PMAA PETROLEUM MARKETERS ASSOCIATION OF AMERICA

1901 N. Fort Myer Drive • Suite 500 • Arlington, VA 22209-1604 • 703-351-8000 • Fax 703-351-9160

COMMODITY FUTURES MARKET REFORM

The Commodity Futures Trading Commission (CFTC) is the federal government regulator of commodity futures/swaps (derivatives) markets in the United States. Energy derivatives contracts that fall under CFTC jurisdiction include: crude oil, gasoline, ultra low sulfur diesel (ULSD), heating oil, electricity and natural gas. Trading of these derivatives contracts takes place predominately on the New York Mercantile Exchange (NYMEX) and the Intercontinental Exchange (ICE) – with trillions of dollars traded daily. Derivatives trading volume in unregulated or over-the-counter (OTC) markets have grown exponentially with some estimates of up to 400 percent since 2006 alone. The OTC market consists of privately negotiated contracts that enable companies or investors to hedge against or bet on swings in the value of energy commodities. Unlike exchanges, the business is unregulated and prices are not public. This is a serious problem that needs an aggressive legislative response, especially following the 2008 unprecedented run-up in gasoline, diesel and heating fuels prices.

Independent gasoline marketers and heating oil dealers have lost faith in the ability to use derivatives markets to determine a fair price for energy based on real-world supply and demand fundamentals. Countless Congressional hearings have revealed that there is inadequate transparency and that aggregate position limits are needed in the commodity trading markets. Public and private pension funds, hedge funds, sovereign wealth funds and other institutional investors are heavily investing in derivatives contracts for crude oil and refined petroleum products, and enjoy little or no controls, such as tough limits on speculative positions. Without sufficient oversight and aggregate position limits, market activity can distort the price of oil and other energy commodities.

Commodity futures markets were established as a tool for true physical hedgers to manage risk. Today, they have been highjacked as an investment tool by speculators looking to turn a profit. Pension funds, hedge funds, sovereign wealth funds and other institutional investments in commodities have exploded from $13 billion in 2003 to $317 billion in July 2008. Investment-only speculators that engage in a “buy and hold strategy” serve no purpose in the commodity markets other than to diminish its role as a tool for managing risk and discovering a fair market price for physical hedgers such as petroleum marketers, airlines and farmers.

Economists now agree that the U.S. economy entered a recession in December 2007 with the supply of crude oil increasing and the demand for crude oil decreasing during the first half of 2008 though oil prices continued to skyrocket. When crude oil reached $150 a barrel for December delivery in July of 2008 and then fell to $33 in December, it was not completely a result of supply and demand fundamentals – it was influenced by excessively-leveraged speculators, index investors and hedge funds in unregulated OTC markets. To understand the overwhelming complexity of the OTC derivatives markets, CFTC Chairman Gary Gensler stated in a recent Congressional hearing: “A $50 gasoline fill-up at the pump could have as much as $1,000 in derivatives behind it on average… the total value of derivatives traded in the United States is based on a dollar amount nearly 20 times the size of our economy.”

OIL SPECULATION STUDIES

- Massachusetts Institute of Technology (MIT) Center for Energy and Environment Policy Research; *“The Oil Price Really Is A Speculative Bubble,”* September 2008
- Rice University’s Baker Institute for Public Policy, *“Who is in the Oil Futures Market and How Has It Changed?”* August 2009
- The Peterson Institute for International Economics; *“The 2008 Oil Price “Bubble,”* August 2009
- Princeton University; *“Index Investing and the Financialization of Commodities,”* September 2009

Updated May 2010

REGULATORY ACTION

In January 2010, the CFTC issued its notice of proposed rulemaking to re-establish speculative position limits on regulated derivatives including crude oil, natural gas, heating oil and gasoline blendstock contracts. PMAA submitted comments in support of the rulemaking. Still, PMAA urges Congress to pass commodity futures market reform legislation to capture the entire over-the-counter (OTC) derivatives marketplace. Because of this proposed rulemaking, once Congress enacts language that captures OTC derivatives, CFTC will be able to move quickly to encompass position limits on the full marketplace. Without Congressional action, CFTC's ability to effectively monitor the entire OTC marketplace cannot be accomplished.

CONGRESSIONAL ACTION

House Agriculture Committee Chairman Collin Peterson (D-MN) and House Financial Services Committee Chairman Barney Frank (D-MA) worked tirelessly during the first session of the 111th Congress to craft comprehensive derivatives market reform legislation. Eventually, their efforts were successful when they were able to attach amendments to the financial reform package known as the "Wall Street Reform and Consumer Protection Act" (H.R. 4173). The amendments would impose aggregate position limits, and set sensible margin and capital requirements that would limit volatility in the commodities derivatives marketplace. The amendments also accomplished other PMAA objectives including: requiring foreign boards of trade (FBOTs) (i.e. "London loophole") that provide services to U.S. participants to adopt for each of its contracts position limits; requires large trader reporting and OTC transactions to strict reporting requirements; requires the Commission to hold two public hearings a year consisting mostly of commercial interests to give their recommendations on position limits; and requires that nearly all OTC transactions be settled and cleared through a CFTC regulated derivatives clearing organization (DCO).

In the Senate, Banking Committee Chairman Christopher Dodd (D-CT) introduced a broad financial reform bill which includes futures market reform legislation in March 2010. The Committee approved the bill by voice vote without amendments. Furthermore, Senate Agriculture Committee Chairwoman Blanche Lincoln (D-AR) introduced the "Wall Street Transparency and Accountability Act of 2010," which was approved by the Agriculture Committee by a vote of 13 to 8 on April 21, 2010. Senator Chuck Grassley (R-IA) was the lone Republican who supported the bill.

"THE ASK"

PMAA strongly supports the substitute amendment derivatives language offered by Senate Agriculture Committee Chairwoman Blanche Lincoln (D-AR) and Senate Banking Committee Chairman Chris Dodd (D-CT) included in the "Restoring American Financial Stability Act of 2010" (S. 3217) which will:

- Require speculative traders to conduct trades on a regulated exchange or swap execution facility and clear their transactions through a clearinghouse as well as subject speculative traders to aggregate position limits.
- Exempt end-users like PMAA member companies from clearing and margin requirements if they are doing so for commercial purposes.
- Grant the Commodity Futures Trading Commission (CFTC) the authority to regulate swaps, OTC, energy-related, and electronically-traded transactions by closing the so-called "Enron," "Swaps," and "London" or "Foreign Exchange" loopholes.

PMAA is aware that many amendments will be offered during PMAA's Washington, DC May 2010 Conference to try and weaken the bill. Some large end-user entities could undermine efforts by Congress to mitigate oil price volatility and prevent systemic risk by introducing amendments to provide broader exemptions to avoid clearing and margin requirements. We urge Senators to avoid the temptation to provide any type of broad end-user exemption that would allow Wall Street banks to exploit the legislation and cause unwarranted speculation in the futures market.

PMAA STAFF CONTACT: Sherri Cabrera, scabrera@pmaa.org; Rob Underwood, runderwood@pmaa.org

Updated May 2010