WRITTEN TESTIMONY OF SIR BOB REID
CHAIRMAN, ICE FUTURES EUROPE
BEFORE A HEARING OF THE COMMITTEE ON ENERGY AND COMMERCE
FOR THE 110TH CONGRESS

June 23, 2008

Chairmen Dingell and Stupak, Ranking Members Barton and Shimkus. I am Sir Bob Reid, Chairman of ICE Futures Europe and a Director of IntercontinentalExchange Inc.

I very much appreciate the opportunity to appear before your hearing today to share ICE Futures Europe's views on the proper amount of regulation is necessary to prevent price manipulation.

Background

ICE Futures Europe, formerly the International Petroleum Exchange of London Ltd, is the leading energy futures exchange outside the United States of America. The Exchange was formed in 1980 and operated as a mutual exchange until 2001 when it was acquired by IntercontinentalExchange Inc. Its primary mode of operation was open outcry trading until 2005 when all trading was switched to the ICE electronic platform. ICE Futures Europe is the home of the Brent Crude Futures contract, a North Sea blend of crude oil. The Brent complex, of which our futures contract is a part, forms the basis for pricing – directly or indirectly – for two thirds of world traded crude oil[1]. We also operate a Gas Oil futures contract – a European heating oil – the primary pricing benchmark for European middle distillate products as well as UK natural gas and electricity contracts. In conjunction with our partners at the Chicago Climate Exchange we operate the market for the European Climate Exchange, which is now the largest carbon market in the world.

The customers of ICE Futures' market are based all over the world. Even when ICE Futures was an open outcry exchange, customers from all over the world used its markets by phoning their orders in to the trading floor in London. Today the trading floor is a virtual one, with orders being sent to the market through computer terminals – but the global nature of our markets has not changed. We have regulatory clearance for our screens to operate in over fifty jurisdictions around the world.

[1] Source: Brent: A User's guide to the Future of the World Price Marker (Liz Bossley, CEAG, 2007)

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In February 2006 we launched a financially settled futures contract for West Texas Intermediate (WTI) crude oil, oil to complement our Brent crude oil contract since both are similar light sweet grades of crude oil. . We chose to offer a financially settled WTI contract at a time when NYMEX was committed to retaining and promoting open outcry trading rather than pursuing electronic trading. As the first to launch an electronically traded WTI contract on a robust electronic trading platform, our contract was successful taking market share from NYMEX. Since the launch of electronic trading by NYMEX, most of the growth in trading of WTI crude oil has been on the NYMEX rather than the ICE market. Nevertheless, the ICE WTI contract is an important contract for ICE Futures Europe, as it is used by commercial participants to hedge exposure to small differences in WTI and Brent prices. Notably, NYMEX similarly offers a cash settled Brent crude oil future settling on ICE Futures Europe's final settlement price for precisely the same reason. Today, ICE has a relatively small 15% share of total WTI futures and options open interest, while NYMEX retains the remaining 85%.

Regulatory framework: ICE Futures Europe's Operations

ICE Futures Europe is a Recognized Investment Exchange which operates under a legislative framework set out in the Financial Services and Markets Act 2000. This framework gives the exchange an equivalent regulatory status under UK law to the status that U.S. Exchanges have under US law. The Exchange is subject to supervision by the Financial Services Authority, which has a designated team whose responsibility is to oversee the work of UK exchanges and other recognized bodies. The financial services regulatory regime in the United Kingdom is well-established and has been used as a model in the design of other regulatory systems around the world.

All contracts traded on ICE Futures Europe are subject to UK law and regulation. For European market participants, this is important for a variety of reasons, including the applicability of UK bankruptcy and insolvency laws in the event of a contract default. All of ICE Futures Europe's contracts are cleared in London by LCH.Clearnet Limited, which acts as central counterparty to all trades on the Exchange. Clearing of such contracts is shortly to be transferred to our own new London-based clearing house, ICE Clear Europe.

