STATEMENT OF SENATOR CARL LEVIN (D-MICH)

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

ON

EXCESSIVE SPECULATION IN NATURAL GAS PRICES

July 9, 2007

At our hearing two weeks ago, we laid out the case history of Amaranth Advisors LLC. A lengthy staff report and testimony from witnesses told the story of how this large hedge fund dominated the U.S. natural gas market in 2006, until Amaranth collapsed in September 2006.

In 2006, Amaranth traded thousands of natural gas contracts daily, sometimes traded tens of thousands of contracts in a single day, and accumulated as many as 100,000 natural gas contracts for delivery of natural gas in a single month. At times during the summer, Amaranth held about 40% of all outstanding NYMEX natural gas contracts for the winter of 2006-07, including 75% of the outstanding futures contracts to deliver natural gas in November 2006; 60% of those delivering natural gas in January 2007; and 60% of those delivering natural gas in March 2007. We heard how Amaranth's trades and holdings were way beyond the norm and way beyond the economic capacity of most natural gas traders.

We also heard how Amaranth's trading practices pushed up prices for winter gas, contributed to price spikes, and socked consumers with extra costs. One public gas company in Georgia testified at the last hearing that it paid $18 million more than it should have for winter gas because of Amaranth's excessive speculation. An industry association told the Subcommittee that Amaranth's trading in winter gas likely cost consumers billions of dollars in extra costs.

The Amaranth hedge fund gambled on the natural gas market. It lost that gamble, but Amaranth's losses aren't our concern. The real issue is that, by using massive trades to bet on natural gas prices, Amaranth raised relative 2006 winter prices for the whole market and caused consumers hedging their winter gas purchases to pay inflated prices. Those consumers couldn't afford to roll the dice and wait to see if prices came down later. They had to lock in their winter gas prices during the summer to ensure a stable supply and in order to carefully budget for the cost. Amaranth upped the cost, which means the public ultimately paid the price.

Just one year ago our Subcommittee released a report showing how widespread speculation in contracts for the future delivery of oil was inflating crude oil prices by about $20 per barrel of oil. The Amaranth case shows how a single hedge fund – backed up by large amounts of capital – produced an equally dramatic effect in the natural gas market. At our last

hearing, I asked one of the Amaranth traders why they engaged in such large-scale trades. He answered: "[I]t was simply a matter of capital. At a hedge fund you are given an amount of capital to trade with. . . . [Y]ou simply have to put that capital to work one way or the other."

To Amaranth, it was simply a matter of putting capital to work. It had billions to invest and decided to invest those billions in the natural gas market. Amaranth did not produce natural gas, it did not supply natural gas, it did not use natural gas. It simply wanted to speculate and hopefully make a lot of money in the natural gas market. And they took users and consumers of natural gas along for the ride.

Excessive speculation and price manipulation are not confined to the natural gas market – they taint many sectors of the U.S. energy market, from Enron's distortion of electricity prices, to alleged price manipulation in the propane market, to alleged price gouging in gasoline. Unfair energy prices are causing real pain for the people we represent. The causes demand a remedy when they reflect manipulation or excessive speculation.

Today's hearing focuses on the role of market regulators to protect the public from unfair energy prices. The Commodity Futures Trading Commission (CFTC) is the key cop on the beat charged with policing U.S. commodity markets to stop price manipulation and excessive speculation. To carry out its mission, the CFTC has delegated authority to a number of exchanges, such as the New York Mercantile Exchange (NYMEX), to establish rules to monitor trading and prevent manipulation and excessive speculation. The CFTC has, for example, authorized regulated exchanges to impose trading limits on individual traders to prevent speculators from engaging in misconduct. These regulated exchanges provide the first line of defense against market misconduct; the CFTC provides the backup.

When it comes to energy, however, Congress has thrown the CFTC a curve that has made its oversight job much harder. In 2000, at the request of Enron Corporation and others, Congress amended the key federal law, the Commodity Exchange Act, to exempt CFTC oversight of energy and metals commodities traded on electronic energy exchanges used by large traders. The result of this so-called "Enron loophole" is that a leading U.S. electronic energy exchange, known as the Intercontinental Exchange or ICE, is exempt from the normal regulatory system that applies to regulated exchanges. That means, unlike NYMEX, ICE has no authority or obligation to monitor trading, no authority or obligation to prevent price manipulation, and no authority or obligation to prevent excessive speculation from distorting prices. And due to the Enron loophole, the CFTC has no authority to limit trading on ICE to prevent price manipulation or excessive speculation.

NYMEX and ICE are the two biggest energy exchanges operating in the United States today. It makes no sense that one market is regulated, and the other is not. Worse, the Amaranth case history shows how the operation of an unregulated market can make it impossible for a regulated market to effectively prevent price manipulation and excessive speculation.

That's because the current system allows traders to avoid restrictions against excessive speculation imposed by NYMEX, the regulated market, simply by switching their positions to ICE, the unregulated market. This switch costs a trader virtually nothing, and enables the trader to engage in unlimited trading on the unregulated market.

That is exactly what happened in August 2006, when NYMEX ordered Amaranth to reduce its holdings of the September 2006 NYMEX futures contracts. As this chart (Exhibit 6) shows, when NYMEX gave that order on August 8, Amaranth held a short position of about 60,000 September contracts on NYMEX – which is a huge position. Concerned that Amaranth might engage in last-minute large-scale trading that could affect the final settlement price of the September contracts, NYMEX ordered Amaranth to reduce its September contracts, in an orderly manner, by the end of the month.

