Testimony of

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I want to thank Chairman Peterson and Ranking Member Goodlatte for myself, and for the 119 cosponsors of my legislation, H.R. 6264, which I call the Consumer Oil Price Protection Act, for holding this important hearing and providing the opportunity for me to speak here today. I'd also like to recognize and thank Congressman LoBiondo, the lead Republican cosponsor on this bipartisan legislation for his commitment to this issue.

First let me recognize the hard work of the Chairman and this Committee on the 2008 farm bill over the last year, which took a first step towards regulating the "dark" energy markets. It has become clear to me, however, that these provisions, first put forward over a year ago, have already been overcome by the frenzied activity in our commodity markets. More direct and expedient action is now required.

According to the American Petroleum Institute's July 1st U.S. Pump Price Update, the price of gasoline is up almost 30% from a year ago. Current prices for gasoline are at their highest levels over the last 90 years when adjusted for inflation, and June set the record for the

highest modern monthly average price for gasoline. The record high for the average price of gasoline changed fifteen times in the last seventeen weeks.

My constituents, consumers and businesses alike, are desperate not just for relief – but for a fair deal. There is increasing evidence that the skyrocketing cost of a barrel of oil today, or a gallon of heating oil or gasoline at the pump no longer reflects actual consumer supply and demand for oil and gas.

A myriad patchwork of loopholes in our commodities markets that have become apparent since the enactment of the Commodity Futures Modernization Act of 2000. These loopholes plague the *perception* that the market is functioning normally *and* impede the ability for the CFTC to conduct necessary oversight and data collection across the entire market.

Today you will hear about legislation introduced by my colleagues to close and regulate the various loopholes that are commonly referred to as the 'Enron Loophole', the 'London' or 'Foreign Board of Trade' Loophole, the 'swaps loophole'. I strongly support these approaches.

However, while closing those loopholes will finally bring transparency and oversight to the markets, it will not entirely address a more fundamental issue: the level of speculative participation in the markets. Which is why my legislation takes a different approach to this problem, one that can be considered as part of a comprehensive approach to reforming these markets.

Very simply, my legislation says that if you intend to participate in the currently unregulated, or "dark" markets established by Section 2(g) or 2(h) of the Commodity Exchange Act, that you must be capable of either producing or taking final delivery of the product. In other words, we are taking the speculators out of the "dark" markets and shedding light on their activities.

This approach is based on the premise that the commodity markets, as established by the Commodity Exchange Act of 1936, exists to serve the benefit of those dealing in the production and consumption of a physical, tangible, product with a finite supply.

My legislation grew out of the concerns of the Independent Connecticut Petroleum Association, which represents fuel oil dealers and gasoline distributors across my state, many of which are small family owned businesses. These businesses are on the front lines of this issue, facing end use consumers on one end, some of whom have to turn over their entire Social Security check to pay for heating oil, and the oil markets on the other end. They are closest on the ground to the true pulse of supply and demand in these markets, and as the price continues to skyrocket, more and more companies are having trouble increasing their credit necessary to continue deliveries to their consumers.

In 2005, I requested a GAO investigation into the CFTC and oil futures trading on NYMEX, specifically to determine the impact of the new trend of large non-commercial or institutional investors such as hedge funds speculating in the market.

This report was completed in October 2007 and concluded "in light of recent developments in derivatives markets and as part of CFTC's reauthorization process, Congress should consider further exploring whether the current regulatory structure for energy derivatives, in particular for those traded in exempt commercial markets, provides adequately for fair trading and accurate pricing of energy commodities."[1]

The Role of Physical Hedgers vs. Speculators

In properly functioning markets, speculators play an important role in managing financial risk. The danger of combining unregulated speculation with commodities that have a finite supply like oil is that it can become excessive, causing artificial price distortions and volatility in the market. New CFTC data, discussed in a hearing in the Energy and Commerce Subcommittee on Oversight and Investigations last month show that in 2000, when the CMFA was enacted, 63 percent of the oil on the WTI futures market was held by physical hedgers, compared to 37 percent held by speculators.

[1] GAO-08-25 Commodity Futures Trading Commission, Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight, October 2007, pg. 58.