At all times since it became a subsidiary of ICE, Inc., ICE Futures Europe has been headquartered in London and has operated as a Recognised Investment Exchange. At all times during this period, ICE Futures Europe has been governed by a separate board of directors, which I chair, and which is accountable to the Financial Services Authority for the operation of ICE Futures Europe's markets. The board's members include myself, the President of ICE Futures Europe, the Chairman and CFO of ICE Inc. and three independent members. This separate governance structure and degree of independence within the ICE, Inc. group is mandated by the Financial Services Authority in order for

ICE Futures Europe to maintain its status as a Recognised Investment Exchange and a self regulatory organization. ICE Futures Europe has approximately seventy employees, all of whom are based in the United Kingdom.

It is important to address one issue head-on, and this is the prior statements and suggestions of certain third parties that ICE Futures Europe is "operated to take advantage of a regulatory loophole", that it is "operated out of Atlanta, Georgia," or that somehow its operations lack regulatory substance and legitimacy. These statements are false.

Our role

Our role as a Recognised Investment Exchange is to provide a fair and orderly market in which the interaction of market participants is allowed to determine prices. We strive to be strictly neutral and independent. Our role is neither to be on the side of the producer nor the consumer; we are dedicated to ensuring that price formation is fair.

A fair and orderly market

Being a fair and orderly market means operating within a framework laid down by law and regulation. The ultimate decision-taking body of the Exchange is its board of directors. The rule-making functions are fulfilled by the Authorization, Rules and Conduct Committee under delegation from the board. Changes of significance are brought back to the board for approval. There is an independent disciplinary framework which is followed in circumstances where the Exchange pursues disciplinary action against members.

The ICE Platform has sophisticated audit facilities which allow it to record extensive information about every trade on the platform. Compliance staff monitor trading patterns and price movements to identify circumstances which warrant further investigation. They seek to identify improper conduct, and in particular, any attempt to manipulate the market.

As well as receiving information about transactions, the Exchange also receives information about any large positions held by members, including details of the customer(s) responsible for such positions. While ICE Futures does not presently impose formal position limits or position accountability rules (but recently has agreed to do so with respect to its WTI contract at the request of the CFTC), the Exchange receives daily reports from all members who hold large positions in the front two months of any contract detailing who is responsible for holding such positions. The Exchange can ask

members to reduce positions in any contract if they judge them to be unduly large and has the power to compulsorily close out positions.

There is a particular focus on physically-delivered contracts – in particular Gas Oil – where it is possible for delivery squeezes to occur, for example by a single participant obtaining control of most of the oil due for delivery in a particular month. In financially-settled contracts such as WTI this risk does not exist in the same way because physical delivery does not occur.

The Exchange has the power to bring disciplinary proceedings against its members. Where an investigation identifies issues beyond its direct control the Exchange will notify the Financial Services Authority and, if appropriate, relevant overseas regulators such as the CFTC.

Cooperation with the CFTC

As noted above, the ICE WTI contract is financially-settled, which narrows the area of risk in comparison with a physically-delivered contract. Nonetheless it is clearly important that the CFTC has the opportunity to have an overview of the market to ensure that there is no activity across Nymex and ICE that might be construed as price manipulation or market abuse. In November 2006, ICE Futures Europe, through the memorandum of understanding between the FSA and the CFTC, began providing trader position data on WTI for the prompt two months. On 29 May 2008, we agreed with the CFTC and FSA an extension of this information sharing to encompass position information across the entire expiry horizon, on a daily basis. Some of this has already been instituted – the CFTC already receives an analysis of positions in the WTI contract on a member by member basis for every contract month. Full implementation is due in the near term.

On 17 June 2008 the CFTC announced an amendment of the conditions under which we are permitted to operate in the United States. They amended the "no-action relief letter" under which ICE Futures Europe is permitted direct access to US customers. The amended letter conditioned our direct access on ICE Futures Europe's adoption of equivalent U.S. position limits and accountability levels on the ICE WTI Crude Oil Futures Contract. In addition, ICE Futures Europe will provide data identifying commercial and noncommercial participants that will allow the CFTC to incorporate the ICE Futures WTI contract into the Commitment of Traders Report. The agreement will be enforceable through the CFTC's broad authority over U.S. traders; the exchange's robust rule enforcement, and the oversight of the FSA.

