Testimony of

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Thank you, Chairman Dorgan and Members of this committee. My name is Michael Masters and I appreciate the opportunity to appear before you today to address the role of speculative investment in the energy markets. Last Wednesday, Adam White and I released two reports that address this topic. I will provide hard copies of both reports to your staffs and if more copies are needed, they can download the reports at www.accidentalhuntbrothers.com.

The first report, entitled "The Accidental Hunt Brothers," is a comprehensive report that deals generally with two problems facing the commodities futures markets: excessive speculation and Index Speculation. It encompasses information from my May and June testimonies before Congress as well as additional research we performed. It was not written for academics, but is meant to be easy to understand for people conversant with these topics.

I want to draw your attention to two chapters within the report. Chapter Three presents all the evidence that we have compiled indicating that institutional investors have had a large impact on commodity prices. Chapter Seven deals with legislative solutions where we argue that Congress should act to impose reasonable and rigid speculative position limits (at the control entity level) across all commodities in all markets, including the over-the-counter (OTC) swaps market. In addition we encourage Congress to ban or severely restrict the practice of commodity index replication because it consumes liquidity, increases price volatility and damages the price discovery function of the commodities futures markets.

The second report, entitled "The Accidental Hunt Brothers – Act 2" looks at dollars allocated to commodity index trading strategies in 2008 and the effects that those dollars have on West Texas Intermediate (WTI) crude oil futures contracts.

This afternoon I would like to briefly summarize those findings for you.

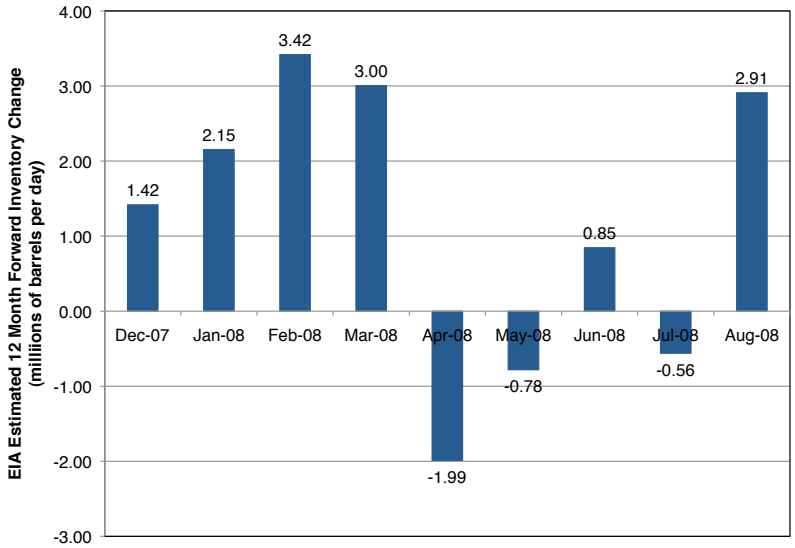
WTI crude oil prices rose dramatically in 2008 from $95 per barrel in January to $145 per barrel in July. Since then, oil prices have fallen just as dramatically to their current levels of around $100 per barrel. Economists are now struggling to explain this massive volatility strictly in terms of supply and demand fundamentals.

How can one explain a $50 spike in prices within a few months time followed by a $45 drop in prices just a few months later? Can supply and demand or a weak dollar really explain the roller coaster ride that oil prices have been on?

Supply and Demand Do <u>Not</u> Fully Explain Oil's Price Moves

The U.S. Energy Information Administration (EIA) is charged with developing forecasts of supply and demand for the United States and the rest of the world. When supply exceeds demand then world inventories grow and vice versa. Chart 1 shows the EIA's monthly forecasts for oil inventories on a 12-month forward-looking basis. This is their professional estimate of what supply and demand will do worldwide over the next 12 months.

Chart 1. EIA 12 Month Forward Worldwide Crude Oil Inventory Forecasts



Source: Energy Information Administration, U.S. Department of Energy "Short Term Energy Outlook"

In the first quarter of 2008 the EIA was forecasting that supply would exceed demand over the next 12 months. Despite this fact, WTI crude oil prices rose substantially. Oil prices continued to rise into July, at which point the EIA was forecasting that demand would outstrip supply (a bullish sign). A week later WTI crude oil began its precipitous drop.

