TESTIMONY OF LAURA CAMPBELL

ASSISTANT MANAGER OF ENERGY RESOURCES,

MEMPHIS LIGHT, GAS & WATER

ON BEHALF OF THE AMERICAN PUBLIC GAS ASSOCIATION

BEFORE THE HOUSE AGRICULTURE SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

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Chairman Etheridge, Ranking Member Moran and Members of the Subcommittee, I appreciate this opportunity to testify before you today and I thank the Subcommittee for calling this hearing on the important subject of trading activity in various commodity futures markets, whether the role in the markets of certain types of speculative trading activity is changing, and possible effects on the markets from that activity. 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 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 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 a run-up in the price of energy and other physical commodities. One of the topics of today's hearing is whether this price behavior reflects market fundamentals or results from other factors in the market, such as a change in the level or nature of speculative trading in the market. We do not know the answer to that question. However, APGA strongly believes that a higher level of transparency with respect to trading activity in these markets than currently exists is needed in order to restore our current lack of confidence in the natural gas marketplace and to enable the CFTC, and market users, to form a reasoned response to this critically important question.

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 step in addressing our concerns. Those provisions are contained in Title XIII of the Farm Bill, which is currently being considered by the Congress. We commend this Committee for its work on the CFTC reauthorization bill and support its passage by the Congress.

We also believe that under Acting Chairman Lukken's leadership the CFTC has taken important first steps in addressing our concerns by forming an Energy Markets Advisory Committee to provide a public forum to examine emerging issues related to the energy markets and the CFTC's role in these markets under the Commodity Exchange Act. The first meeting is scheduled for June 10, 2008.

APGA believes that the additional authorities which will be provided to the CFTC under the reauthorization bill may provide the CFTC with the additional tools to answer the questions raised by this hearing, at least with respect to the energy markets. We also believe, however, 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.

Speculators' Effect on the Natural Gas Market

As consumers that make use of the futures and the over-the-counter ("OTC") energy markets for hedging purposes, we value the role of speculators in the 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 recent 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 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

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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") at p. 119

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.

We believe that in order to restore confidence in the pricing of these energy markets, and in order to answer the questions raised by this Committee with respect to the effect of speculative trading interests in the current environment, a greater level of market transparency is needed.

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 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. 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, such as the effect of Amaranth's trading in the markets, results in prices for natural gas that are distorted and which 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 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 futures exchanges, and the CFTC and the exchanges provide a significant level of transparency. But, 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

[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 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."

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.

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]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform has determined to voluntarily provide the CFTC with information on traders' large positions,[5] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions.[6] 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 by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas.

Greater Transparency Needed

Our 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 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

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[4] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.
[5] *Id*, at 7. The CFTC presumably issued this call for information under Section 2(h)(5) of the Act.
[6] 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.

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. 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.

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.[7] 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 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.

Accordingly, APGA supports proposals to increase and enhance transparency in the energy markets, generally, and in the markets for natural gas, specifically. However, APGA also notes that there are additional steps to increase transparency that the CFTC should consider taking within its existing authorities.[8] The CFTC in 2007 made certain enhancements to its Commitment of Traders Reports by reporting separately the aggregate positions held by long-only, passively managed investment funds. To the extent that such funds hold positions in energy commodities, APGA encourages the CFTC to consider expanding these enhancements to their Commitment of Traders Reports to include energy commodities. Enhanced transparency with respect to the participants in the markets and their aggregate position in the markets will improve our

[7] *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.

[8] For example, the CFTC recently amended its Rule 18.05 "special call" provision to make explicit that its special call authority to traders applies to OTC positions, including bi-lateral transactions and transactions executed on the unregulated electronic trading facilities where the trader has a reportable position on a designated contract market in the same commodity. This amendment made explicit authority that the CFTC has previously exercised under Rule 18.05 to require a trader with a reportable position on a regulated exchange, upon special call, to report related OTC positions.

understanding of the dynamics of the market at any particular time, potentially increasing hedger's confidence in the markets' price discovery function.

CFTC Resources

The CFTC plays a critical role in protecting consumers, and the market as a whole, from fraud and manipulation. It is essential that the CFTC have the necessary resources to monitor markets and protect consumers from attempts to manipulate the market. This is essential given the additional oversight responsibilities the CFTC will have through the market transparency language included in the Farm Bill. Over the last several years, trading volumes have doubled while CFTC staffing levels have, on average, decreased. In fact, while we are experiencing record trading volumes, employee levels at the CFTC are at their lowest since the agency was created. APGA is concerned that if funding for the CFTC is inadequate, so may be the level of protection.

Conclusion

Our testimony today is not meant to imply that the CFTC has not been vigilant in pursuing wrongdoers. 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 otherwise abuse 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. Similarly, because of the current lack of transparency in the natural gas markets, we, the regulators, and the self-regulatory organizations, are not in a position to answer definitively whether prices in the natural gas markets today are truly reflective of market fundamentals or are responding, in part, to certain speculative trading strategies and traders. 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 activity before our members and their customers suffer harm.

This hearing 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 whether 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.

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. It is too soon to determine whether the provisions of the Farm Bill, if enacted, will fully achieve the goals of increasing transparency with respect to the pricing in the natural gas markets. These goals will be met if the proposed amendments enable the CFTC 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 approximately 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 to determine whether further enhancements are necessary to restore consumer confidence in the integrity of the price discovery mechanism.