

**SUBMITTED TESTIMONY OF THE AMERICAN PUBLIC GAS ASSOCIATION
BEFORE THE HOUSE AGRICULTURE COMMITTEE ON DERIVATIVES
LEGISLATION**

FEBRUARY 3, 2009

Chairman Peterson, Ranking Member Lucas and Members of the Committee, the American Public Gas Association (APGA) appreciates this opportunity to submit testimony to you today. We also commend the Committee for calling this hearing on the important subject of derivative trading. APGA would also like to commend Chairman Peterson and the House Agriculture Committee for its ongoing focus on market transparency and oversight.

APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 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 number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to a long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public

confidence in the pricing of natural gas. This 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, excessive speculation or other abusive market conduct.

We, along with other consumer groups, have watched with alarm over the last several years certain pricing anomalies in the markets for natural gas. More recently, we have noted much greater volatility in the price of energy and other physical commodities. APGA has strongly supported an increase in the level of transparency with respect to trading activity in these markets from that which currently exists. We believe that additional steps are needed in order to restore our current lack of confidence in the natural gas marketplace and to provide sufficient transparency to enable the CFTC, and market users, to form a reasoned response to the critically important questions that have been raised before this Committee during the course of these hearings.

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in legislation that reauthorizes the Commodity Futures Trading Commission (“CFTC”) is a critically important first step in addressing our concerns. Those provisions are contained in Title XIII of the Farm Bill which has become law. We commend this Committee for its work on this important legislation. The market transparency language that was included in the Farm Bill will help shed light on whether market prices in significant price discovery

energy contracts are responding to legitimate forces of supply and demand or to other, non-bona fide market forces.

However, APGA believes that more can, and should, be done to further increase transparency of trading in the energy markets. Many of these steps would likely also be useful in better understanding the current pricing trends in the markets for other physical commodities as well.

Although the additional authorities which have been provided to the CFTC under Title XIII of the 2008 Farm Bill will provide the CFTC with significant additional tools to respond to the issues raised by this hearing (at least with respect to the energy markets), we nevertheless believe that it may be necessary for Congress to provide the CFTC with additional statutory authorities. We are doubtful that the initial steps taken by the reauthorization legislation are, or will be, sufficient to fully respond to the concerns that we have raised regarding the need for increased transparency. In this regard, we believe that additional transparency measures with respect to transactions in the Over-the-Counter markets are needed to enable CFTC to assemble a more complete picture of a trader's position and thereby understand a large trader's potential impact on the market.

We further believe, that in light of the critical importance of this issue to consumers, that this Committee should maintain active and vigilant oversight of the CFTC's market surveillance and enforcement efforts, that Congress should be prepared to take additional legislative action to further improve transparency with respect to trading

in energy contracts and, should the case be made, to make additional amendments to the Commodity Exchange Act, 7 U.S.C. §1 *et seq.* (“Act”), that allows for reasonable speculative position limits in order to ensure the integrity of the energy markets.

Speculators’ Effect on the Natural Gas Market

As hedgers that use both the regulated futures markets and the OTC energy markets, we value the role of speculators in the markets. We also value the different needs served by the regulated futures markets and the more tailored OTC markets. As hedgers, we depend upon liquid and deep markets in which to lay off our risk. Speculators are the grease that provides liquidity and depth to the markets.

However, speculative trading strategies may not always have a benign effect on the markets. For example, the 2006 blow-up of Amaranth Advisors LLC and the impact it had upon prices exemplifies the impact that speculative trading interests can have on natural gas supply contracts for local distribution companies (“LDCs”). Amaranth Advisors LLC 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.”¹

Many natural gas distributors locked-in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. They did so because of their hedging procedures which require that they hedge part of their winter natural gas in the spring and summer. Accordingly, even though natural gas

¹ See “*Excessive Speculation in the Natural Gas Market*,” Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) (“PSI Report”) at p. 119

prices were high at that time, it would have been irresponsible (and contrary to their hedging policies) to not hedge a portion of their winter gas in the hope that prices would eventually drop. Thus, the elevated prices which were a result of the excess speculation in the market by Amaranth and others had a significant impact on the price these APGA members, and ultimately their customers, paid for natural gas. The lack of transparency with respect to this trading activity, much of which took place in the OTC markets, and the 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.

Recently, additional concerns have been raised with respect to the size of positions related to, and the role of, passively managed long-only index funds. In this instance, the concern is not whether the positions are being taken in order to intentionally drive the price higher, but rather whether the unintended effect of the cumulative size of these positions has been to push market prices higher than the fundamental supply and demand situation would justify.

The additional concern has been raised that recent increased amounts of speculative investment in the futures markets generally have resulted in excessively large speculative positions being taken that due merely to their size, and not based on any intent of the traders, are putting upward pressure on prices. The argument made is that these additional inflows of speculative capital are creating greater demand than the

market can absorb, thereby increasing buy-side pressure which results in advancing prices.

Some have responded to these concerns by reasoning that new futures contracts are capable of being created without the limitation of having to have the commodity physically available for delivery. This explains why, although the open-interest of futures markets can exceed the size of the deliverable supply of the physical commodity underlying the contract, the price of the contract could nevertheless reflect the forces of supply and demand.