It is important to note that during the first six months of 2008, actual worldwide inventories for crude oil were essentially flat – they barely changed. Therefore, supply and demand were in balance during this time period. Clearly, supply and demand cannot fully explain crude oil's dramatic rise and fall during 2008.

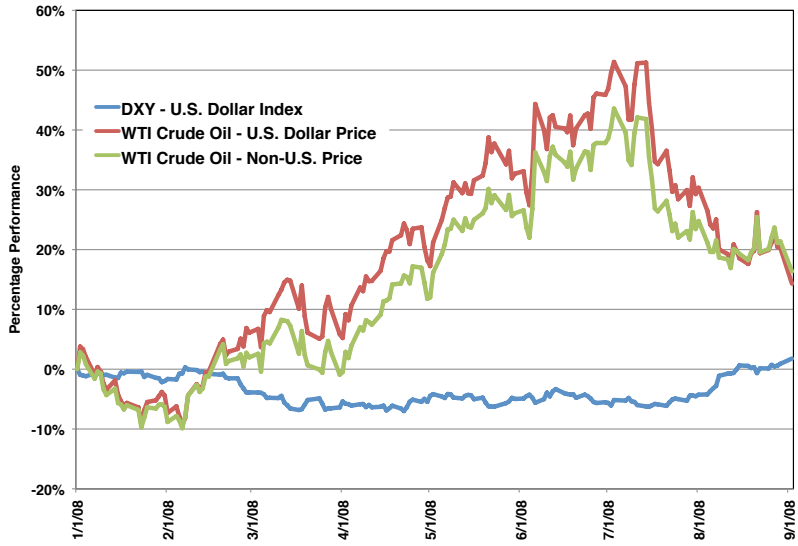
U.S. Dollar Weakness Does Not Fully Explain Oil's Price Moves

Many people believe that the U.S. dollar has had a significant impact on oil prices. This line of reasoning maintains that countries whose currencies are strengthening vis-à-vis the dollar will demand more oil because the price they pay for oil falls when the U.S. dollar falls.[1]

Chart 2 shows how the U.S. Dollar Index performed (on a percentage basis) compared with the U.S. dollar price of WTI crude oil. Chart 2 also adjusts the WTI crude oil price, taking into account the weakness in the U.S. dollar, in order to show what non-U.S. consumers would have to pay for crude oil.

[1] Crude oil is priced in U.S. dollars around the world.

Chart 2. Percentage Performance of U.S. Dollar Index and WTI Crude Oil Prices (in U.S. dollar and Non-U.S. dollar Terms)



Source: Bloomberg

In 2008 the U.S. dollar never weakened more than 7%, yet the price of WTI crude oil climbed by as much as 50%. For a non-U.S. consumer prices peaked at 43% above their January 1st level. Clearly, a 7% weakening in the U.S. dollar cannot come close to fully explaining a 50% increase in WTI crude oil prices.

Without question, supply and demand fundamentals and a weakening dollar have played some part in the rise and fall of crude oil prices, but it is difficult to believe that they fully explain the tremendous volatility we have seen. In seeking to identify other factors that might further explain this volatility, we turned our attention to the trading patterns of Index Speculators.[2]

Index Speculation Is a Major Cause of the Dramatic Movement in Oil Prices

We took data from the Commodities Futures Trading Commission's (CFTC) Commodity Index Trader (CIT) report and used that data to estimate how much money was allocated to the Standard & Poor's Goldman Sachs Commodity Index (S&P-GSCI) and the Dow Jones AIG Commodity Index (DJ-AIG).[3] With these numbers, we were able to estimate how many WTI futures contracts were held by Index Speculators each week and therefore how many contracts were bought and sold as a result.[4]

[2] An Index Speculator is an institutional investor such as a pension fund, university endowment or sovereign wealth fund that allocates money to a commodity index replication strategy.

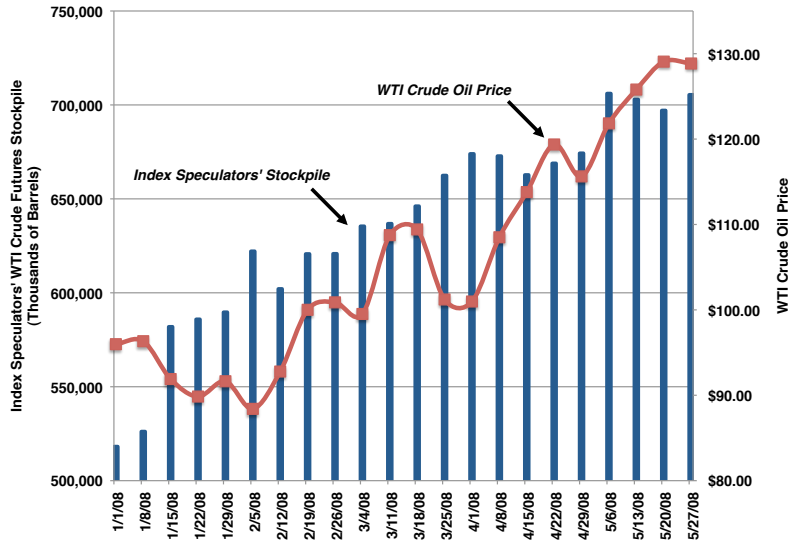
[3] The S&P-GSCI and DJ-AIG account for between 85% and 95% of the total investment in commodity index replication strategies.

[4] The methodology for how we calculate these estimates can be found at the back of my May 20th Senate testimony as well as in the Appendix of our large report "The Accidental Hunt Brothers."

January 1, 2008 to May 27, 2008: Oil Prices Skyrocket

From January 1st to May 27th, Index Speculators poured over $60 billion into commodity indices. As Chart 3 illustrates, this led to the purchase of about 187 million barrels of WTI crude oil futures. This buying pressure contributed greatly to the $33 per barrel increase in the WTI crude oil price.

Chart 3. Index Speculators' WTI Crude Futures Stockpile vs. WTI Crude Oil Price



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon the Commodities Futures Trading Commission's Commodity Index Trader report

May 27, 2008 to July 15, 2008: Congress Threatens Action

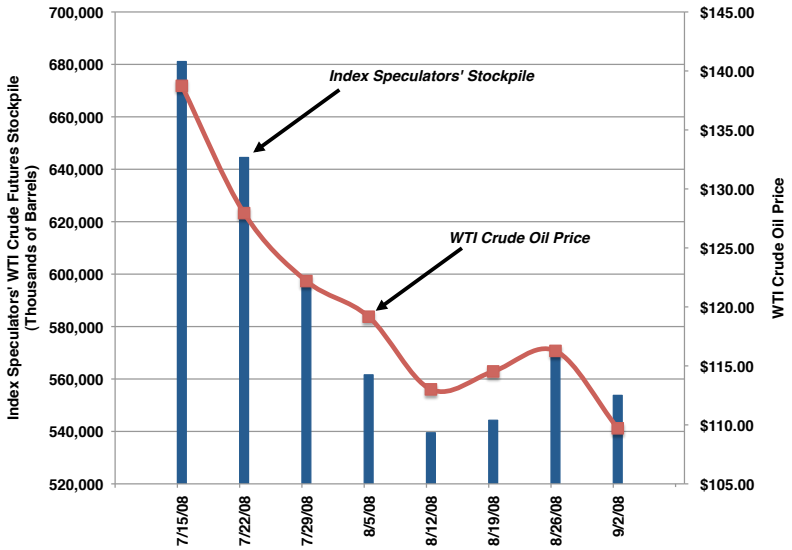
Then, from May 27th to July 15th, there were multiple hearings held in both houses of Congress focused on the effect that speculators were having on food and energy prices. There were several pieces of legislation introduced that were designed to crack down on speculation. In addition, the Commodities Futures Trading Commission (CFTC) announced multiple initiatives and investigations with the stated intent of determining what role speculators played in oil's rapid price rise.

Those who advocate in favor of Index Speculators' participation in the commodities futures markets highlight the "passive," "buy and hold," "long term" nature of their investment strategy. In spite of their stated intentions, it appears likely that many of these speculators were concerned enough by what was occurring in Washington to pull their money out of commodity index investments.

