. In the first half of this year, we're bringing clearing to 50 bilateral contracts that we already offered.

ICE: "The market has spoken," Futures & Options Week, April 24, 2006. As previously discussed, quantitative data on the WTI contract traded on the ICE OTC electronic exchange is not readily available. According to former Federal Reserve Chairman Greenspan's recent testimony, during this period hedge funds and other institutional investors conducted a substantial amount of trading in crude oil in this market.

[145] CFTC data provided to the Subcommittee.

Morgan Stanley – were "doing their best to support the ICE WTI contract, with Goldman Sachs directing its traders to use the ICE platform rather than Nymex."[146]

ICE Futures has further expanded its reach into the U.S. energy commodities market. In addition to trading WTI crude oil futures on its London exchange, in April 2006, ICE Futures began trading futures in U.S. gasoline and home heating oil.

C. Implications for Oversight of U.S. Commodity Markets

The trading of U.S. energy commodities on the ICE Futures exchange in London from terminals within the United States permits traders within the United States to trade U.S. energy commodities without any U.S. oversight or regulation. This type of unregulated trading of a U.S. commodity from within the United States undermines the very purpose of the Commodity Exchange Act and the central mission of the CFTC – to prevent manipulation or excessive speculation of commodity prices "to the detriment of the producer or the consumer and the persons handling commodities." Without information about the trading of U.S. energy commodities, the CFTC cannot undertake, let alone accomplish, its mission.

Furthermore, the trading of U.S. energy commodities on foreign or unregulated OTC exchanges without any reporting to the CFTC undermines the reporting system for commodities traded on CFTC-regulated exchanges. With respect to traders that trade on both exchanges, the CFTC will be provided only partial data regarding the extent of their trades, thereby affecting the accuracy of the data to the CFTC.

For example, a trader wishing to disguise its position on the regulated market, or give the regulated market a false impression of its trading, could buy and sell an identical number of futures in different months; this would then be reported to the CFTC as a spread position. That same trader then could offset one of those positions, say, for example, the short position, on the unregulated exchange. In this example, the trader would have a net long position, but it would appear to the CFTC and the public, through the Commitment of Traders report, as a spread position. Hence, both the CFTC and the public would have an inaccurate view of the composition of the market. Only the trader would know the correct position. It is not difficult to imagine other schemes to distort the CFTC's market data.

For the CFTC to be able to carry out its fundamental mission to protect the integrity of the U.S. commodity futures markets, all U.S. traders of U.S. energy futures or futures-like contracts must keep records and report large trades to the CFTC, regardless of where the trade takes place – on the NYMEX, an electronic exchange, or a foreign exchange. To continue the present situation, in which the CFTC does not police two of three major markets trading U.S. energy futures, is to turn a blind eye to an increasingly large segment of these markets, thereby impairing the ability to detect, prevent, and prosecute market manipulation and fraud. The United States needs to put the cop back on the beat in all of these key energy markets.

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[146] *Market Forces: Big Oil increases market reach*, Energy compass, March 24, 2006.

APPENDIX

MEASURING THE INCREASE IN SPECULATIVE TRADING

A. CFTC Commitment of Traders Report

One of the few direct, quantitative measures of the increased trading activity by speculative money managers in energy futures trading is provided by the Commodity Futures Trading Commission (CFTC) weekly report on futures trading activity. The CFTC publishes, on a weekly basis, a "Commitment of Traders" (COT) Report, providing, for each commodity traded on a U.S. futures exchange, statistical information regarding the extent and nature of trading in that commodity in the previous week. Oil industry consultant and analyst Matthew R. Simmons characterizes the COT report as, "In the Land of the Blind, it is the 'One-Eyed King.'"[147] The report "tells who the players are," provides a "snapshot of Tuesday market close," and can "spot some long-term trends (after the fact)."[148]

For trades conducted on the regulated futures markets, the CFTC regulations require clearing houses and brokers to report, on a daily basis, futures positions on their books for traders that hold positions exceeding certain levels established by the CFTC ("reportable positions"). Traders holding futures positions are also required to file a report with the CFTC describing the nature of their business; the CFTC uses this data to classify each trader as "commercial" or "non-commercial." Commercial traders are those entities that use the commodity as part of their business, and hence use the futures markets for hedging; non-commercial traders are all other traders. The non-commercial category includes commodity pools, pension funds, hedge funds, and other types of managed money funds. Generally, non-commercial traders do not use the commodity in their normal course of business or purchase futures to hedge their exposure to changes in the price of those commodities; they are instead engaged in market speculation to profit from price changes.[149]

The COT report provides, for each commodity: the total amount of open interest in that commodity, meaning the total of all futures and option contracts entered into and not yet offset by another transaction or delivery of the commodity.[150] The COT report also provides the

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[147] Matthew R. Simmons, *Oil Prices, Volatility and Speculation*, Presentation at the IEA/NYMEX Conference, New York, New York, November 23, 2004.

[148] *Id.*

[149] In some cases, a hedge fund or other type of managed money fund may purchase futures for portfolio diversification to limit the fund's financial exposure to energy prices fluctuations.

