MCCULLOUGH RESEARCH

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Depending On 19th Century Regulatory Institutions to Handle 21st Century Markets

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Thank you for the invitation to testify today.

Six years ago, I appeared before this Committee to discuss market pricing anomalies and regulatory indifference. Some mistakes are so seductive that we feel impelled to make them again and again. Today, I am discussing the same topic as before, probably with many of the same actors and similar facts. At the heart of the matter is transparency – markets that function in secrecy easily fall victim to manipulation. My testimony today is based on a report issued by my firm on August 5, which we have updated and reissued today.

Energy price regulation in the United States is now divided haphazardly into three agencies: the Federal Energy Regulatory Commission (FERC), the Federal Trade Commission (FTC), and the Commodity Futures Trading Commission (CFTC). A fourth agency located in the Department of Energy, the Energy Information Administration (EIA), is in charge of collecting data and making forecasts.

The events in the oil markets over the past nine months make it clear that none of these agencies or the nation's policy-makers currently have enough information to make informed decisions.

On January 2, 2008 the price of West Texas Intermediate (WTI) crude was $99.64 a barrel. Both NYMEX forwards and the EIA's Short Term Energy Outlook predicted July prices in the range of $80 to $90 a barrel – a gradual decline for the immediate future. The predictions were off by 50%. This would be understandable if a major dislocation in supplies had occurred, but there was no such dislocation.

Instead, by July 3, 2008, the price of WTI crude crested at $145.31. Facile explanations published in the media include surging demand for oil in China and India, faltering global supplies, and expectations of dramatic changes in the Middle East.