In addition, pursuant to the amended letter, we will follow similar US hedge exemption requirements and will report violations of any such provisions to the CFTC. This action

also formalizes the information sharing announced in May. The CFTC will incorporate data directly into the CFTC's Commitments of Traders report, their weekly report categorizing traders and positions. The revised Commission staff foreign access conditions must be satisfied by ICE Futures Europe within 120 days. The changes are subject to the approval of the UK Financial Services Authority.

Rising oil prices

Oil prices are at historically high levels. US oil prices so far in 2008 have averaged $109, around one third higher than the 2007 average of $72. The causes of these oil price rises are complex and much has been written about them, particularly in recent weeks. Some commentators have asserted that the bulk of the recent increase in oil prices is related to the 'fundamentals'.

In a report published earlier this month the International Energy Agency said "supply growth so far this year has been poor and higher prices are needed to choke off demand to balance the market." It went on to say that abnormally high prices are largely explained by the fundamentals.

Jeffrey Harris, the chief economist of the Commodity Futures Trading Commission (CFTC) said in a recent Senate testimony that he did not see any evidence that the growth of speculation in oil has caused the price to rise. Rising prices might have stimulated the growing investment rather than the other way round, Harris noted. In the oil futures market, investment can flow in without driving up the price because the speculators are not buying actual crude to be able to hold onto it or keep it off the market. Instead, contracts are bought for future delivery. When the contracts mature, they either cash settle them or sell them to genuine consumers of oil. The contracts allow traders to take a view on price direction with the number of views not affecting the amount of oil available.

Some have asserted that the primary cause of recent oil price rises is speculation. "Speculation", however, needs to be distinguished from manipulation, which is to deceive investors by controlling or artificially affecting a market. A central role of a regulated marketplace such as ours is to take steps to prevent and detect such manipulation.

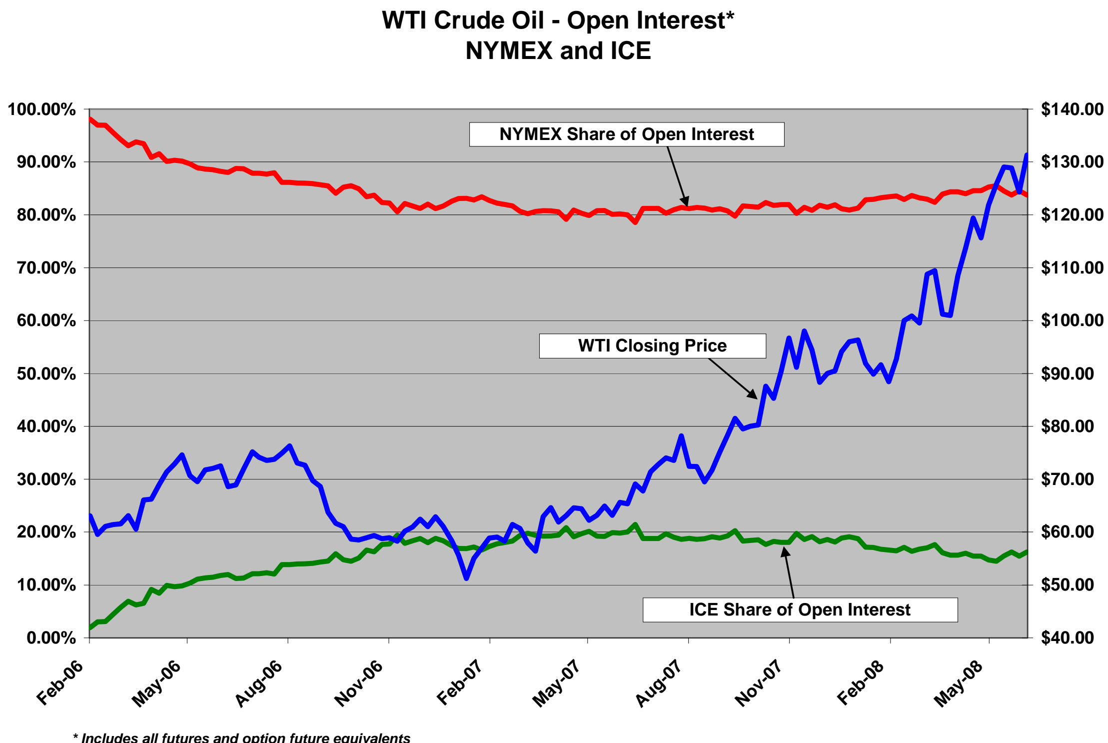
Rather than "speculation" I prefer the term "financial participation". There is nothing wrong with financial participation in oil markets per se. Such participation helps to increase liquidity, which makes it easer for market participants to get in and out of positions at a given price, and make it more difficult for any individual participant to manipulate the market. Financial participants are the counterparties to the commercial entities who hedge their production or consumption. Such participants can take either

