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On behalf of the  
Petroleum Marketers Association of America and the  
And the New England Fuel Institute (NEFI)**

**Testimony for the  
Homeland Security and Governmental Affairs  
Permanent Subcommittee on Investigations  
United States Senate  
Washington, DC**

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Honorable Chairman Levin, Ranking Member Dr. Coburn and distinguished members of the subcommittee, thank you for the invitation to submit the following testimony. I appreciate the opportunity to provide some insight on the extreme volatility and high oil prices seen in recent months on energy commodity markets.

### **1. Introduction**

My name is Gerry Ramm and I am the Immediate Past Chairman of the Petroleum Marketers Association of America (PMAA) and a current member of PMAA's Executive Committee. PMAA is a national federation of 48 state and regional trade associations representing over 8,000 independent petroleum marketing companies. These companies own 60,000 convenience store/gas stations and supply gasoline and diesel fuel to an additional 40,000 stores. Also, PMAA member companies sell at retail 90 percent of the heating oil consumed in the U.S.

I also work for Inland Oil Company in Ephrata, Washington. My Dad started Inland Oil Company in 1946 after he returned from duty in World War II. Today we operate seven gas stations and convenience stores and we also supply fuel to eight independent dealers.

Also joining PMAA in these comments is the New England Fuel Institute. NEFI is a member of the Petroleum Marketers Association of America and an independent trade association that has represented the home heating industry for 70 years. NEFI represents approximately 1,200 home heating fuel retailers and related services companies, most of which are small, multi-generational family owned- and operated-businesses.

I first want to point out that we strongly support the free exchange of commodity futures on open, well regulated and transparent exchanges that are free of manipulation. I am grateful to have this chance to express our support for the Commission's effort to establish speculative position limits for the energy markets and to provide our comments as to how they may be implemented in a sound and workable fashion.

### **2. Excessive Speculation Causes Volatility and Price Spikes at the Pump, Not Petroleum Marketers**

Excessive speculation on oil futures exchanges is the fuel extreme volatility in prices at the pump in recent years. In April 2011, Goldman Sachs warned clients to lock-in trading profits before oil and other markets reversed suggesting speculators were boosting crude prices as much as \$27 a barrel which translates in upwards of 40-60 cents-per-gallon at the pump. Goldman noted that every one million barrels of oil held by speculators contributed to an 8-10 cent rise in oil price. This comment came as the CFTC found that speculators made up more than 70 percent of the open interest of positions held overnight in crude oil futures, whereas, physical end-users (like my company) made up less than 30 percent. Additionally, the CFTC reported in July 2011, that almost 95 percent of U.S. crude oil futures volume was generated by day trading. The last time I testified on this subject before Congress in 2008, one floor trader bought 1,000 barrels, the smallest amount permitted, and sold it immediately for \$99.40 at a \$600 loss on January 3, 2008. The trader deliberately pushed the price of a barrel of crude oil over \$100 just because he wanted to tell his grandchildren that he was the first person ever to buy crude oil over \$100.<sup>1</sup>

PMAA has previously expressed the need for effective regulation of excessive amounts of speculative activity in the energy markets. In testimony before the CFTC over the last several years, we outlined how the price of crude oil and energy products have become increasingly determined by distortions in the market attributable to speculative trading by large-scale, institutional investors not the law of supply and demand. For example, in 2008, the price of crude oil rose from less than \$50 a barrel in January to over \$147 in July, and then dropped to just \$33 in December. Not much has changed in 2011. From late 2010 into the summer of 2011, oil prices rose dramatically, which curtailed the travel budgets for average Americans, and caused an overall drag on the

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<sup>1</sup> (BBC News, 2008)

economy as the costs of business overhead soared. The spring and summer of 2011 run-up in prices occurred notwithstanding the sluggish state of the economy, high inventory levels, and steady supplies.

### **3. *The High Cost of Oil and Refined Products Hurt Petroleum Marketers***

The effect of excessive speculation on small business petroleum marketers is a major problem. In recent years, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. Gasoline retailers do not benefit from high crude oil or gasoline prices. Because they operate in such a competitive environment, the higher prices climb, the further margins are squeezed. Thus, rising gasoline prices not only hurt motorists, but gasoline station owners as well. Of the 160,000 U.S. retail gasoline locations, 99 percent are owned by independent businesses, not the major oil companies. While those small businesses may sell a particular brand of gasoline, they do not share in any of the profits (or losses) generated by refiners and big oil companies. The major integrated oil companies have essentially removed themselves from the retail gasoline business because they see that the retail environment is not very profitable for gasoline sales.