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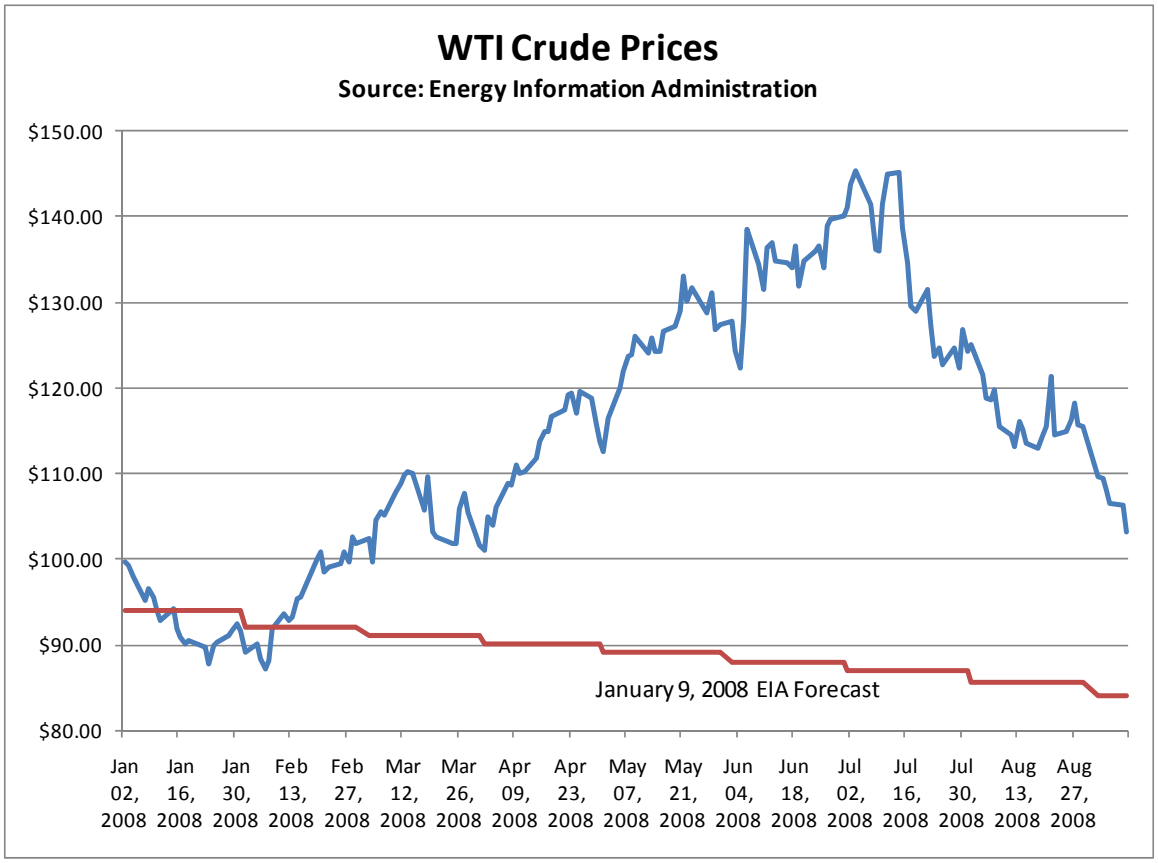
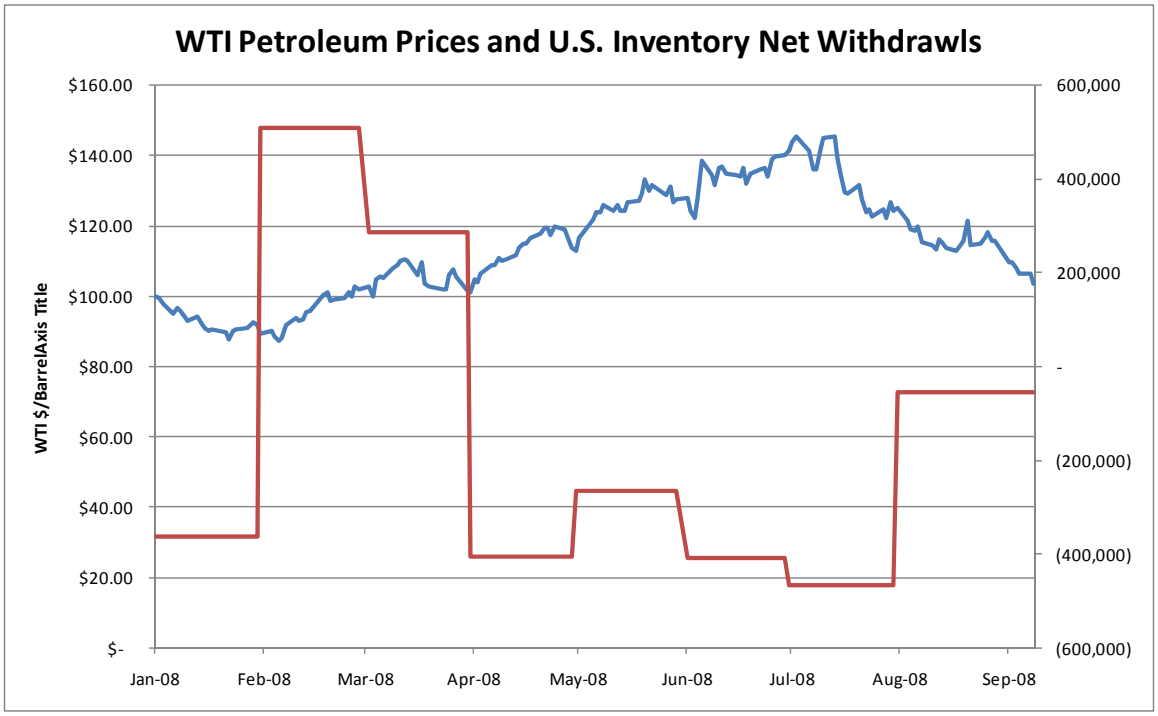


The irony is that if any of these explanations were correct, the price of oil would have remained at high levels. Yet in the following four months, oil has gradually dropped close to and even below $100. The EIA's forecast, which explicitly considers Chinese and Indian consumption, global supplies, and a host of other factors, was hopelessly inaccurate by midsummer. It is now looking fairly good.

A careful review of the fundamentals does not explain why the price of oil increased by 50% in the first six months of this year and then fell by 50% in the next three months. Supply and demand stayed in rough balance over the first nine months of 2008.