As we noted above, as hedgers we rely on speculative traders to provide liquidity and depth to the markets. Thus, we do not wish to see steps taken that would discourage speculators from participating in these markets using *bona fide* trading strategies. But more importantly, APGA's members rely upon the prices generated by the futures to accurately reflect the true value of natural gas. Accordingly, APGA would support additional regulatory controls, such as stronger speculative position limits, if a reasoned judgment can be made based on currently available, or additional forthcoming market data and facts, that such controls are necessary to address the unintended consequences arising from certain speculative trading strategies or to reign in excessively large speculative positions. To the extent that speculative investment may be increasing the price of natural gas or causing pricing aberrations, we strongly encourage Congress to take quick action to expand market transparency in order to be able to responsibly

address this issue and protect consumers from additional cost burdens. Consumers should not be forced to pay a “speculative premium.”

The Markets 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 NYMEX, a designated contract market regulated by the 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, such as the Intercontinental Exchange (“ICE”). ICE also operates an electronic trading platform for trading non-cleared (bi-lateral) OTC contracts. 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 linking the various financial natural gas market segments economically.

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies, 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 do not reflect its true value.³ 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 consumers pay for the fuel needed to heat their homes and cook their meals will be similarly manipulated or distorted.

Today, the CFTC provides generally effective oversight of futures exchanges and the CFTC and the exchanges provide a significant level of transparency. And under the provisions of the Title XIII of the Farm Bill, the CFTC has been given additional regulatory authority with respect to significant price discovery contracts traded on exempt commercial markets, such as ICE. This is indeed a major step toward greater market transparency. However, even with this additional level of transparency, a large

²See 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.” A further question with respect to whether other speculative strategies, or excessively large speculative positions is also distorting market prices by pushing prices higher than they otherwise would be.

³ The effect of Amaratth’s trading resulted in such price distortions. *See generally 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.”

part of the market remains opaque to regulatory scrutiny. The OTC markets lack such price transparency. This 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.

Equally significant, even where the trading is not intended to be abusive, the lack of transparency for the over-all energy markets leaves regulators unable to answer questions regarding speculators' possible impacts on the market. For example, do we know who the largest traders are in the over-all market, looking at regulated futures contracts, significant price discovery contracts and bi-lateral OTC transactions? Without being able to see a large trader's entire position, it is possible that the effect of a large OTC trader on the regulated markets is masked, particularly when that trader is counterparty to a number of swaps dealers that in turn take positions in the futures market to hedge these OTC exposures as their own.

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.⁴

Title XIII of the 2008 Farm Bill, empowered the CFTC to collect large trader information with respect to “significant price discovery contracts” traded on the ICE trading platform. However, there remain significant gaps in transparency with respect to trading of OTC energy contracts, including many forms of contracts traded on ICE. 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

⁴ See letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

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 by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas. More profoundly, it leaves the regulator unable to assemble a true picture of the over-all size of a speculator's position in a particular commodity.

Greater Transparency Needed

Our members, and the customers served by them, believe that although Title XIII of the 2008 Farm Bill goes a long way to addressing the issue, there is not yet an adequate level of market transparency under the current system. This lack of transparency has led 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, or two, segments of the total market. Without comprehensive large trader position reporting, the government will remain handicapped in its ability to detect and deter market misconduct or to understand the ramifications for the market arising from unintended consequences associated with excessive large positions or with certain speculative strategies. 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.

Similarly, we simply do not have the information to analyze the over-all effect on the markets from the current practices of speculative traders.

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. APGA is optimistic that the enhanced authorities provided to the CFTC in the provisions of the CFTC reauthorization bill will help address the concerns that we have raised, but recognizes that more needs to be done to address this issue comprehensively.

Additional Potential Enhancements in Transparency

In supporting the CFTC reauthorization bill, we previously noted that only a comprehensive large trader reporting system would enable the CFTC, while a scheme is unfolding, to determine whether a trader, such as Amaranth, is using the OTC natural gas markets to corner deliverable supplies and manipulate the price in the futures market.⁵ A comprehensive large trader reporting system would also enable the CFTC to better detect and deter other types of market abuses, including for example, a company making

⁵ See e.g. *U.S. Commodity Futures Trading Commission v. BP Products North America, Inc.*, Civil Action No. 06C 3503 (N.D. Ill.) filed June 28, 2006.

misleading statements to the public or providing false price reporting information designed to advantage its natural gas trading positions, or a company engaging in wash trading by taking large offsetting positions with the intent to send misleading signals of supply or demand to the market. Such activities are more likely to be detected or deterred when the government is receiving information with respect to a large trader's overall positions, and not just those taken in the regulated futures market. It would also enable the CFTC to better understand the overall size of speculative positions in the market as well as the impact of certain speculative investor practices or strategies on the future's markets ability to accurately reflect fundamental supply and demand conditions.

Accordingly, APGA supports proposals to further increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. APGA supports greater transparency with respect to positions in natural gas financial contracts acquired through bi-lateral transactions. Because bi-lateral trading can in fact be conducted on an all-electronic venue, and can impact prices on the exchanges even if conducted in a non-electronic environment, it is APGA's position that transparency in the bi-lateral markets is critical to ensure an appropriate level of consumer protection.