By April of this year, that ratio had reversed itself, with speculators now dominating 71 percent of the market compared to physical hedgers at 29 percent. This dramatic shift begs this committee to address the philosophical questions:

1) *Who do the commodity markets exist to serve - The producers and consumers of the underlying commodity, or the speculators?*

2) *Should oil be treated as a physical commodity with a finite supply, as it was before 2000, or as a financial asset, as it is being treated today?*

The historical record is quite clear that the commodity markets exist for what are referred to as physical hedgers. Physical hedgers are essentially the producers and consumers of the underlying product.

Report Number 421 from the Committee on Agriculture in the 74th Congress, on the Commodity Exchange Act submitted on March 18, 1935 stated the two basic tenants behind the Commodity Exchange Act:

1) "the fundamental purpose of the measure is to insure fair practice and honest dealing on the commodity exchanges and *to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.*"

2) "The bill has another objective the restoration of the primary function of the exchanges which is *to furnish a market for the commodities themselves.*"

President Roosevelt said in his message to Congress on February 9, 1934, "It should be our *national policy* to restrict, as far as possible, the use of these exchanges for purely speculative operations." Given that since 2000 speculators have taken control of over 70 percent of the WTI futures market, *on the one exchange that is currently regulated*, we need to ask ourselves if the market has become exactly what President Roosevelt warned against.

Market Fundamentals No Longer Apply

There are many parallels to what is happening today in our economy between investment in the commodity markets and Congress' grappling with the activities of speculators during consideration of the Commodity Exchange Act in 1935 and 1936. This committee recognized in its report on the Commodity Exchange Act in 1935, that "Since the passage of the Securities Exchange Act of 1934, there has been observed an increasing tendency on the part of professional speculators to transfer their activities from the security markets to the commodity markets, a tendency which makes the enactment of this bill without further delay of vital importance."

A similar shift in activity and capital has become evident since large portions of the commodity markets for oil were deregulated by the CFMA of 2000. Just as the equity markets face increasing scrutiny and potential regulation from the subprime mortgage fallout, we start to see more dramatic increases in capital suddenly flowing to the oil commodity markets. Additionally actions by new institutional investors not envisioned in the 2000 CFMA reforms have emerged, including those seeking to use the commodity markets as a hedge against the falling dollar and those applying long term equity portfolio growth strategies to commodities.

The essential function of price discovery that futures markets play has become distorted in the current excessive speculative activity. As far back as 2005, Lee R. Raymond, the chairman and CEO of Exxon Mobil said, "We are in the mode where the fundamentals of supply and demand really don't drive the price."[2] Earlier this year, Chip Hodge, a Managing director of MFC Global Investment Management's $4.5 billion energy portfolio said, "Clearly, the fundamentals don't matter at this point."[3] Guy Caruso, head of the Energy Information Agency testified to the Senate earlier this year that a speculative premium existed in the price of a barrel of oil.[4] Even Abdalla al-Badri, OPEC secretary general was widely quoted in the press in

[2] "*Some Wonder if the Surging Oil Market Is Ignoring Supply and Demand"* by Simon Romero, **New York Times**, March 15, 2005

[3] "*Crude Oil Trades Near Record $108 as Returns Outpace Equities*" by Mark Shenk, Bloomberg.com, March 11, 2008

[4] Senate Energy and Natural Resources Committee Oversight Hearing: EIA's Revised Energy Outlook, March 4, 2008.

December 2007 saying that "The market is not controlled by supply and demand…It is totally controlled by speculators who consider oil as a financial asset."

There seems to be general agreement between oil executives, investment managers, the Department of Energy, and consumers that the current price of oil is not entirely contributable to supply and demand.

Supply-Side Arguments Reinforce the Need for Re-regulating Oil Markets

Critics of legislation targeting speculators often cite increased demand from China and India, bottlenecks in the refining process, or other supply disruptions like natural disasters for rising prices.

However, if it is limited access to supplies of oil that is increasing the price, not excessive speculation in the market, then clearly, oil is a tangible commodity with a finite supply, not an intangible financial instrument as defined by the CFMA of 2000. It should therefore minimally be subject to the same regulatory protections provided for agriculture products.

These arguments only reinforce the need for the approach taken in H.R. 6264, that the markets should operate on the needs of the underlying physical producers and consumers.

Restoring Basic Fundamentals to the Market

The approach H.R. 6264 takes to restore the fundamentals of supply and demand to the market and reestablish a reliable price discovery process is to focus on the activities of the physical hedgers, the producers and consumers, the market participants the commodity markets were established to serve.

Michael Masters, in his testimony before the Energy and Commerce Subcommittee on Oversight and Investigations on June 23, 2008, summed up why this is effective very succinctly:

> *"Bona fide physical hedgers are motivated by one thing – risk reduction. Physical commodity producers trade in order to hedge their actual physical production. Physical commodity consumers only trade in order to hedge their actual consumption. For this reason, their trades are always based on the actual supply and demand fundamentals that directly affect them in the underlying physical markets. Their trading decisions strengthen the price discovery function of the commodities futures markets."*

To accomplish this, H.R. 6264 says that if you intend to participate in the currently unregulated, or "dark" markets established by Section 2(g) or 2(h) of the Commodity Exchange Act, that you must be capable of either producing or taking final delivery of the product. In its current form, it is written against current law, and assumes that sections 2(g) and 2(h) of the CEA are not modified as proposed by Mr. Stupak in H.R. 6330 or Mr. Van Hollen in H.R. 6341. Recognizing that responsible speculation provides the liquidity necessary for the commodity markets to function efficiently, H.R. 6264 allows speculators to continue to participate in the existing regulated markets, where their activities can be conducted in the light of day and are fully disclosed, and subject to position limits and other oversight measures followed by regulated exchanges. By limiting the participation of speculators and focusing on the activities of the physical hedgers this legislation will ensure that prices will most accurately reflect the true supply and demand of the underlying physical commodity.

Even if provisions of H.R. 6330 or H.R. 6341 are adopted that would change the current structure of Sections 2(g) or 2(h) of the CEA, this committee will still need to look at solutions to address or determine the limits defining excessive speculation in the market. H.R. 6264 is adaptable to those changes. For example, one approach suggested by Michael Masters in his recent testimony would be to allow the physical commodity producers and consumers to determine what level of speculation, and thereby liquidity, is necessary for the proper functioning of their market.[5]

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[5] Michael Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC, Testimony before the House Committee on Energy and Commerce Subcommittee on Oversight and Investigations, June 23, 2008

Establish an Independent Inspector General at the CFTC

As Congress seeks to implement reforms of the oil commodity markets, it is imperative that the CFTC have an independent Inspector General office to ensure that the directives issued by Congress are implemented and adhered to by the CFTC. The current Inspector General sits under the office of the Chairman of the CFTC, who also hires the agency's IG. This relationship makes the IG dependent on the Chairman. However, an Inspector General appointed under Section 3 of the Inspector General Act of 1978 would be chosen by the President and confirmed by the Senate. They maintain an independent office. I have recently introduced legislation, H.R. 6406 that would establish an independent Inspector General's office at CFTC. While this legislation has been referred to the Government Reform Committee, it is nevertheless relevant to this discussion and important to this Committee's deliberations.

Closing

This Committee must determine whether the underlying purpose of the Commodity Exchange Act is to provide a market for the commodities themselves and some control over speculative activities, or whether the markets exist purely for the use of speculators.

The historical record to me is clear: commodity markets exist to match buyers and sellers of physical commodities, with finite supplies, with consumers or end-users. The data that continues to come forward in Congressional hearings and now even from the CFTC is clear. The ratios of speculative activities to physical activities in these markets are skewed. A mechanism must be set to determine or limit speculative positions across all markets and reduce the role non-commercial investors, who cannot and do not accept delivery of the physical product.

HR 6264 provides a pathway to accomplish that. Together this bill and the proposals put forward by my colleagues today provide a framework for a comprehensive solution. I stand ready to work with you to craft the best possible policy to address the changes in the commodity markets that have evolved over the last several years.

I thank the Chairman and Ranking Member for their consideration of these views, and would be happy to answer any questions.