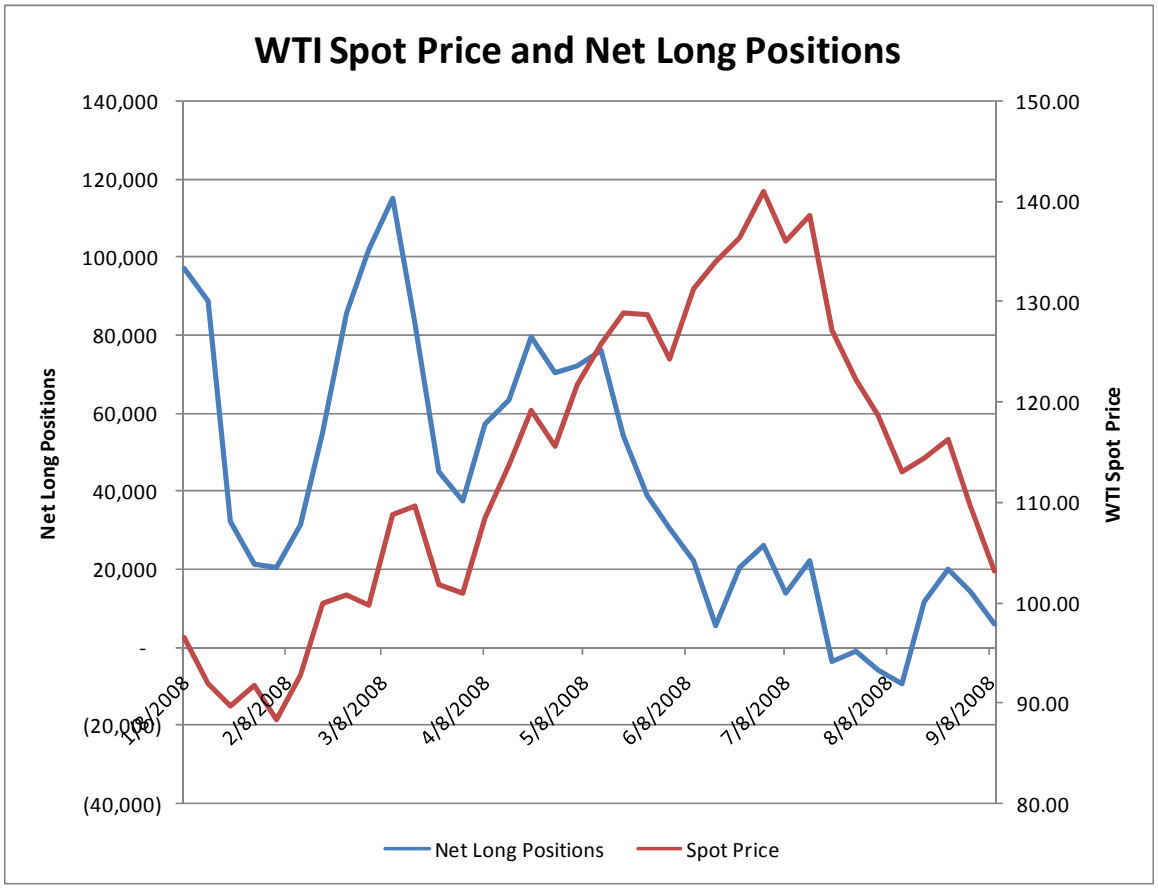


The obvious conclusion from the fundamentals is that prices should have continued upwards in July, not declined precipitously.

When the standard explanations fail, this is a strong indication that we are driving ahead of our headlights. A scientist in this situation views this as a wonderful opportunity when theories are disproved by the facts. This is the case in the July price spike.

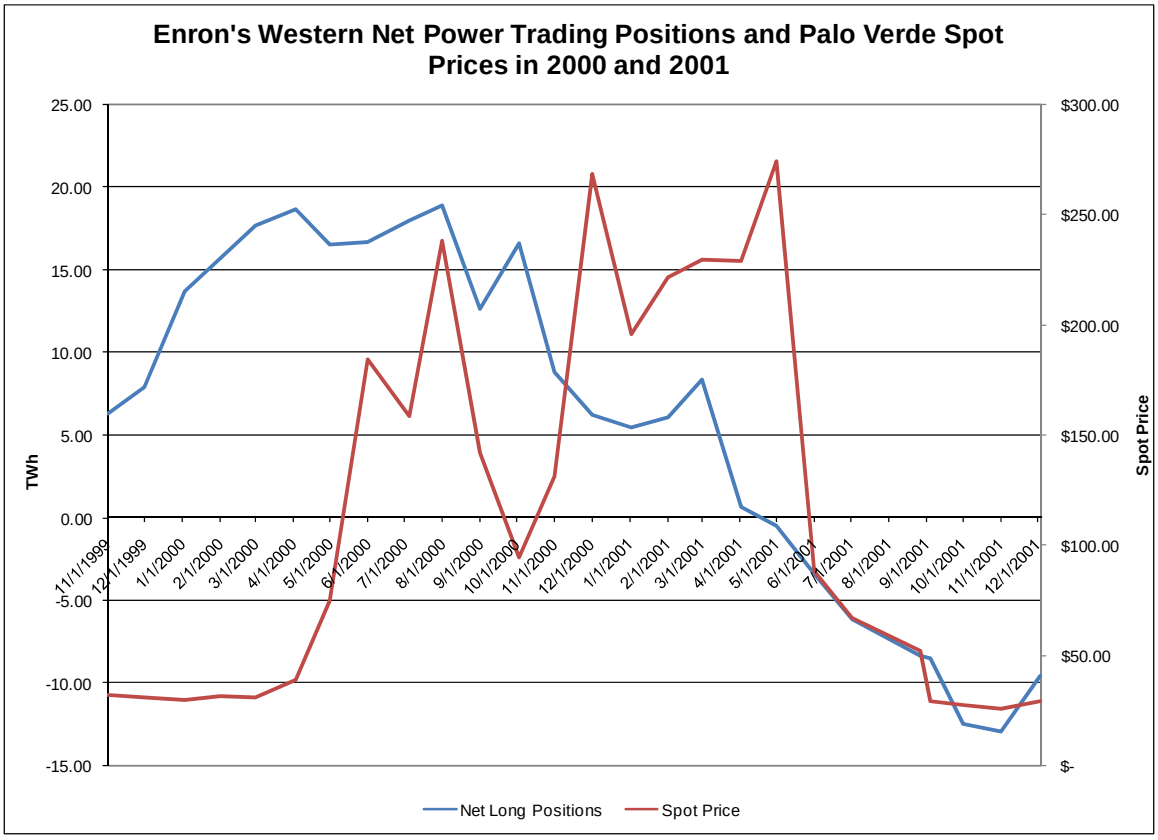
As Senator Cantwell said last week, eighty percent of Americans believe that speculators are manipulating the price of oil. Clearly, they are reacting to the same inconsistencies between prices and explanations that bring us here today.

