Testimony of Congressman Bart Stupak
U.S. House of Representatives

Commodity Futures Trading Commission
Hearing on Energy Position Limits and Hedge Exemptions

July 28, 2009

Thank you, Chairman Gensler and members of the Commission, for holding these public hearings and for the opportunity to testify. The CFTC, the Administration and Congress must work together to effectively reform the energy markets. Currently, I serve as Chairman of the House Energy and Commerce Subcommittee on Oversight and Investigations, and I have been investigating the role of excessive speculation in the energy markets since 2006. Recognizing that some individuals remain skeptical of the claim that anything other than supply and demand fundamentals dictates price changes in the market, I would like to review a number of recent studies and events that prove otherwise.

According to CFTC data, from January 2008 through the end of June 2008, index investors poured $55 billion into major commodity indexes, pushing the price of crude oil from $99 per barrel to $140 per barrel. Gasoline prices spiked to a national average of more than $4 a gallon, with prices reaching more than $5 a gallon in some regions of the country.

That same market collapsed over the course of the next six months, with prices plummeting to $30 per barrel by December 2008 as investors withdrew $73 billion from the market. This was not a coincidence. The dramatic drop in oil prices was occurring at the same time index investors fled the market. From January 2009 through May 2009, you can see the price rise from $35 per barrel to $70 per barrel as index investors come back into the market and pour in $35 billion into major commodity indexes.

I have three charts here illustrating the fact that supply and demand fundamentals are still not driving the oil market. This year, domestic oil supplies are at a 20-year high, oil demand is at a 10-year low, yet in June, oil was trading at more than $70 a barrel, up from $35 a barrel in January, representing a price increase of more than 100 percent in the first six months of the year. This comes in the midst of the worst global economic decline since the Great Depression, but oil prices keep going up!

The driving factor contributing to an increase in the price of oil this year was the surge of funding from index investors back into the oil markets. According to an independent analysis of CFTC data on oil futures positions, index investors increased their crude-oil holdings to the equivalent of more than 600 million barrels in June, up more than 30 percent from the end of 2008.

There have been a number of reports and studies over the past few years implicating excessive speculation as the cause for volatility and price increases in the commodity futures markets. In October 2007, the Government Accountability Office (GAO) released its report on the ability of the CFTC to properly monitor energy markets to prevent manipulation. The GAO found that the volume of trading in energy commodities had skyrocketed, specifically after the Enron Loophole was enacted in 2000. The GAO also found that while trading has doubled since 2002, the number of CFTC staff monitoring these markets has declined.

On June 23, 2008, the Oversight and Investigations Subcommittee held its second of two hearings on the effect speculators have on energy prices. Fadel Gheit, Managing Director and Senior Oil Analyst at Oppenheimer & Co. Inc., said in his testimony:

> *"I firmly believe that the record oil price in excess of $135 per barrel is inflated. I believe, based on supply and demand fundamentals, crude oil prices should not be above $60 per barrel."*

In 2000, physical hedgers – businesses such as airlines and trucking companies that need to hedge to ensure a stable price for fuel in future months – accounted for 63 percent of the oil futures market. Speculators accounted for 37 percent. By April 2008, physical hedgers' share of the same market had dropped to 29 percent, with speculators now controlling an astonishing 71 percent of the oil market. The market was taken over by swap dealers and speculators, a considerable majority of whom have no physical stake in the market.

This excessive speculation is a significant factor in the price Americans are paying for gasoline, diesel and home heating oil. Even the executives of the major U.S. oil companies recognize this. On April 1, 2008, in testimony before the House Select Committee on Global Warming, Mr. John Lowe, Executive Vice President of ConocoPhillips said:

> *"It is likely that the large inflow of capital into the commodity funds is temporarily exaggerating upward oil price movements."*

At a May 21, 2008 hearing of the Senate Judiciary Committee, Shell President John Hofmeister agreed that the price of crude oil has been inflated, saying that the proper range for oil prices should be *"somewhere between $35 and $65 a barrel."*

The Federal Energy Regulatory Commission released its State of the Market report on April 16, 2009. That report indicated that excessive speculation within the natural gas market was a principal reason for the price increase in natural gas. And, while I know we are focusing on energy in this hearing, the Senate Homeland Security and Governmental Affairs Subcommittee on Investigations released a report on June 23, 2009 indicating that excessive speculation was to blame for the distortion of the wheat futures prices in relation to the settling cash market price.

On October 24, 2008 the Committee on Energy and Commerce requested company-by-company data underpinning the CFTC staff report on swap dealers and index traders, with specific information on individual company swap positions and related futures positions for crude oil, heating oil, natural gas and gasoline.

This data request followed questions raised by Commissioner Bart Chilton and others regarding the accuracy and conclusions of the September 2008 staff report. I understand that the CFTC will issue a new report possibly contradicting previous assumptions on the role speculation played in the energy markets. I look forward to the CFTC's revised analysis.

Although the data provided by the CFTC on swaps did not distinguish between commercial and non-commercial positions, it was possible to draw insights not presented in the CFTC staff report. By identifying the core business activities of each company (airlines, investment banks, oil producers, utilities, etc.) one can estimate the role each entity played in the combined swaps and futures market.

This chart shows that speculators, such as banks and hedge funds, held 60 percent of the open interest in natural gas markets on June 30, 2008, and 75 percent of the West Texas Intermediate crude oil market. Physical hedgers and middlemen took a much smaller share for both natural gas and oil markets. I encourage the CFTC to take a closer look at this data, update it with more recent positions, and see if the conclusion is the same.