'long' or 'short' positions depending on their expectations of the way in which prices will change.

Recent price moves

The increase in oil prices has been particularly marked since January 2007, when oil prices stood at $58 per barrel. During the period from 2000 to 2007 we had seen a steady upward movement in the oil price, but over the past six months in particular we have seen a breakout from those price levels. During this time, the dollar has been devalued; supply has decreased, while demand has remained constant. We have also seen particularly high volatility prices with a move in the WTI price of over $10 on 6th June2008.

Some have asserted that the change in WTI prices since the beginning of 2007 has been driven by speculative traders building large positions in the ICE WTI contract. The facts, however, indicate otherwise as ICE Futures Europe's share of global WTI open interest has declined from about 20% to 15% over that same period. Furthermore, the total WTI open interest, on both the Nymex and ICE contracts has not increased materially over the past year, and indeed is significantly lower than its peak levels.



Margin levels

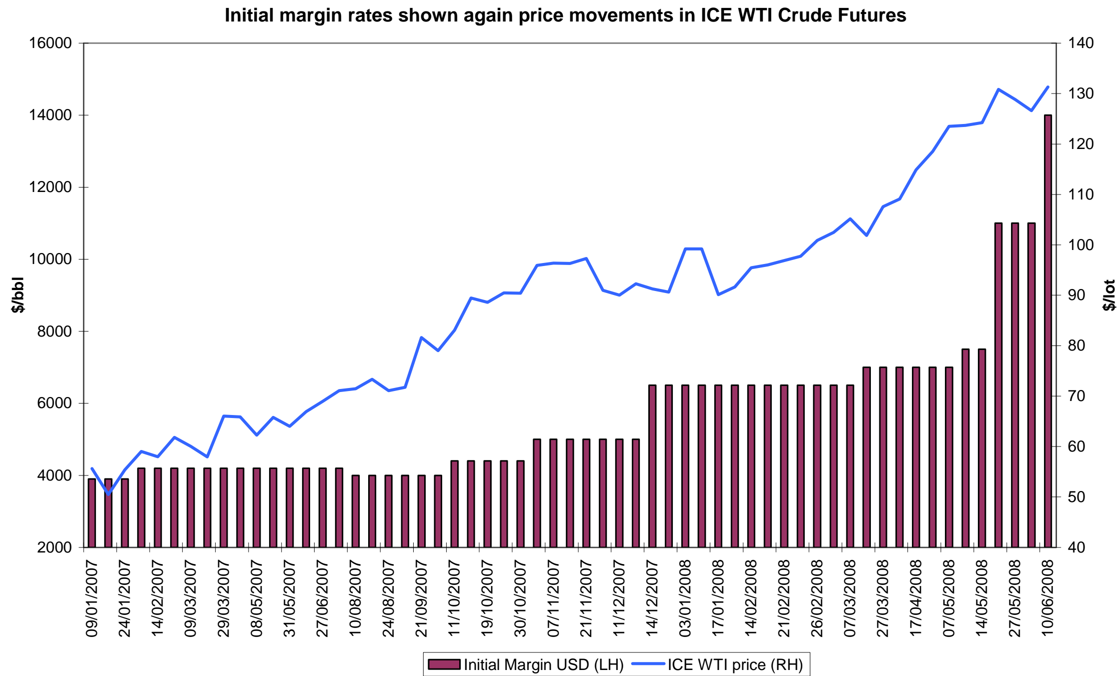
One proposal under the Consumer First Energy Act of 2008 is to require the CFTC to substantially increase the margin requirement on crude oil futures trades.