While the CFTC market surveillance efforts are both arcane and insufficient, it does publish an interesting document on a weekly basis called the Commitments of Traders Report (CoT). The first such reports date back to 1924 and the Grain Futures Administration. The CoT was introduced in 1962 and it has a vintage feel – using old-fashioned terminology and unique statistics to cover a large subset of U.S. forward markets. Among the markets is WTI Sweet Crude on the NYMEX.



This is a surprising chart. It shows that speculators, or non-commercial traders in CFTC terminology, reduced their net position to zero on the NYMEX as the price of oil soared. This traders' behavior illustrated is troubling. In July 2001, Hunter Shively, an Enron natural gas trader, showed similar prescience in a scheme to set prices on the NYMEX Henry Hub forward market. Eventually, the CFTC discovered his manipulation and prosecuted Shively.

A similar, though less well-documented exploit was conducted by another Enron trader, Timothy Belden, in the electricity markets on the West Coast during the Western Market Crisis of 2000-2001. Indeed, the chart of Enron's forward positions and market prices during the infamous "California crisis" is almost identical to the chart above.



The mechanics of such exploits, called Spot Forward Gambits, is to create a large enough change in spot prices so that the forward curve reacts to the new information. This effect is called a "curve shift" and is a common characteristic in many forward markets. Once the forward curve has shifted, traders can liquidate their position at favorable prices. Since the profits in the forward market can dwarf the losses in the spot market, the net effect can be quite favorable for the traders.

Such exploits are only possible when market players hold market power – generally as a result of oligopoly or monopoly. In mid-July, a reclassification of the trader, Vitol, revealed that such oligopoly power is present in the NYMEX. Vitol held more than 25% of the forward positions in sweet crude on July 15, 2008.

The resemblance of the July 3, 2008 oil price spike to earlier spot forward gambits is troubling. Even more troubling is that data on WTI Crude spot and forward prices gathered by FERC, the FTC, the CFTC, and at the EIA is too insufficient to determine whether the price of oil was manipulated. Even more disturbing, last week's CFTC report that mini-

mized the effects of speculation on oil prices chose to stop its analysis in June, prior to the price spike.[1]

Today, a double standard exists for data reporting and publishing. For example, electricity market data is published in FERC's Electric Quarterly Reports (EQR). Unlike the CFTC's weekly CoT, the EQR contains all transactions by market participants, right down to locations, quantities, and prices.

When market results look anomalous, the correct response is to assemble and publish data so questions of market power and market manipulation can be directly addressed. A good first step would be to create an Oil Quarterly Report with the same level of detail as EQR. An Oil Quarterly Report should include spot and forward trades for bilateral transactions, and at both NYMEX and ICE. This data would allow policy-makers to proceed on the basis of facts.

Thank you. This completes my comments.

[1]See, for example, the discussion of crude trading on page 4 of the September 11, 2008 Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations.