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ON BEHALF OF THE AMERICAN PUBLIC GAS ASSOCIATION

BEFORE THE SENATE HOMELAND SECURITY AND GOVERNMENT AFFAIRS

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

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Chairman Levin, Ranking Member Coleman and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on the important subject of natural gas market transparency. My name is Arthur Corbin and I am the President & CEO of the Municipal Gas Authority of Georgia. The Municipal Gas Authority of Georgia is the largest non-profit natural gas joint action agency in the United States. Our agency is made up of 76 publicly-owned natural gas distribution system members in five states: Georgia; Alabama; Florida; Pennsylvania; and Tennessee. Our principal role is to supply all the natural gas requirements of these systems. Together, our members meet the gas needs of approximately 243,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to a long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct. APGA strongly believes that this level of transparency currently does not exist and this has directly led to a lack of confidence in the natural gas marketplace.

The economic links between the natural gas futures contracts traded on the New York Mercantile Exchange ("NYMEX") and those contracts, agreements and transactions in natural gas traded in the over-the-counter ("OTC") markets are beyond dispute. Without question, a participant's trading conduct in one venue can affect, and has affected, the price of natural gas contracts in the other. Today, the Commodity Futures Trading Commission ("CFTC") has effective oversight of NYMEX, and the CFTC and NYMEX provide a significant level of transparency with respect to NYMEX's price discovery function. But, the OTC markets lack such price transparency.

This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market. It simply makes no sense to have transparency over one small segment of the market and none over a much larger segment, especially when the OTC markets are the fastest growing sectors of the natural gas marketplace. APGA strongly believes that it is in the best interest of consumers for Congress to rectify this situation by passing legislation that would ensure an adequate level of transparency with respect to OTC contracts, agreements and transactions in natural gas.

The Market in Natural Gas Contracts

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on NYMEX, a designated contract market regulated by the CFTC. Contracts for natural gas are also traded in the OTC markets. These may be traded in direct, bi-lateral transactions between counterparties, through voice brokers or on electronic trading facilities. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus linking the various financial natural gas market segments economically.

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies ("LDC"), including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts. Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[1] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and which do not reflect its true value. This has a direct effect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that reflects bona fide demand and supply conditions. If the futures price is manipulated or distorted, then the price a consumer pays for the fuel needed to heat their home and cook their meals will be similarly manipulated or distorted.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to pervasive oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable

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[1] *See* the Congressional findings in Section 3 of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[2]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform reportedly has determined to voluntarily provide the CFTC with information on traders' large positions,[3] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions. Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market

[2] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.
[3] *Id*, at 7.

congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas. It simply makes no sense to have transparency with respect to one segment of the market and none with respect to another, particularly given that the OTC markets are one of the fastest growing sectors of the natural gas marketplace and are linked to pricing on the regulated futures market in natural gas.

Amaranth Advisors LLC

Last year's blow-up of the Amaranth Advisors LLC and the impact it had upon prices exemplifies these linkages and the impact they can have on natural gas supply contracts for LDCs. Amaranth Advisors LLC was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock— further contributed to the extreme volatility in the price of natural gas.

Many natural gas distributors locked-in prices prior to the period Amaranth collapsed at prices that in hindsight were elevated due to the accumulation of Amaranth's positions. In the case of the Municipal Gas Authority of Georgia, Amaranth's activities had a significant impact on the price we, and ultimately our members' customers, paid for natural gas. To reduce volatility and mitigate additional price spikes on supplies of natural gas, the Gas Authority's hedging procedures required that we hedge part of our 2006-2007 winter natural gas in the spring and summer of 2006. In the spring of 2006 we knew natural gas prices were still extremely high, but it would have been irresponsible if we were to gamble and not hedge a portion of our winter gas in the hope that prices would eventually drop. As a result, we hedged half of our winter gas prior to September 2006. By hedging earlier in 2006 when natural gas prices were high as a result of Amaranth's market activities, our members incurred hedging losses of $18 million over the actual market prices during the winter of 2006-07. The Gas Authority's members were forced to pay an $18 million premium and pass it through to their customers on their gas bills as a result of the excess speculation in the market by Amaranth and others.

The lack of OTC transparency and extreme price swings surrounding the collapse of Amaranth leave bona fide hedgers reluctant to participate in the markets for fear of locking-in prices that may be artificial.

Greater Transparency Needed

Our members, and the customers served by them, do not believe there is an adequate level of market transparency under the current system. This lack of transparency leads to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one segment of the total market. Without comprehensive large trader position reporting, the government is currently handicapped in its ability to detect and deter market misconduct. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists. Unless Congress moves forward to enable the CFTC to increase transparency with respect to OTC contracts, agreements or transactions in natural gas, the government will continue to be woefully unprepared to: (1) detect a problem until it is too late; (2) protect the public interest; and (3) ensure the price integrity of the markets, thus impairing our ability as a nation to maintain the flow and deliverability of a fundamental fuel.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on NYMEX, on an OTC trading platform or through bi-lateral or voice-brokered OTC transactions. Such a comprehensive large trader reporting system would have enabled the CFTC to spot the relative size of Amaranth's OTC position prior to its collapse. A comprehensive large trader reporting system would enable the CFTC, while a scheme is unfolding, to determine whether a trader is using the OTC natural gas markets to corner deliverable supplies and manipulate the price in the futures market.[4] A comprehensive large trader reporting system would also enable the CFTC to better detect and deter other types of market abuses, including for example, a company making misleading statements to the public or providing false price reporting information designed to advantage its natural gas trading positions, or a company engaging in wash trading by taking large offsetting positions with the intent to send misleading signals of supply or demand to the market. Such activities are more likely to be detected or deterred when the government is receiving information with respect to a large trader's overall positions, and not just those taken in the regulated futures market.

[4] *See e.g. U.S. Commodity Futures Trading Commission* v. *BP Products North America, Inc.*, Civil Action No. 06C 3503 (N.D. Ill.) filed June 28, 2006.

The need to provide the CFTC with additional surveillance tools is not meant to imply that the CFTC has not been vigilant in pursuing wrongdoers. Experience tells us that there is never a shortage of individuals or interests who believe they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The fact that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets affirms this. These efforts to punish those that manipulate or otherwise abuse markets are important. But it must be borne in mind that catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

Accordingly, APGA has petitioned Congress to pass legislation that would expand the large trader reporting system to mandate the reporting of positions held in financial contracts for natural gas in all segments of the market. Specifically, we believe that large traders should report their positions regardless of whether they are entered into on designated contract markets, on trading platforms, in the voice-brokered or in bilateral OTC markets. This would treat all trading positions in natural gas contracts equally in terms of reporting requirements. Extending large trader reporting to OTC natural gas positions and to positions entered into on electronic trading platforms will provide the CFTC with a complete picture of the natural gas marketplace and ensure that the cop on the beat has the tools necessary to be effective.

Greater Transparency is a Reasonable Response to Conditions in the Natural Gas Market.

It is important to note that the APGA's proposal is narrow in scope. First, APGA is requesting a comprehensive large trader reporting system only with respect to financial contracts, agreements and transactions in natural gas. The legislation that APGA is seeking is not intended to, and would in no way effect financial swaps. Natural gas contracts are more susceptible to manipulation than other commodities or instruments because the deliverable supply of natural gas is often small relative to the size of the derivatives positions held by large traders and, as mentioned previously, natural gas is constrained by the manner in which it can be delivered. These conditions do not necessarily pertain to other commodities or instruments which are "exempt commodities" under the Act[5] and they most certainly do not pertain to contracts, agreements or transactions in the "excluded commodities" under the Act. [6] Accordingly, it must be emphasized that APGA's proposal is limited to contracts in natural gas. It would have no effect with respect to the OTC markets in financial swaps or in any other contracts, agreements or transactions on an "excluded commodity" or in any "exempt commodity"

[5] "Exempt commodities" are defined in Section 1a(14) of the Act as, "a commodity that is not an excluded commodity or an agricultural commodity." Thus, for example, exempt commodities include other energy commodities and base and precious metals.

[6] "Excluded commodities" are defined in Section 1a(13) of the Act and include interest rates, currency, indexes and various other types of financial instruments or interests.

other than natural gas. Moreover, APGA's proposal with respect to contracts, agreements or transactions in natural gas is merely a reporting requirement and would not impose any regulatory requirements with respect to such transactions.

Second, the CFTC's large trader reporting system would not in any way result in the public release of information relating to an individual entity's trading positions. Information collected through the CFTC's large trader reporting system is used for the government's market surveillance purposes only and is kept confidential by the CFTC in accordance with Section 8 of the Act. Any information which is made publicly available by the CFTC, as described above, is on an aggregated basis and does not disclose individual trading positions. APGA is not advocating a change in this practice.

Finally, although some have raised concerns about the costs of expanding the large trader reporting system, we believe the costs would be reasonable. Insofar as the CFTC's large trader reporting system is already operational, the CFTC will not be creating an entirely new program to collect this information. In addition, large traders, such as those which would be required to report to the CFTC, will likely have automated recordkeeping systems for their own internal risk management purposes that could be adapted for the purpose of reporting positions to the CFTC. Finally, as discussed above, certain trading platforms have already taken steps to make information available to the CFTC. Accordingly, APGA believes that the costs of a comprehensive large trader reporting system for natural gas would be reasonable and are far outweighed by the benefits in terms of helping assure consumers that the market price is a reflection of appropriate market forces.

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Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves. The current situation is not irreversible. Congress can provide American consumers with the protection they deserve by passing legislation that would expand the CFTC's large trader reporting requirements to include financial contracts for natural gas that are currently exempt from reporting. APGA and its approximately 700 public gas system members stand ready to work with you towards accomplishing that goal.