It is the responsibility of a Futures Market to be a neutral venue for the setting of prices. Margins are required by clearing houses for the purpose of ensuring that they have adequate security in the event of the default of a market member. Margins are used by a clearing house to manage risk and should be set on the basis of the needs of risk management and of risk management alone. The level of margins is calculated by clearing houses on the basis of calculations carried out in accordance with a proven margining methodology such as SPAN – an approach which was developed by the Chicago Mercantile Exchange and is also used by Nymex and LCH.Clearnet and will be used by ICE Clear. Changes in margin levels tend to be driven by changes in price levels and levels of volatility.

Artificially increasing margin levels on regulated futures markets would drive business either to futures markets in other jurisdictions where there are no such constraints, or to off-exchange OTC marketplaces where clearing is not available. Moving business away from cleared markets is precisely the opposite of what should be done at a time of highly volatile prices and systemic financial risk. Clearing provides a valuable function in the mitigation of financial risk and has been a tried and tested source of risk mitigation at a difficult time for financial markets.

Even if margins were to be increased it is not clear that such increases would reduce price levels. They could well introduce market distortions that could drive up prices, particularly in circumstances where commercial participants found it more difficult to meet higher margins than financial participants, or where financial participants with short positions were forced to buy them back.

Margin levels have in fact been increasing over recent months. Margin levels today are over 3.5 times margin levels at the start of 2007. They have been set at those levels because of the higher volatility that we have seen in oil markets. We have not seen evidence that this increase in margins has reduced prices.



Foreign Boards of Trade

The last time I took part in a public hearing in Washington was during 2006, when the then Chairman of the CFTC, Reuben Jeffrey, convened public hearings to consider the issue of the regulation of Foreign Boards of Trade in the US. Consideration of the issue at that time was largely triggered by the launch of the ICE WTI Crude Futures Contract. An overwhelming majority of participants in those hearings thought that the CFTC 'no action' regime had been very successful. The CFTC reaffirmed its no action regime thereafter[2], recognizing the benefits of regulatory cooperation and mutual recognition. The basis of this approach is that markets, particularly oil markets, are global. Participants are based all over the world and cooperation between regulators is crucial in this context. ICE Futures has cooperated fully with the CFTC and will continue to do so. As well as supplying position information on a regular basis ICE has provided extensive transaction information to CFTC to assist in investigations.

Conclusion

We recognize the severe impact of high crude oil prices on the U.S. economy and understand the Congressional desire to "leave no stone unturned." However, with a 15%

[2] CFTC Release: 5252-06 issued October 31 2006

share of global WTI futures and options open interest; we feel it is highly unlikely that our WTI contract is the primary driver of WTI prices. This "inconvenient truth" clearly contradicts any notion of a London loophole.

Our view, Mr Chairman, is therefore that the current regulatory regime works well, and that greater regulation is not the answer. The priority for regulators in our increasingly interconnected world should be increasing cooperation with their counterparts in other countries. This is best promoted and developed by the international sharing of best practice in the context of an environment where comparable regulators operate within a framework of mutual recognition. This is a framework in which the CFTC and the FSA take a leading role, and one which they should seek further to build on in the future.