July 15, 2008 to September 2, 2008: Oil Prices Plummet

Beginning on July 15th [5], Index Speculators led a mass stampede for the exits, pulling out approximately $39 billion from the S&P Goldman Sachs Commodity Index.[6] As Chart 4 shows, this resulted in the selling of about 127 million barrels of WTI crude oil futures between July 15th and September 2nd. This dramatic selling pressure contributed greatly to the $29 oil price drop during those seven weeks.[7]

Chart 4. Index Speculators' WTI Crude Futures Stockpile vs. WTI Crude Oil Price



Source: Bloomberg, Standard & Poors, Dow Jones, calculations based upon the Commodities Futures Trading Commission's Commodity Index Trader report

Our findings have been corroborated by a series of research reports by Lehman Brothers that reached similar conclusions. In a July report, Lehman estimates that $98 billion was poured into commodity indices from 2006 to June 2008.[8] And in an August report they estimate that from June to August, $42.6 billion was liquidated by Index Speculators.[9]

When Index Speculators pour large amounts of money into the commodities markets and buy large amounts of futures contracts, prices go up. When they pull large amounts of money out prices go down. These large financial players have become the primary source of the dramatic and damaging volatility seen in oil prices.

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[5] July 15th was a significant date because many Institutional Investors make portfolio allocation decisions on a quarterly basis. July 15th was the first day in the 3rd quarter following the index "roll period."

[6] The Dow Jones – AIG commodity index did not experience outflows during this period; it actually experienced a nearly $7 billion inflow. But because the S&P-GSCI is 40% WTI crude and the DJ-AIG is only 16% WTI crude there were a net 127 million barrels sold.

[7] When Index Speculators liquidate positions they sell all the commodities futures in the index. As a result 22 out of the 25 commodities in the index dropped in price right along with oil.

[8] "Index Inflows and Commodity Price Behavior," Daniel Ahn, et al., Lehman Brothers, July 31, 2008, p.11.

[9] "Punctured Balloon," Daniel Ahn, et al., Lehman Brothers, August 22, 2008, p. 1.

The CFTC's New Report on Commodity Swaps Dealers and Index Traders[10]

Having based our analysis upon the CFTC's CIT data, we eagerly anticipated the release of their report on commodity swaps dealers and index traders, hoping to find richer and more revealing data. We were greatly encouraged when they announced their special call and their intent to ask for much more granular and detailed disclosures. Unfortunately, after reading their report we are greatly disheartened because it represents a step backward rather than a step forward. In fact, the report raises more questions than it answers.

Our concerns center on three different areas: transparency, accuracy and consistency.

Transparency

With regard to our first concern – transparency – our understanding is that the CFTC sent out 43 letters, with two single-page forms attached, asking for summary information of each swaps dealer and index trader's gross long and gross short positions broken down by index "brand" (S&P-GSCI, DJ-AIG, etc.) and within each "brand" by individual commodity. They also requested gross long and gross short positions for single commodity transactions broken down by "commercial," "non-commercial," and "intermediaries." These one-page forms are to be submitted monthly by the 43 swaps dealers and index traders that received them.

For the sake of transparency, we are perplexed as to why the CFTC has released such a miniscule fraction of the data they collected.

- Why have they not released the data on the different "brands" of indices or the breakdown within the indices of all 33 commodity positions?
- Why has the CFTC only released data for three of the last nine months?
- Why have they released none of the data on single-commodity transactions, which might reveal the actions of non-Index Speculators?
- Why has the CFTC only revealed net figures rather than the gross long and gross short positions that they were provided with?

At least with the Commitment of Traders Report, the CFTC included long and short information. Net figures, by their very nature, do not tell the whole story. Net positions are only meaningful when viewed in conjunction with gross long and gross short positions. Net position data does not provide any information about price trends.[11]

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[10] "Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations," Commodity Futures Trading Commission, September 2008. http://cftc.gov/stellent/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf

[11] People who advocate "net positions" believe that short positions offset long positions. These are the same people who like to say, "for every buyer there is a seller," as if that explains something about price movement. By definition, there has been a seller and a buyer for every transaction in history, but the question is "at what price?" Financial markets allocate based on price. If there are more buyers than there are sellers at a certain price level then the price will increase until every buyer is paired off with a seller.