In order to remain competitive, retail station owners offer the lowest price for motor fuels so that they generate enough customer traffic inside the store where station owners can make a modest profit by offering drink and snack items. Because petroleum marketers and station owners must pay for the inventory they sell, their lines of credit approach their limit due to the high costs of gasoline, heating oil and diesel when crude prices go up. This creates a credit crisis with marketers' banks, which creates liquidity problems and may force petroleum marketers and station owners to close up shop. Both the Michigan Petroleum Association (MPA) and the Oklahoma Petroleum Marketers and C-Store Association (OPMCA) agree that excessive speculation is bad for business and can see firsthand how prices do not reflect fundamentals. "Oklahoma petroleum marketers are detrimentally affected by volatile and high gasoline prices. All we ask for is a fair price resulting from supply and demand fundamentals, not Wall Street's money influence that now influences prices at the pump," said Oklahoma Petroleum Marketers and C-Store Association Executive Director, Bill Maxwell.

### **4. *Cash-Settled Contracts Impact Physical Prices***

PMAA and NEFI have concluded that excessive speculation on energy commodity markets has driven up the price of crude oil (and, consequently, all refined petroleum products) without the supply and demand fundamentals to justify the recent run-up. Large purchases of crude oil futures contracts by speculators have, in consequence, created an additional paper demand for oil which drives up the prices of oil for future delivery. This has the same effect that additional demand for contracts for the delivery of a physical barrel today drives up the price for oil on the spot market. Basically, a futures contract bought by a speculator has the same effect on demand for a barrel that results from the purchase of a futures contract by a petroleum marketer. The very definition of cash-settled contracts as "look-alikes" means that what occurs in the financially-settled markets directly affects what occurs in the physical market.

The Commission's initial proposed rule on position limits was to create a separate "conditional spot month position limits" for certain cash-settled contracts under Section 151.4(a)(2) that is five times the spot month limit (or 125 percent of deliverable supply) if the trader does not have a hedge exemption, if the positions are held exclusively in cash-settled contracts, and if the trader holds physical commodity positions that are less than or equal to 25 percent of deliverable supply. The conditional spot month limits could apply to passive investors (i.e., index funds) and therefore used as an evasion of more stringent spot month limits.

Given that the spot month is the period when the futures price converges with the underlying spot price as time approaches the contract's month of delivery, allowing five times leverage in the cash-settled "look alike" contract could be susceptible to arbitrageurs shorting or buying financially-settled contracts. This event could potentially disrupt the liquidation of the physically-settled futures contracts. Since the physically-settled contract and the linked cash-settled contract are economically equivalent, this could result in a traders'

migration to the cash-settled contract rather than trading in the physically-settled contract which could potentially prevent hedgers from fulfilling the delivery of physical contract due to less liquidity in the physically-settled contract. The very definition of these contracts as “look-alikes” means that what occurs in the financially-settled markets directly affects what occurs in the physical market.

Volatility and increased options costs would likely ensue if the financial-settled contract is able to enjoy five times leverage which could disrupt or unduly influence the price discovery function of the physical market leaving PMAA and NEFI member companies very few options to hedge effectively. There is the possibility that options costs may exceed profit margins for many of PMAA and NEFI’s member companies because higher conditional spot month limits may restrict the physical players’ ability to compete for spot month speculative trading interests. Companies won’t be able to hedge, whether in the petroleum, airline or agriculture business and it will affect long-term planning for these companies. Volatility created by cash-settled paper players has already increased option hedging costs which prevent end-users from using these tools to hedge in the marketplace.

PMAA and NEFI were pleased to see that the Commission reversed its initial conditional spot month limit rule. The final rule treats the physically-settled contract and the cash-settled “look alike” contracts the same (1:1 ratio for oil and refined products). PMAA and NEFI argued that given that most cash-settled contracts take place on unregulated exchanges granted through the Commission’s “no-action letters,” there’s no need to treat physically-settled contracts and cash-settled “look- alike” contracts differently since they are economically equivalent.