If the dollars in swaps and related futures positions equals votes in the market place, the banks and hedge funds are determining prices, and physical hedgers have become small players in the process. This data points to excessive speculation dictating the pricing of commodities in June 2008. The prices paid by physical hedgers, whose bid and ask prices are linked to supply and demand, are being swamped by speculators who have overtaken this combined market.

A number of reports, market experts, and regulators agree that reform of the derivates market is necessary. Physical hedging, long used to provide liquidity, transparency and set market prices, is no longer possible due to the manipulation action of financial traders. The recent statements by Treasury Secretary Geithner advocating derivatives reform, Chairman Gensler's support for aggregate position limits on all commodities, and these hearings by the CFTC are a welcome step toward reigning in excessive speculation in the marketplace. I caution the CFTC against regulating only so-called standardized contracts, as loopholes for customization will circumvent any regulations in place to prevent manipulation of the markets.

The Commodities Exchange Act recognizes the dangers of excessive speculation. Section 4a of the Act states, **"Excessive speculation in any commodity** under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities **causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce."** (emphasis added) As a result, Section 4a provides the CFTC with the authority to set aggregate position limits or take other actions necessary to curb excessive speculation.

However, there are significant loopholes that exempt energy trading from these protections against excessive speculation: |

- The swaps exemptions in Section 2(g) and 2(h)(1) of the Commodity Exchange Act;
- The Foreign Boards of Trade "No Action" letters;
- The Swaps Loophole, which allows swap dealers to circumvent position limits designed to prevent excessive speculation.
- Finally, state attorneys general are handcuffed from applying bucketing and gaming laws to swaps dealers through a pre-emption of state law contained in the Commodity Futures Modernization Act.

Legislation I have introduced and included in the American Clean Energy and Security Act, otherwise known as ACES, which recently passed the U.S. House of Representatives and is now pending in the Senate, contains strong provisions to comprehensively address excessive speculation in the energy markets. I encourage the Commission to take a thorough look at each of these issues and take action within its existing authority to begin addressing the problems:

- **Swaps transactions for energy commodities:** Because the Farm Bill only closed the Enron Loophole for futures trades on electronic exchanges, most bilateral swaps trades remain in the dark. These bilateral trades must be subject to CFTC oversight.

- **Foreign Boards of Trade:** Petroleum contracts offered through the InterContinental Exchange (ICE) on ICE Futures are cleared on a foreign board of trade in London. Data provided by the CFTC indicates that more than 60 percent of traders of West Texas Crude originate in the United States. These contracts for West Texas Crude have a delivery point in the United States. ICE is a foreign board of trade in name only.

  ICE Futures agreed to provide the CFTC with information and to set position limits for their traders. However, this step is not enough. The CFTC does not have the authority to regulate foreign markets that act as price-setting markets dominated by U.S. energy trading. CFTC must enforce standards on all markets to eliminate loopholes. Similar to ICE, the Dubai Exchange raises the same issues, and because of CFTC's inability to enforce regulations on trades bound for the U.S., this loophole remains open for excessive speculation to impact energy prices.

  The CFTC should exert jurisdiction over these exchanges when they are using computer terminals in the United States, and when they are trading energy commodities that provide for a delivery point in the United States.

- **Swaps Loophole/Bona Fide Hedging Exemption:** The Commodity Exchange Act allows exemptions from position limits for businesses to "hedge their legitimate anticipated business needs." However, in 1991, CFTC authorized the first "bona fide hedging" exemption to a swap dealer (J. Aron and Company, which is owned by Goldman Sachs) with no physical commodity exposure, and therefore no legitimate anticipated business need.

  Since 1991, 15 different investment banks have taken advantage of this exemption, even though they do not have a legitimate anticipated business need. Since 2006, NYMEX has granted 117 hedging exemptions for West Texas Intermediate crude contracts, many of which are for swap dealers without physical hedging positions. Swaps are currently excluded from requirements for position limits designed to prevent excessive speculation. An estimated 85 percent of futures purchases tied to commodity index speculation come through swap dealers.

  Because there are no requirements for position limits, these swaps have grown considerably, driving crude oil prices higher. By eliminating this exemption, swaps would be subject to position limits to prevent excessive speculation.

  The CFTC created this exemption and can undo it. The CFTC must clarify that "legitimate anticipated business needs" does not mean energy speculators.

- **Strong aggregate position limits:** The CFTC should set aggregate trader position limits on energy contracts over all markets. With the growing number of markets, speculators can currently comply with exchange specific position limits on several exchanges, while still holding an excessive number of total contracts taken together.

  By setting strong aggregate position limits over all markets, CFTC would be able to curb excessive speculation by making sure traders are not amassing huge positions in a commodity in an attempt to play one exchange off another.

- **Carbon Market Regulation:** The ACES legislation passed by the U.S. House of Representatives creates an economy wide cap-and-trade program for carbon dioxide and other greenhouse gas emissions. Companies will hedge their risks and lock in prices for these carbon credits in a new carbon futures market.

  The CFTC should have authority to regulate any carbon futures market with strong regulations from the start to prevent price volatility from excessive speculation. I included these protections in the ACES legislation, and I believe the CFTC should apply strong rules on aggregate position limits and bona fide hedging exemptions to any carbon futures market created by Congress.

By closing all of these loopholes and setting strong aggregate position limits, the CFTC would be better able to monitor trades in real time to prevent market manipulation. Eliminating unreasonable inflation of energy prices caused by excessive speculation protects American consumers.

We cannot continue with the status quo, and allow excessive energy speculation to inflate energy prices beyond underlying supply and demand fundamentals. Excessive speculation is having a devastating effect on energy prices and the global economy, and I appreciate the opportunity to testify today. Thank you.