In response, Amaranth reduced its NYMEX position down to about 10,000 contracts by the end of August. However, Amaranth also increased its position on ICE to about 80,000 September contracts, in trades that took place without NYMEX or CFTC scrutiny or limitations. In making the switch from NYMEX to ICE, Amaranth took advantage of the Enron loophole. The end result was that NYMEX's order did not cause Amaranth to reduce the size of its holdings – it instead led Amaranth to move from a regulated to an unregulated market.

Now consider the trading that took place on August 29, 2006, the last day of trading allowed on September contracts. On that date, Amaranth sold tens of thousands of contracts during the day, primarily on ICE. Despite those sales, the contract price didn't fall much, because Amaranth's trades were counterbalanced all day by other traders, including another large hedge fund, Centaurus, that bought the September contracts Amaranth was selling. In the last hour of trading, Amaranth stopped trading on NYMEX in response to the NYMEX directive that it refrain from trading during the final 30 minutes. Other traders, however, continued buying the September contract. Without Amaranth's sales to counterbalance the pressure on the contract price, in the last hour of trading, the final contract price shot up 10%.

Almost all of the trades made by Amaranth and Centaurus on August 29th took place on ICE. Amaranth sold about 16,000 September contracts that day, while Centaurus bought about 12,000 – 10,000 of which were in the final 45 minutes of trading. NYMEX rules bar traders from holding more than 1,000 contracts in the last 3 days of trading on a contract. The torrent of ICE trading during those same 3 days not only nullified NYMEX's efforts to limit trading near the contract deadline, but also clearly affected the NYMEX final price. For Amaranth, because of all the short sales it made, the last-minute upward spike in the contract price dropped the value of its holdings by nearly $500 million.

Some of the questions we will examine today are, first, why any organized exchange with energy trading is exempt from routine CFTC oversight and regulation. Energy is a vital commodity to the United States. There is no rational reason to exempt energy commodities from normal market oversight to prevent price manipulation and excessive speculation. Second, we

will examine why ICE is treated differently from NYMEX. Both exchanges affect energy prices. Both exchanges are used by the same traders whose trades lead to virtually identical energy prices on both markets. Both exchanges are vulnerable to misconduct that can inflate energy prices. And as the Amaranth case history illustrates, regulating one U.S. energy exchange without regulating the other is a recipe for failure, since speculators restricted on NYMEX can simply move to ICE and carry out the very same trades.

The flaws in the current regulatory structure for U.S. energy trades are painfully obvious, but the CFTC has been slow to call for reform. For years, the CFTC has resisted requesting authority to monitor energy trades taking place outside the regulated markets. It has resisted recognizing the role of unregulated markets in affecting prices on regulated markets and the impact of excessive speculation in pushing up energy prices. It has also resisted asking for explicit authority to prevent price manipulation and excessive speculation on ICE.

Amaranth's excesses may have finally broken down some of that resistance. In late 2006, after Amaranth collapsed and the scale of its trading became widely known, the CFTC used its special call authority to require ICE, for the first time, to begin turning over daily trading data. Last month, the CFTC proposed a rule that would require traders on NYMEX, the regulated exchange, to disclose upon request their holdings on all exchanges, whether regulated or not. That would enable the CFTC to get a more complete picture of a trader's relevant holdings. But unless the CFTC can obtain the same information from ICE traders that it can from NYMEX traders, and unless ICE is subject to the same rules prohibiting excessive speculation as NYMEX, the ultimate effect of the proposed rule may be to create one more incentive for traders to choose trading on the unregulated ICE market over the regulated NYMEX market.

While the CFTC's recent innovations will help expand its access to essential energy trading data, they do not give the CFTC the authority needed to protect U.S. energy markets from price manipulation and excessive speculation. The CFTC must not only obtain the information it needs, it must also be able to act on that information to protect the public.

Our report presents three bipartisan recommendations to enable the CFTC to effectively police U.S. energy markets. The first is to close the Enron loophole by giving the CFTC equal oversight and regulatory authority over NYMEX and ICE energy trades. Second, the CFTC needs to strengthen enforcement of the prohibition against excessive speculation, including by monitoring speculative trades of contracts in all months, not just the contracts nearing expiration. Third, Congress needs to give the CFTC more funds to do its job, including if necessary authorizing the CFTC, like every other U.S. financial regulator, to collect user fees from the markets it oversees.

Right now, U.S. energy markets are dangerously vulnerable to price manipulation and excessive speculation. Regulators charged with protecting the public are hobbled by laws that create irrational rules for energy commodities, establish an uneven regulatory playing field between NYMEX and ICE, and render market regulators powerless to effectively stop

inappropriate trading on electronic exchanges from affecting contract prices. We can and must do more to protect the public. We must put the cop back on the beat in all U.S. energy markets.

I would like to thank Sen. Coleman, the Subcommittee's Ranking Republican, for his continued support of these efforts. I'd also like to thank his staff for their dedication and assistance in this truly joint effort. And of course, thanks to my staff for their almost herculean efforts to review massive amounts of data. Finally, I would like to thank each of our witnesses today – the CFTC, NYMEX, and ICE – for their cooperation with the Subcommittee's investigation. In particular, NYMEX and ICE provided extensive data and responded to many Subcommittee requests in a timely manner. We appreciate everyone's assistance in unraveling the Amaranth case history.