It is this apparent unwillingness to provide even a basic level of disclosure that has caused us to question the CFTC's commitment to transparency.

Accuracy

Our second concern is accuracy. As one example, the CFTC data shows that the notional value of index investments in Cotton grew from $2.6 billion to $2.9 billion during the March 31, 2008 to June 30, 2008 timeframe. That is an 11.5% increase. However, the price of cotton only grew by 3%. That means that money had to flow into cotton during the 2nd quarter in order to make up the difference. This would result in an increase in the futures equivalent position in cotton. Instead, the CFTC data shows it unchanged.

We have identified several other apparent inconsistencies and inaccuracies. Perhaps if the CFTC releases a new report with more detailed and granular data, then these issues can be resolved. We note that the CFTC states in their report that

> ". . . as a result of the survey limitations, there may be a margin of error in the precision of the data which will improve as the staff continues to work with the relevant firms and to further review and refine the data."

I hope that as the new CFTC data is further refined, we will see much more detailed disclosure to help the public discern if, in fact, there are discrepancies in the data. Until that time, the question remains as to whether or not commodity swaps dealers and index traders submitted truly accurate data and whether or not it was compiled accurately by the CFTC.

Consistency

Our final concern centers on the lack of consistency between the CIT data that CFTC has been releasing to the public for more than two years and this new data that they just released. There are vast differences between the two data sets.

Using Corn as an example, the newly released data says that on March 31, 2008, index traders held 362,000 contracts. However, the April 1, 2008 CIT report shows them with a net position of 439,000 contracts - a difference of 77,000 *fewer* contracts in the new report compared to the CIT data.

On the flip side, the newly released data for Wheat shows that index traders held 194,000 contracts on June 30, 2008. However, the CIT report from July 1, 2008 shows them with a net position of approximately 178,000 contracts – a difference of 16,000 *more* contracts in the new report compared to the CIT data.[12]

[12] The new CFTC report lists the notional index investment in Wheat at $8.7 billion and the price of Wheat on June 30, 2008 closed at $8.435. Therefore, one would expect the futures equivalent position size to be equal to 206,000, not 194,000. If the 194,000 figure should in fact be 206,000, then that would mean a difference of 28,000 contracts instead of 16,000 contracts.

In 29 out of 36 data points, the index trader position size in the CFTC's CIT report is significantly larger than the position sizes implied in their new report. The new data is self-reported by commodity swaps dealers based on the notional value of their OTC derivatives outstanding, while the CIT data showed existing commodity swaps dealers' positions on the exchanges. One must question the accuracy of the self-reporting done by the swaps dealers.

With this new report, the CFTC challenges the validity of its own CIT data. The CFTC has been releasing the CIT data for over two years, and financial professionals rely upon that data for their analysis of the markets. If the CFTC is saying that the old data is not accurate and should be replaced with this new data, it would be natural for people to question whether the new data is, in fact, any more accurate than the old data.

For the reasons that we have outlined, we are seriously concerned about this new data set. In his dissent, Commissioner Chilton repeated similar concerns, saying

> "I am concerned that, while I believe the staff did a tremendous amount of work in a short period of time, the agency may not have received the type of comprehensive data sets needed to make reliable analyses and conclusions. . . . Absent compelling evidence, I believe that the most responsible course of action is to refrain from making conclusions or declarative statements based upon such limited and unreliable data."

In our opinion, it would be a mistake to replace the existing CIT data with this new data that is less transparent, less accurate and less consistent. If the CFTC believes that the CIT data is truly inaccurate, then they should issue a press release and remove it from their website immediately. As it stands right now the general public cannot tell which, if any, of the CFTC's data sets are reliable.

Conclusion

Excessive speculation and Index Speculation in the commodities futures markets are two problems that are not going to be resolved until Congress takes action.

Congress needs to pass legislation re-establishing reasonable and rigid speculative position limits at the control entity level that apply to all commodities across all markets including the over-the-counter swaps markets. Further, Congress should take action to ban or severely restrict the practice of commodity index replication because of the damage it does to the commodities futures markets.

If Congress fails to act, then our commodities futures markets will remain excessively speculative and extremely volatile. There currently is nothing to prevent Index Speculators from pouring more money back into these markets and driving prices to new highs.