### **5. West Texas Intermediate Crude Oil Contract vs. Brent Crude Oil Contract**

A recent phenomenon in the oil markets is the price spread between the *Brent crude oil* contract and the *light sweet West Texas Intermediate (WTI) crude oil* contract. With WTI supplies well above its five year average, demand down by five percent and the Euro weakened against the dollar (the dollar has strengthened considerably), oil prices should be low. Since oil is priced in dollars that would mean that oil should be much cheaper, but prices have remained high. Some experts believe the loss of Libya’s 1.7 million barrels-per-day supply has caused the Brent contract price run-up. However, Saudi Arabia raised production unilaterally after failing to convince other OPEC members to agree to a coordinated increase to meet a shortfall in supplies from Libya.

*The Oil Price Information Service* recently reported that U.S. coastal markets would see higher prices compared to the middle of the country. Last month, the Pacific Northwest saw prices soar some 35 cents over the futures, even as Chicago and Gulf Coast spot gasoline moved below the RBOB benchmark. Crude oil for refiners in the central US is essentially 50-75 cents-per-gallon cheaper than product in the coastal areas because they are tied to the Brent contract.

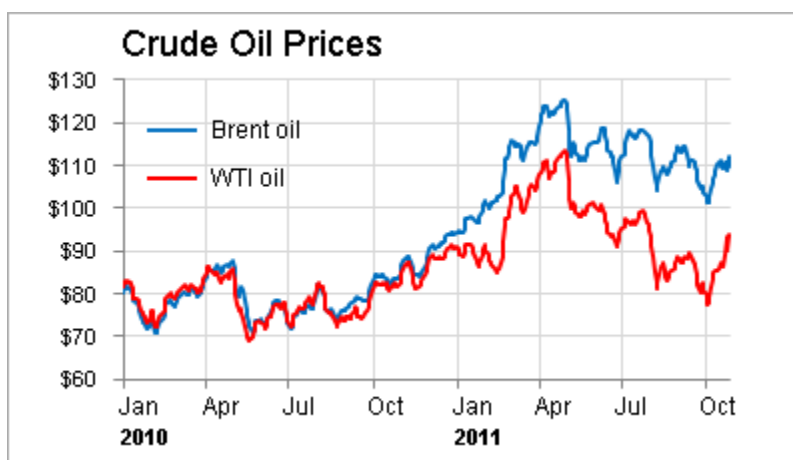
#### ***West Texas Intermediate Crude Oil (Symbol: CL)***

- Price \$89 a barrel
- Traded on regulated exchange (NYMEX)
- **Delivered at Cushing, OK**
- NYMEX raised margins on traders (more money down)
- Prior to 2005, Prices based on inventory levels.
- Now, based on money flows.
- The “Financialization of oil.”

#### ***Brent Crude Oil Contract (Symbol: BZ)***

- Price: \$106 per barrel
- Traded on over-the-counter OTC market -- ICE. ICE/CME lists Brent. CME enforces limits
- ICE doesn’t enforce position limits.
- Traders -- highly leveraged bets on the Brent contract
- Brent is highly speculative
- **Not based off inventories, no delivery point.**
- US East coast gasoline prices now based off Brent contract, not WTI contract
- Now, based on money flows, the “dark market” deals.
- Higher leverage = higher prices.

Since there is no delivery point and no inventory level for the Brent crude oil contract, how would the CFTC determine deliverable supply for Brent crude? The position limits final rule only applies to WTI crude, gasoline and heating oil, but would not apply to the Brent contract. What is interesting is that the ICE Brent crude futures contract is a deliverable contract based on EFP (exchange for product) with the option to cash-settle (99.9 percent of these contracts are cash-settled anyway). Since much of the US market is now priced off the Brent contract, the CFTC should be examining the price discovery and fundamentals of the Brent contract. Therefore, PMAA and NEFI urge the Subcommittee to examine whether the CFTC has the authority to determine deliverable supply for the Brent contract and how the contract works in the marketplace between the CME and ICE?



#### **6. PMAA and NEFI's Position on Energy Position Limits**

Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires the CFTC to establish within 180 days of its enactment speculative position limits for commodities that had been exempt under the Commodity Exchange Act.<sup>2</sup> These "exempt commodities" include energy-related commodities (i.e., crude oil, gasoline, natural gas and heating oil) as well as metals. PMAA and NEFI are strongly supportive of the immediate implementation of position limits. We believe that establishing appropriate and meaningful speculative position limits is essential in establishing the proper price functioning of the energy derivative markets.