[150] The CFTC defines "open interest" as "the total of all futures and/or option contracts entered into and not yet offset by a transaction, by delivery, by exercise, *etc.*" Open interest held or controlled by a trader is referred to as that trader's position. For the CFTC's Commitment of Traders Futures and Options Combined Report, the open interest in options is calculated by mathematically computing the futures-equivalent of the unexercised option contracts. CFTC, Backgrounder, The Commitment of Traders Report, at

number of outstanding short and long positions held by commercial and non-commercial traders, respectively; and the number of "spreading" positions held by non-commercial traders. Spreading includes each trader's reported long and short positions in the same commodity, to the extent they are balanced.[151] The report also identifies the number of long and short non-reportable positions, which is derived from the total open interest and the data on the reportable positions. Generally, reportable positions represent from 70-90 percent of the particular market.[152] The COT report also provides data on the percentage of open interest and various other positions held by the largest four and largest eight traders. This data provides a gauge on how much of the market is dominated by the largest traders.

B. Increased Speculative Trading on the NYMEX

The increase in trading in oil and natural gas futures and options by money managers and speculators is seen clearly in the trends in the CFTC trader data over the past several years. Figure A-1 shows the increasing amount of open interest in crude oil and natural gas contracts traded on the NYMEX since 1998.

http://www.cftc.gov/opa/backgrouder/opacot596.htm.

[151] For example, a trader might purchase a contract in the near-future, and, at the same time, sell a longer-term futures contract. This would be reported to the CFTC as a spread position. If the trader purchased two long futures contracts, and sold one short contract, it would be reported as one spread contract and one long contract.

[152] Haigh, Hranaiova and Overdahl, at pp. 3-4.

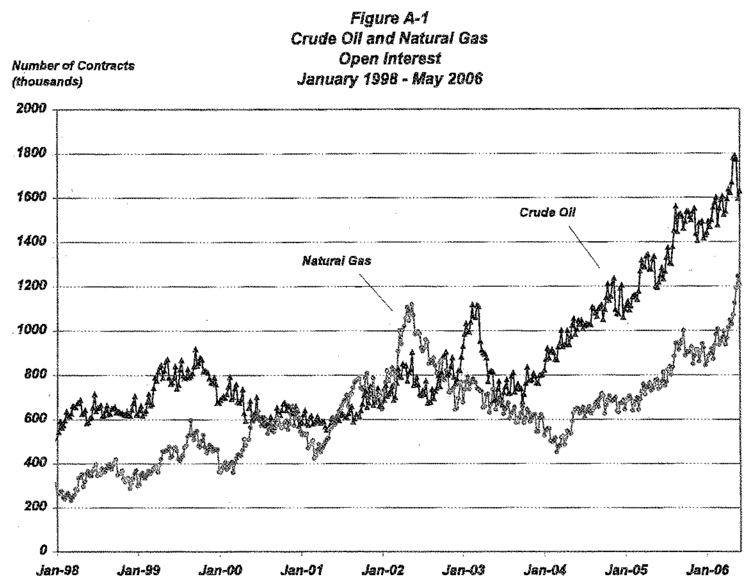

Figure A-1. The open interest in both crude oil and natural gas contracts has doubled since 2004. Data source: CFTC COT data.

A breakdown of the crude oil and natural gas open interest by the various types of positions tracked by the CFTC shows how there has been a shift in the composition of trading on the NYMEX over the past couple of years. As Figure A-2 demonstrates for crude oil contracts, and Figure A-3 demonstrates for natural gas contracts, in the past few years there has been a significant increase in the amount of open interest held by non-commercial traders. In both markets, there has been a large increase in the amount of spreading – i.e. holding of both long and short positions that do not offset each other – by non-commercial traders. In short, the amount of speculative trading in crude oil and natural contracts has increased significantly in the past two years.

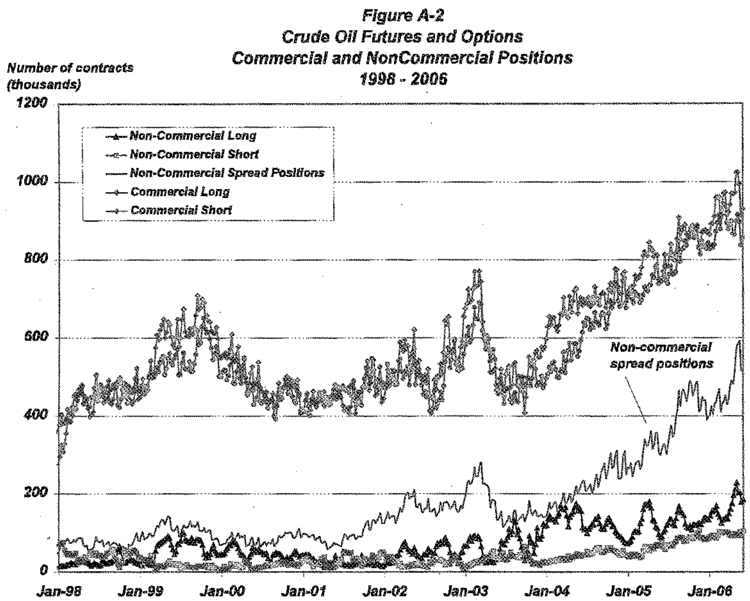

Figure A-2. The amount of speculative trading in crude oil contracts has increased significantly in the past two years, as evidenced by the increase in the number of non-commercial spread positions. Data source: CFTC.

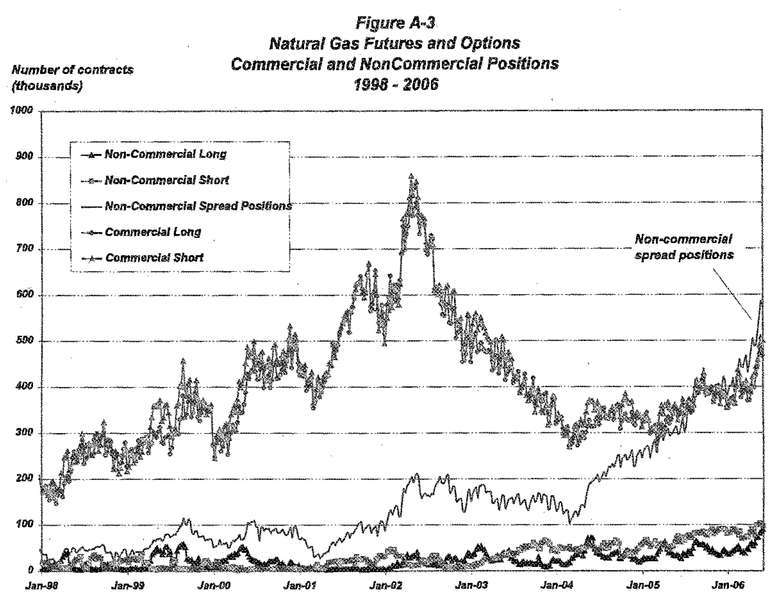

Figure A-2. The amount of speculative trading in natural gas contracts has increased significantly in the past two years, as evidenced by the increase in the number of non-commercial spread positions. Data source: CFTC.

Table A-1 presents similar information in tabular format. Additionally, Table A-1 shows the increase in the number of non-commercial traders over this same period. Although the number of commercial traders holding short and long positions has not varied by more than about 20 percent during this period, the number of non-commercial traders holding spread positions has quadrupled, so that there are now more non-commercial traders than commercial traders.

Table A-1
Increase in Non-commercial Trading in Oil Futures
1998 - 2005

CFTC COT Report Date	12/1/98	12/7/99	12/5/00	12/4/01	12/3/02	12/2/03	12/7/04	12/6/05
Open Interest (OI) in All Contracts	644,936	789,893	660,074	693,429	781,551	764,592	1,190,842	1,484,702
# Commercial Traders Long	98	93	79	74	80	86	85	82
# Commercial Traders Short	88	94	83	72	74	91	88	82
% OI Commercial Traders Long	72.8	73.2	70.2	71.1	66	62.9	62.7	56.2
% OI Commercial Traders Short	68	79.5	74.5	67.6	70.1	72.1	64.1	58.9
# Non-Commercial Traders Long	31	42	39	24	47	65	65	83
# Non-Commercial Traders Short	40	16	31	45	31	30	66	97
# Non-Commercial Traders Spread	33	36	42	46	50	60	93	128
% OI Non-Commercial Traders Long	4.7	6.1	6.8	2.8	4.6	10.9	7	9.3
% OI Non-Commercial Traders Short	8.7	1.2	2.1	5.3	2.7	2.2	4.6	5.6
% OI Non-Commercial Traders Spread	12	11	15.9	20.1	20.1	18.9	24.9	29.6

Table A-1. CFTC data shows a significant increase in the number of non-commercial traders and the percentage of open interest held by non-commercial traders in the past few years. Data source: CFTC.

Figure A-4 shows how the influx of investment into longer-term futures has raised the prices of futures contracts above the price of the nearer-term futures contracts ("contango"). The relative increase in the price of longer-term futures contracts has provided a financial incentive for oil companies and refiners to purchase additional oil and put it into inventory.

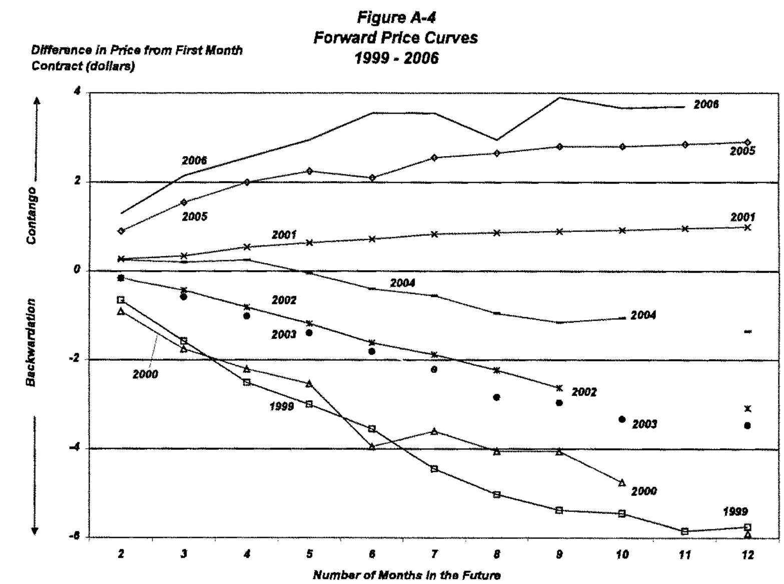

Figure A-4. In recent years longer-term futures prices have increased to levels higher than nearer-term futures contracts, providing a financial incentive to purchase and store oil. For years 1999-2002, the dates reflect the forward curve as of December 1 of that year. For other years, the dates reflect the foward curve as of December 2, 2003; December 2, 2004; December 6, 2005; and April 1, 2006. Data source: NYMEX.

C. Increased Speculative Trading on ICE

Because there are no reporting requirements for OTC trading, there are no publicly available quantitative measures of the extent of speculative trading in the OTC markets. Industry participants are not required to file large trader reports and the CFTC does not have any data to compile Commitment of Trader reports. What little information has been publicly disclosed, however, indicates there has been a substantial growth in speculative activity on the ICE OTC market.

ICE financial statistics show a tripling in the amount of OTC commission fees it has received from a level of approximately $8 million in the fourth quarter of 2004 to approximately $24 million in the first quarter of 2006.[153] ICE reported an increase in the number of cleared Henry Hub natural gas contracts from 4,512,000 in 2003 to 15,887,000 in 2004 and then to 42,760,000 in 2005.[154] In the first three months of 2006, ICE reported a trading volume of 44,906 million North American natural gas contracts as compared to a trading volume of 23,838 million gas contracts for the first three months of 2003.[155]

The ICE financial statistics indicate that a large part of this growth can be attributed to increased trading by hedge funds, managed money, and individual speculators. Table A-2 provides the most recent breakdown provided by ICE of the composition of ICE participants.

Table A-2
ICE OTC Participants

OTC Participants Trading (as % of total commissions)	Year ended December 31,		
	2003	2004	2005
Commercial companies (including merchant energy)	64.1%	56.5%	48.8%
Banks and financial institutions	31.3%	22.4%	20.5%
Hedge funds, locals and proprietary trading shops[156]	4.6%	21.1%	30.7%

Table A-2. Hedge funds and other speculators have significantly increased their use of OTC electronic markets. Data source: ICE Form 10-K, at p. 73.

# # #

[153] ICE Form 10-Q, at p. 22.

[154] ICE Form 10-K, at p. 73.

[155] ICE Form 10-Q, at p. 22 (each contract representing one million BTUs).

[156] The term "local" refers to an individual who commits his or her own capital for speculative trading on an electronic exchange. A "proprietary trader" is a professional trader hired by a firm to trade that firm's money. *See, e.g.*, Jim Kharouf, *Prop Shops and Trading Schools Raise the Bar, Stocks*, Futures & Options Magazine, January 2004.

U.S. Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581

Walter L. Lukken
Acting Chairman

(202) 418-5014
(202) 418-5550 Facsimile
wlukken@cftc.gov

December 10, 2007

The Honorable John D. Dingell
Chairman
U.S. House of Representatives
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

The Honorable Joe Barton
Ranking Member
U.S. House of Representatives
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

The Honorable Bart Stupak
Chairman, Subcommittee on Oversight and Investigations
U.S. House of Representatives
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

The Honorable Ed Whitfield
Ranking Member, Subcommittee on Oversight and Investigations
U.S. House of Representatives
Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Dingell, Ranking Member Barton, Subcommittee Chairman Stupak and Ranking Member Whitfield:

Thank you for your November 29, 2007 letter inquiring about the Commission's views on the Administration's September 4, 2007 proposed legislation to provide for the assessment and collection of user fees by the Commodity Futures Trading Commission (CFTC). As you know, the CFTC does not have the authority to assess user fees on market participants. As a result, the CFTC is funded entirely through the regular appropriations process. The House Appropriations Subcommittee on Agriculture, Rural Development, Food and Drug Administration, and Related Agencies and the Senate Appropriations Subcommittee on Financial Services and General Government are currently charged with appropriations authority for the CFTC. During the past 20 years, several different Administrations have proposed user fees as a means of funding the CFTC. In February 2007, as part of the President's budget, the White House included a user fee proposal for the CFTC. The fees would be on the mandatory side of the budget and would have to be adopted by Congress. The fees would be deposited in special accounts at the U.S. Treasury and available for appropriation to the CFTC. In September 2007, the Office of Management and Budget (OMB) transmitted a letter and legislative language to Capitol Hill in support of enacting a user fee to partially fund the CFTC. The CFTC staff provided technical assistance on this proposal, at OMB's request.

As stated by OMB, the user fee legislation would "allow the CFTC to collect fees from market participants to help offset some of the taxpayer costs of funding the Commission's operations through regular appropriations. As proposed in the 2008 Budget, the fee level would be set equal to the costs of the Commission's non-enforcement activities and associated administrative costs, since industry participants benefit directly from the CFTC's activities in these areas."

As the Commission understands the OMB proposal, the fees would be similar to user fees that support the Securities and Exchange Commission (SEC) (known as Section 31 fees), except the CFTC fees would be collected at the clearing level, while SEC fees are imposed on securities exchanges. The CFTC would be authorized under OMB's proposal to exempt certain cleared transactions when in the public interest, and transactions already charged Section 31 fees would be exempt.

The Commission has not taken an official position on OMB's proposed user fee legislation. As regulators, we are best equipped to provide information concerning the level of funding necessary for the Commission to fulfill its mission and to advise on how and where appropriated funds should be utilized. The Commission has a consensus view that the fee proposal determination is best left to the appropriate Congressional authorizing and appropriations committees, although individual Commissioners may have more detailed views regarding the fee proposal.

From 2000 to 2006, volume on the U.S. futures exchanges has grown 328 percent, compared to 16 percent volume growth on the major U.S. stock markets. In addition to volume growth, there has been a seven-fold increase in the rate of new product listings by U.S. futures exchanges. During this period of unprecedented growth for the futures industry, the CFTC's resources have been steadily diminishing. The CFTC currently operates with a staff of approximately 440 – an historic low. The decline in CFTC staff and resources threatens the ability of the CFTC to carry out its critical missions.

We urge Congress to provide the CFTC with sufficient funding to permit the agency to continue to protect market users and the public from fraud, manipulation, and abusive practices and to foster open, competitive, and financially sound futures and option markets. The issue of whether to provide the CFTC with the authority to impose user fees should properly be considered and reviewed by Congress and the relevant authorizing and appropriations committees.

Thank you for your attention to these matters.

Sincerely,

Walt Lukken

Walter L. Lukken
Acting Chairman

Michael V. Dunn

Michael V. Dunn
Commissioner

Jill E. Sommers /MKB

Jill E. Sommers
Commissioner

Bartholomew H. Chilton
Commissioner

cc:
The Honorable Collin C. Peterson
The Honorable Bob Goodlatte
The Honorable Bob Etheridge
The Honorable Jerry Moran
The Honorable Tom Harkin
The Honorable Saxby Chambliss
The Honorable Dave Obey
The Honorable Jerry Lewis
The Honorable Rosa DeLauro
The Honorable Jack Kingston
The Honorable Robert Byrd
The Honorable Thad Cochran
The Honorable Dick Durbin
The Honorable Sam Brownback

April 7, 2008

The Honorable Bart Stupak
Chairman
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

Dear Chairman Stupak:

Thank you for your additional questions regarding my appearance before the Subcommittee on Oversight and Investigations on Wednesday, December 12, 2007, at the hearing entitled "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?" I have provided my responses below.

1. What is the most efficient means for eliminating the Foreign Board of Trade loophole, which allows U.S. based commodity traders to trade energy commodities for delivery in the U.S. on Foreign Boards of Trade?

As I stated in my written testimony, since the FBOT exemption is the product of a CFTC staff no action letter, the CFTC staff can immediately "terminate" or "suspend" no action rights.[1] In lieu of the staff's termination or suspension of no action rights, the CFTC itself has the authority to terminate or suspend these rights.[2] If the CFTC staff or the Commission itself do not terminate or suspend the FBOT exemption, legislation is required to eliminate the loophole.

Furthermore, the FBOT no action process was initiated for exchanges that were organized and operated in foreign countries.[3] It was never intended that the no action process apply when the foreign exchange obtaining no action FBOT status is bought by a U.S. entity; operated in the U.S. with trading engines in the U.S.; and with U.S. delivered contracts being traded on that exchange. This is now the case with ICE which is based in Atlanta with U.S. trading engines in the U.S. while trading, inter alia, West Texas Intermediate crude oil contracts.[4]

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[1] *See* Written Testimony of Professor Michael Greenberger, *Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?: Hearing Before the H. Subcomm. on Oversight and Investigations*, p. 12 (2007).
[2] *Id.* at 15.
[3] *Id.* at 12.
[4] *Id.*

The Honorable Bart Stupak
April 7, 2008
Page Two

2. Please provide suggested text for legislation to close this loophole.

As I stated in my written testimony, a new § 2 (j) should be added to the existing Commodity Futures Modernization Act (CFMA) to provide expressly:

"No entity or subsidiary of an entity that: (i) is incorporated or has its principal place of business in the United States; or (ii)) facilitates agreements, contracts, or transactions that serve a significant price discovery function within the United States shall be eligible for status as an approved Foreign Board of Trade."[5]

Of course, as I stated in my written testimony, a grace period is needed to accommodate the new legislation.[6]

3. Does the U.K. Financial Services Authority require public disclosure which is equivalent to the Commodity Futures Trading Commission (CFTC)?

The U.K. Financial Services Authority's regulatory requirements in general are much more lax than CFTC's regulation of exchanges and transactions.[7]

4. Does the U.K. Financial Services Authority provide regulatory oversight and enforcement which is equivalent to the CFTC?

No. During last summer's subprime mortgage crisis, Northern Rock PLC, one of the U.K.'s largest mortgage banks, had difficulty raising funds and borrowed several billion dollars from the U.K.'s central bank.[8] After news of the bailout was released to the public, thousands of customers wary of losing their savings stood in long lines for several days outside of Northern Rock's branches to withdraw deposits.[9] With Northern Rock on the brink of collapse, FSA provided over $100 billion in loans to the bank and in February 2008, the British government nationalized it.[10] In March 2008, FSA published an internal report stating that its regulation of Northern Rock "was not carried out to a standard that is acceptable," and highlighted FSA's

[5] *Id.* at 14.
[6] *Id.* at 14-15.
[7] *See* Allistair MacDonald, *Assessing U.K. Watchdog: FSA's Regulatory Model Gets Some Raves in U.S.; A Lapdog at Home?*, WALL STREET J., July 23, 2007, *available at* http://online.wsj.com/article/SB118515214144274556.html ?mod=googlewsj; Steve Pearlstein, *Auditing Reform: Mission Accomplished!*, WASH. POST, Dec. 15, 2006, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/12/14/AR2006121401796.html.
[8] *See* BBC NEWS, *Rock expects £30bn loan this year*, Nov. 7, 2007, *available at* http://news.bbc.co.uk/1/hi/business/ 7073556.stm.
[9] *See* INTERNATIONAL HERALD TRIBUNE, REUTERS, *Crisis deepens for Northern Rock*, Sep. 17, 2007, *available at* http://www.iht.com/articles/2007/09/17/asia/17northern.php.
[10] *See* Stephen Castle, *EU to investigate Northern Rock nationalization in Britain*, INTERNATIONAL HERALD TRIBUNE, April 2, 2008, *available at* http://www.iht.com/articles/2008/04/02/business/rock.php.

failure to provide adequate supervision, oversight, and resources.[11] In addition to FSA's self-criticism, earlier this month the European Union opened a formal investigation into FSA's restructuring of Northern Rock.[12] This series of events exemplifies FSA's inability to provide regulatory oversight and enforcement that is equivalent to the CFTC.

