Consumer Federation of America

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before the

COMMODITY FUTURES TRADING COMMISSION
HEARING TO EXAMINE THE OVERSIGHT OF TRADING ON REGULATED FUTURES EXCHANGES AND EXEMPT COMMERCIAL MARKETS

September 18, 2007

Mr. Chairman and Members of the Commission,

In May of 2006, I prepared a report on natural gas for the Attorneys General of Iowa, Illinois, Missouri, and Wisconsin[1] that concluded that structural and behavioral problems in commodity markets, particularly the lack of regulation of trading allowed by the Enron loophole, had influenced the price of natural gas in an upward direction. I choose the word influence purposely because the concept of manipulation is too narrow to describe the problems in commodity markets or to prevent consumers from being abused. Market power can move prices to the benefit of the mover and the detriment of the consumer without manipulation.

At the time, Federal authorities were in full denial mode, similar to the period in late 2000 when regulators insisted that nothing was wrong with the California electricity market and Enron was the darling of the commodity world. Less than two years later, Enron was in bankruptcy and dozens of cases of abuse were starting to turn up, but the Enron loophole remained in the law and regulatory practice.

Interestingly, in the 18 months since my report to the Attorneys General on natural gas, several reports from Congressional Committees,[2] private consultants[3] and even the popular press have echoed my findings. The Amaranth fiasco has underscored either how little regulators knew about what was going on or how little power they had to prevent it.

[1] Mark Cooper, *The Role of Supply, Demand and Financial Markets in the Natural Gas Price Spiral,* prepared for the Midwest Attorneys General Natural Gas Working Group (Illinois, Iowa, Missouri and Wisconsin), March 2006. An updated summary discussion is provided in Mark Cooper, "The Failure of Federal Authorities to Protect American Energy Consumers Market Power and Other Abusive Practices," *Loyola Consumer Law Review,* 19: 4 (2007).

[2] The Senate Permanent Subcommittee on Investigations has issued two reports, June 27, 2006 and June 25, 2007.

[3] Robert J. Shapiro and Nam D. Pham, *An Analysis of Spot and Futures Prices for Natural Gas: The Role of Economic Fundamentals, Market Structure, Speculation and Manipulation,* August 2006.

Thus, it is quite ironic, that the Enron loophole has continued to afflict American energy consumers long after Enron has disappeared.

The problem is clear. If you cannot see what is happening in all the major interconnected markets in which a commodity is traded, you cannot know what is going on. If you do not have the power to regulate all of the major commodity markets, you cannot prevent abuse. Efforts to influence the price will be invisible to you or beyond your regulatory power to prevent. Bank shot oversight, that is, the effort to glean activity in unregulated markets by its reflection in regulated markets, results in an imprecise and distorted picture.

The solution is equally clear. Regulators need direct oversight. Large traders should be required to register and report all their transaction in all the U.S. markets that can influence the price of a commodity. If traders are unwilling to register and report their activities in U.S. markets, they should not be allowed to participate in those markets.

Because the information will be confidential to the regulatory agency, it will not compromise proper market functioning in any way. This single step will significantly discipline unsavory behavior. As we observed with the private reporting services, even the hint of oversight scares the bad guys away, although in the case of the private services they have failed to discipline people who refuse to report. Federal regulators should make registration and reporting mandatory.

In the case of a commodity like natural gas, which has numerous characteristics that make its price vulnerable to influence (high transportation and storage costs, low elasticities of supply and demand in the short and long term, and highly seasonal consumption patterns), there are many other steps that commodity exchanges should take to reduce excessive speculation and the potential for influence over price. A commodity like natural gas does not need to be transacted 20 or 30 times between the wellhead and the burner tip in order to achieve efficient allocation. These transactions raise the risk and cost of the commodity unnecessarily. Stricter position limits both during and before settlement periods, longer settlement periods, higher margin requirements, and smaller allowed price swings, will restrain excessive speculation and reduce the risk of influence. From Enron to Amaranth, American energy consumers have been afflicted by the Enron loophole. Dozens of enforcement actions have failed to discipline manipulation, excessive speculation and influence over price. After the fact enforcement has not cleaned energy financial markets because the commodity is so vulnerable that it invites abuse. For these special commodities an ounce of prevention is worth more than a pound of cure. It is time to close the loophole and protect consumers.