Electronic Bi-lateral trading

One example of the conduct of bi-lateral trading on an all-electronic trading platform was "Enron On-line." Enron, using its popular electronic trading platform,

offered to buy or sell contracts as the universal counterparty to all other traders using this electronic trading system. This one-to-many model constitutes a dealer's market and is a form of bi-lateral trading. This stands in contrast to a many-to-many model which is recognized as a multi-lateral trading venue. This understanding is reflected in section 1a(33) of the Commodity Exchange 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." 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.

Section 1a(3) continues 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 bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, nondiscretionary 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. To the extent that these examples of electronic bi-lateral trading platforms were considered by traders to be a superior means of conducting bi-lateral trading over voice brokerage or the telephonic call-around markets, or will not fall within the significant price discovery contract requirements, their use as a substitute for a more-regulated exempt commercial market under section 2(h)(3) of the Act should not be readily discounted.

Non-electronic Bi-lateral Trading

Moreover, even if bi-lateral transactions are not effected on an electronic trading platform, it is nonetheless possible for such direct or voice-brokered trading to affect prices in the natural gas markets. 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 NYMEX 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 hedge fund.

Given that the various segments of the financial markets that price natural gas are linked economically, it is critical to achieving market transparency that traders holding large positions entered into through bi-lateral transactions be included in any large-trader reporting requirement. As explained above, by trading through multiple dealers, a large hedge fund would be able to exert pressure on exchange prices similar to the pressure that it could exert by holding those positions directly. Only a comprehensive large-trader reporting system that includes positions entered into in the OTC bi-lateral markets would enable the CFTC to see the entire picture and trace such positions back to a single source.

If large trader reporting requirements apply only to positions acquired on multi-lateral electronic trading platforms, traders in order to avoid those reporting requirements may very well move more transactions to electronic bilateral markets or increase their direct bi-lateral trading. This would certainly run counter to efforts by Congress to increase transparency. APGA remains convinced that all segments of the natural gas

marketplace should be treated equally in terms of reporting requirements. To do otherwise leaves open the possibility that dark markets on which potential market abuses could go undetected would persist and that our current lack of sufficient information to fully understand the impact of large speculative traders and certain trading strategies on the markets will continue, thereby continuing to place consumers at risk.

Derivatives Markets Transparency and Accountability Act of 2009

As stated previously, APGA supports proposals to further increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. APGA commends Chairman Peterson for drafting the Derivatives Markets Transparency and Accountability Act of 2009. This legislation would significantly enhance market transparency and would provide the CFTC with additional needed resources to help ensure that the “cop on the beat” has the tools needed to do its job.

Specifically, this legislation would provide greater transparency with respect to the activities of the Index Funds by requiring them to be separately accounted for in the CFTC's Commitment of Traders Reports. APGA strongly supports provisions in the legislation that would provide greater transparency to the CFTC with respect to bi-lateral swap contracts.

Another provision in the bill that APGA strongly supports is the requirement that the CFTC appoint at least 100 new full time employees. The CFTC plays a critical role

in protecting consumers, and the market as a whole, from fraud, manipulation and market abuses that create distortion. It is essential that the CFTC have the necessary resources, both in terms of employees but also in terms of information technology, to monitor markets and protect consumers from attempts to manipulate the market. This is critical given the additional oversight responsibilities the CFTC will have through the market transparency language included in the 2008 Farm Bill and the additional transparency requirements that APGA is proposing to the Committee.

Over the last several years, trading volumes have doubled while CFTC staffing levels have decreased. In fact, while we are experiencing record trading volumes, employee levels at the CFTC are at their lowest since the agency was created. Further, more complex and comprehensive monitoring practices from the CFTC will require the latest technology. It is critical that CFTC have the necessary tools to catch abuses before they occur. APGA is concerned that if funding for the CFTC is inadequate, so may be the level of protection.

Conclusion

Experience tells us that there is never a shortage of individuals or interests who believe they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The fact 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 affirms this. These efforts to punish those that manipulate or

abuse markets or to address those that might innocently distort markets are important. But it must be borne in mind that 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 answer that question and to detect and deter potential manipulative or market distorting activity before our members and their customers suffer harm.

The Committee's ongoing focus on energy markets has raised issues that are vital to APGA's members and their customers. We do not yet have the tools in place to say with confidence the extent to which the pricing mechanisms in the natural gas market today are reflecting market fundamentals or the possible market effects of various speculative trading strategies. However, we know that the confidence that our members once had in the pricing integrity of the markets has been badly shaken.

In order to protect consumers the CFTC must be able to (1) detect a problem before harm has been done to the public through market manipulation or price distortions; (2) protect the public interest; and (3) ensure the price integrity of the markets. Accordingly, APGA and its over 700 public gas system members applaud your

continued oversight of the CFTC's surveillance of the natural gas markets. We look forward to working with the Committee towards the passage of legislation that would provide further enhancements to help restore consumer confidence in the integrity of the price discovery mechanism.