Sincerely,

Michael Greenberger

[11] *See* ASSOCIATED PRESS, *British regulator admits failings in oversight of Northern Rock, announces new procedures*, INTERNATIONAL HERALD TRIBUNE, March 26, 2008, *available at* http://www.iht.com/articles/ap/2008/03/26/business/EU-FIN-COM-Britain-Northern-Rock.php.
[12] *See* Castle, *supra* note 9.

ICE Atlanta Calgary Chicago Houston London New York Singapore

March 27, 2008

VIA FACSIMILE AND ELECTRONIC MAIL
Mr. Kyle Chapman
Legislative Clerk
U.S. House of Representatives
Committee on Energy and Commerce
316 Ford House Office Building
Washington, D.C. 20005

RE: December 12, 2007 Hearing Additional Questions

Dear Mr. Chapman:

In response to Representative Bart Stupak's additional questions from the hearing "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?" below are the IntercontinentalExchange, Inc.'s answers.

1. What is the history of stock ownership by Goldman Sachs in the IntercontinentalExchange, Inc. (ICE) since ICE was established in May 2000? In answering this question, please provide Goldman Sachs' initial shareholder position in ICE and the number of shares and percentage ownership in ICE held on January 1 of each year from May 2000 through January 1, 2008?

As background, on May 11, 2000, IntercontinentalExchange, LLC, or the LLC, ICE's predecessor entity, was formed as a Delaware limited liability company. Subsequent to its formation, the LLC created a wholly-owned subsidiary, IntercontinentalExchange, Inc., a Delaware corporation, to provide stock options to our employees. The original members of the LLC were BP Products North America Inc, Continental Power Exchange, Inc., DB Structured Products, Inc., Elf Trading Inc., The Goldman Sachs Group, Inc. (Goldman Sachs), MHC Investment Company, Morgan Stanley Capital Group Inc., Société Générale Financial Corporation and S T Exchange Inc. On June 15, 2001, in connection with ICE's acquisition of the International Petroleum Exchange, the LLC merged into its subsidiary, IntercontinentalExchange, Inc., which was the surviving entity. Each of the members of the LLC exchanged its rights and interests in the LLC for a proportionate number of shares of Class A common stock, Series 2 of IntercontinentalExchange, Inc., which we refer to as our Class A2 shares, and the LLC ceased to exist by operation of the merger.

Thus, in the newly created ICE, on December 31, 2001, Goldman Sachs owned 12.44% (28,477,164 shares).

As of December 31, 2002, Goldman Sachs owned 12.44% (28,477,164 shares). In November 2002, ICE elected a new independent board with seven directors. Since 2002, ICE's board has continued to meet the New York Stock Exchange's independence standards.

As of December 31, 2003, Goldman Sachs owned 12.43% of ICE (28,477,164 shares).

As of December 31, 2004, Goldman Sachs owned 13.02% of ICE (28,340,444 shares).

IntercontinentalExchange
2100 RiverEdge Parkway
Suite 500
Atlanta, GA 30328
phone 770 857 4700
fax 770 951 1307
online www.theice.com

ICE

ICE undertook an initial public offering of its stock in November, 2005. Before ICE's initial public offering, Goldman Sachs owned 14.21% of ICE (30,114,638 shares). At the time of its initial public offering, ICE undertook a 4-for-1 reverse stock split, which resulted in Goldman Sachs owning 7,528,659 shares but the same proportionate share ownership. As a result of the initial public offering and share sales by Goldman Sachs therein, Goldman Sachs owned 11.59% of ICE (6,428,659 shares). Goldman Sachs sold 1,980,570 shares in the secondary offering of ICE's common stock on July 17, 2006. After the secondary offering, they owned 4,139,379 shares of ICE's common stock (7.5% of ICE).

As of October 26, 2006, Goldman Sachs owned 4.7% of ICE (2,678,392 shares).[1]

As of December 31, 2007, Goldman Sachs owned 240,859 shares of ICE or less than .3%.[2]

2. With respect to total volume of trading on ICE in 2007, what percentage of contracts was cleared versus uncleared?

In 2007, the 78% of the contracts that were traded on ICE's exempt commercial market were submitted for clearing.

3. With respect to natural gas swaps for delivery at Henry Hub that were traded on ICE in 2007, what percentage of contracts was cleared versus uncleared?

In 2007, in the financially settled Henry Hub natural gas swap, 84% of the contracts that were traded on ICE's exempt commercial market were cleared.

If you have any questions, please feel free to contract Trabue Bland, Director of Regulatory Affairs at 770-916-7832.

Sincerely,

Charles A. Vice

Charles A. Vice
Chief Operating Officer and President
IntercontinentalExchange, Inc.

[1] Based on Goldman Sach's 2006 filings with the Securities and Exchange Commission (SEC).
[2] Based on Goldman Sach's 2007 filings with the SEC.

Energy and Commerce QFRs

1. What are the CFTC's views on the potential for CFTC regulation of Financial Transmission Rights traded on Independent System Operators? Could these contracts for electricity transmission potentially fall under CFTC jurisdiction?

The CFTC does not have regulatory authority over cash or forward commodity transactions and the sale and marketing of such commodities. The Commission's regulatory jurisdiction is determined by whether a given transaction is a contract of sale of a commodity for future delivery (commonly known as a futures contract), which primarily serves to manage price risk in a commodity.

Determining whether any given transaction constitutes a contract of sale of a commodity for future delivery is governed by a body of case law and administrative actions on the subject matter applied to the particular facts and circumstances surrounding such transactions. If the relevant facts and circumstances demonstrate that given agreements constitute "... transactions involving contracts of sale of a commodity for future delivery, traded or executed on a [designated contract market] ... or any other board of trade, exchange or market ..." then, pursuant to Section 2(a)(1)(A) of the Commodity Exchange Act (CEA), the transactions would be subject to the CFTC's exclusive jurisdiction on a contract by contract basis.

In the absence of the facts and circumstances under which Financial Transmission Rights (FTRs) are currently being traded, it is difficult to answer the question with more specificity. Nevertheless, it is clear that the CFTC does not have regulatory authority over cash or forward commodity transactions that are commonly associated with the physical sale and marketing of such commodities, including physical energy transactions that fall into this category.

2. Why has the CFTC intervened in two separate lawsuits to which it is not a party, to challenge the Federal Energy Regulatory Commission's (FERC) authority to assert its anti-manipulation authority with respect to Amaranth? Is CFTC escalating its disagreement with FERC from merely providing a position to a judge where it was already a party, as it did in the matter of CFTC v. Amaranth et al. in the Southern District of New York?

The CEA provides in Section 2(a)(1)(A) that the CFTC shall have exclusive jurisdiction with respect to futures trading on a designated contract market such as the New York Mercantile Exchange (NYMEX). An unbroken line of federal court decisions dating from the mid-1970s holds that this grant of exclusive jurisdiction to the CFTC bars other federal regulatory agencies from exercising jurisdiction over this activity.

In July 2007, the CFTC brought an enforcement action against Amaranth in the U.S. District Court for the Southern District of New York alleging that Amaranth had attempted to manipulate the settlement price of the NYMEX natural gas futures contract in 2006 through a pattern of unlawful trading on the NYMEX. Also in July 2007, the FERC filed an administrative enforcement action similarly alleging that Amaranth had manipulated the settlement price of the NYMEX natural gas futures contract in 2006 through unlawful trading activity on the NYMEX. The FERC alleges that Amaranth's futures trading had downstream effects on physical natural gas prices and thereby violated the Natural Gas Act (NGA), as amended by the Energy Policy Act of 2005. The FERC has asserted that the alleged manipulative trading activity on NYMEX does not fall within the scope of the CFTC's exclusive jurisdiction under the CEA and, further, that the Energy Policy Act of 2005 implicitly limits the CFTC's exclusive jurisdiction with respect to futures trading that is alleged to have affected physical natural gas prices.

The CFTC disagrees with the FERC's interpretation of the CEA, and does not believe that the Energy Policy Act of 2005 lessened the scope of its exclusive jurisdiction under the CEA. Because the FERC has charged the Amaranth respondents with engaging in an unlawful pattern of futures trading on a designated contract market, the CFTC believes that the FERC action conflicts with the exclusive jurisdiction provision in the CEA. Equally important, the CFTC believes that the FERC action conflicts with the fundamental policy objective underlying Congress's grant of exclusive jurisdiction to the CFTC: avoiding inconsistent standards governing trading on U.S. futures exchanges. This is of critical importance to the continued expansion of the futures markets, which have witnessed dramatic growth since 2000.

The respondents in the FERC administrative action have challenged the agency's authority to prosecute the case in three different forums. First, in July 2007, respondent Brian Hunter filed an action in the U.S. District Court for the District of Columbia seeking declaratory and injunctive relief to block the FERC action. The district court denied Hunter's motion for a temporary restraining order on July 24, 2007 and denied his motion for a preliminary injunction on December 10, 2007. In neither of these rulings did the court reach the exclusive jurisdiction issue. The CFTC has not sought to participate in the Hunter case.

Second, on August 16, 2007, Amaranth filed a motion challenging the FERC's authority to prosecute its case by seeking injunctive relief in the case filed by the CFTC against Amaranth in New York. The presiding judge ordered briefing on Amaranth's motion, making clear on the record that he expected the CFTC to address the exclusive jurisdiction question in its brief. In response to the court's directive, the CFTC on September 28, 2007 filed a brief opposing Amaranth's request for a preliminary injunction and setting out the CFTC's position regarding the scope of its exclusive jurisdiction over futures trading on designated contract markets. On November 1, 2007, the court denied Amaranth's request for a preliminary injunction without reaching the exclusive jurisdiction issue.

Finally, various respondents in the FERC case requested reconsideration of the agency's decision to file charges in the case, asserting that the CEA vests in the CFTC exclusive jurisdiction over futures trading on the NYMEX. On November 30, 2007, the FERC issued an adjudicatory Order that denied those reconsideration requests and for the first time spelled out its theory for asserting jurisdiction over futures trading on a designated contract market.

Various respondents petitioned for review of the FERC's November 30, 2007 Order in the U.S. Court of Appeals for the District of Columbia Circuit. Because the FERC has now issued a formal Order taking a position on the scope of the CFTC's exclusive jurisdiction under the CEA that directly conflicts with the CFTC's views on that issue, the CFTC concluded that full participation in the appeal as an intervenor was both necessary and warranted. As the agency charged with administering the CEA for the past 34 years, it is incumbent on the CFTC to provide the D.C. Circuit with its views regarding the important questions presented in this appeal.

In opposing Amaranth's motion in the New York case, the CFTC's brief argued that "FERC should be permitted to determine in the first instance the scope of its new anti-manipulation authority under [the Energy Policy Act of 2005] in light of the pre-existing statutory grant of exclusive jurisdiction over futures trading to the CFTC in the CEA . . . If FERC's determination is adverse to the respondents in that action . . . they will have an opportunity to petition for review of that decision by the U.S. Court of Appeals for the District of Columbia." That is what has now occurred.

Accordingly, the CFTC's request to intervene in the D.C. Circuit case – which is the first instance in which we have sought to intervene in any matter involving Amaranth – does not represent an escalation of our legal disagreement with the FERC. Rather, it is a response to FERC's position on the scope of the CFTC's exclusive jurisdiction, as spelled out in the November 30, 2007 Order. Further, as Chairman Kelliher testified before the Subcommittee on December 12, 2007, the "respectful disagreement" between the CFTC and the FERC over this legal issue is "best resolved by the courts." *[Source: December 12, 2007 House Energy and Commerce Subcommittee on Oversight and Investigations Hearing, "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?"]* The CFTC agrees with Chairman Kelliher that this question should appropriately be decided by the courts, and we believe that the courts should hear fully from both of the interested agencies.

3. Would the CFTC support or oppose legislation that would eliminate no action letters and require electronic exchanges to register with the CFTC as designated contract markets if they are trading on a Foreign Board of Trade through terminals in the U.S. for commodities that are designated for delivery in the U.S. (such as West Texas Intermediate Crude for Cushing, OK delivery)?

In 2006, the CFTC carefully examined this issue in its review of our foreign board of trade (FBOT) policy. At that time, the CFTC concluded that it would be problematic to have a requirement that FBOTs register with the CFTC as designated contract markets if their members used U.S. terminals to trade commodities that are subject to U.S. delivery.

The CFTC found that the best way to handle the issue was to continue its no-action approach, a response that reflects the internationally accepted "deference to home regulator" approach used by regulators in many developed market jurisdictions to govern access to foreign electronic exchanges by persons located in their jurisdictions. This approach generally is based upon a review of, and ongoing reliance upon, the foreign market's "home" regulatory regime, and is designed to maintain a threshold level of regulatory protections while avoiding the imposition of duplicative regulation.[1]

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[1] See, e.g., United Kingdom Financial Services Authority, Financial Services Handbook, Recognised Overseas Investment Exchanges (ROIE), Section 6; Australian Securities and Investments Commission, Policy Statement 177.8 describing alternative licensing for overseas markets; Ontario Securities Commission Staff Notice 21-702, Regulatory Approach for Foreign-Based Stock Exchanges; and Autorite des marches financiers (Quebec), Policy Statement Respecting the Authorization of Foreign-Based Exchanges. The German Bundesanstalt für

The CFTC has followed the no-action approach since 1996 and it has never experienced any market integrity or customer protection problems. The CFTC held an FBOT hearing in June 2006, including a related open public comment opportunity, during which market users, foreign exchanges and even competitive domestic exchanges overwhelmingly confirmed the success of the CFTC's approach in terms of market and customer protection and access to additional products. Subsequently, the CFTC issued a Statement of Policy re-affirming the use of the FBOT no-action process, but also enhancing it through support of information-sharing conditions where no-action relief is sought for FBOT contracts that could adversely affect the pricing of contracts traded either on a designated contract market or on any cash market for commodities subject to the CEA.

Requiring designation rather than issuing no-action letters may trigger responsive regulation by foreign jurisdictions that could lead to the imposition of greater regulatory costs on U.S. futures exchanges, such as full registration in those foreign jurisdictions. Since U.S. exchanges generally operate in multiple foreign jurisdictions, they could become subject to a wide variety of different, and possibly conflicting, regulatory requirements in every jurisdiction in which their trading systems are made available.

Even if foreign jurisdictions were more measured and only required full registration by U.S. futures exchanges when they listed commodities that were deliverable in those jurisdictions, it would still expose U.S. futures exchanges to greater regulation abroad. Notably, several U.S. exchanges that permit foreign access currently list futures contracts on commodities that are produced or delivered in foreign jurisdictions, including the CME, NYMEX and ICE Futures U.S.

Finally, the no-action procedure provides the CFTC with flexibility in dealing with particular foreign exchanges and different practices. Requiring designation would result in standardized requirements and conditions on FBOTs and would be less tailored to a particular foreign exchange that is already subject to regulation in its home jurisdiction.

Finanzdienstleistungsaufsicht (BAFIN) authorizes the placement of foreign terminals in Germany under Sections 37i et seq. of the German Securities Trading Act.