It is well established that the CFTC's primary statutory mandate is to foster fair, open and efficient functioning of the commodity markets as a hedging and price discovery tool for bona-fide physical hedgers. PMAA and NEFI believe that the proposed position limits are critical to fulfilling this mandate and thereby protecting market users and the public from undue burdens that may result from "excessive speculation." Section 737 of the Dodd-Frank Act is a clear expression by the Congress that "excessive speculation" is bad for the markets, market participants, American consumers and the welfare of the broader economy.

*(i) To diminish, eliminate, or prevent excessive speculation as described under this section;*

*(ii) To deter and prevent market manipulation, squeezes, and corners;*

*(iii) To ensure sufficient market liquidity for bona fide hedgers; and*

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<sup>2</sup> 180 days after enactment was January 17, 2011.

(iv) To ensure that the price discovery function of the underlying market is not disrupted and to establish position limits for Swap Dealers.

## **7. Final Rule on Energy Position Limits**

The CFTC's final rule imposes spot month, single-month, and all-months combined speculative position limits on specified physical commodity futures and options contracts ("referenced futures contracts") and physical commodity swaps that are economically equivalent to such contracts (together, "referenced contracts"). The Commission will impose non-spot speculative position limits for referenced contracts to single-months and to all-months-combined and will determine the non-spot month limits by using a formula based on open interest. The aggregate all-months-combined and single-month position limits would each be equal to 10 percent of the first 25,000 contracts of the "average all-months-combined aggregated open interest" with a marginal increase of 2.5 percent of the open interest for amounts above 25,000 contracts.

PMAA and NEFI are concerned that the public has received inaccurate information from the CFTC on the periodic review of spot-month position limits for energy contracts. We were of the understanding that the spot month position limits would be reviewed at least once a year indicated during the October 18<sup>th</sup> CFTC public hearing, but the final rule published in the Federal Register indicated that energy contracts would be reviewed every two years. PMAA and NEFI urge the Subcommittee to clarify with the CFTC on the periodic review of spot-month position limits for energy contracts.

We support the Commission's final rule to immediately implement speculative position limits for the spot months as mandated by the Dodd-Frank Act. However, the final formula for determining both spot-month and non-spot month position limits does not adequately address all four goals of speculative position limits as mandated by the Dodd-Frank Act. The CFTC will need to revisit this issue in the near future to better fulfill Congressional intent and the CFTC's stated mission. First, the spot-month limit of 25 percent of open interest is far too generous. The Commission will need to consider lowering the stated limit to a level that is more consistent with existing limits referenced agricultural commodities (to which the Commission is proposing to maintain under "Legacy Limits") or that are more reflective of existing accountability limits for referenced energy contracts on Designated Contract Markets. Second, instead of relying on an open interests based formula for determining position limits, we believe that the Commission should determine an acceptable aggregate level of speculation and set individual trader limits to be reflective of that aggregate level. The Commission should consider setting separate, lower position limits for passive long traders (*i.e.*, index funds, exchange traded funds, and other similar vehicles that generally buy without regard to price), and should require that positions of passive long speculators who follow the same trading strategy be aggregated for purposes of applying the position limits. In moving forward with a phased approach for implementing position limits, the Commission needs to assess all of its data requirements and to assure that necessary data to support full analysis of speculative position limit issues will be available to the Commission.

Additionally, PMAA and NEFI are concerned that the non-spot month position limits that would result from the final rule would be so high as to be ineffective. The Commission acknowledges that the proposed framework sets high position levels. These levels are equivalent to the largest positions held by market participants. PMAA and NEFI believe the proposed position limits fail to address the overall impact of speculators on the futures, options and swaps markets. Position limits that only target very large positions intended to manipulate the market do not address the problem of the cumulative effect of a large number of speculators with significant positions. PMAA and NEFI also believe that the CFTC should retain exclusive discretion in determining "deliverable supply" for the purposes of establishing speculative position limits. When determining "deliverable supply" and when formulating limits, the Commission should consult with and solicit information from market experts, including appropriate governmental entities (*i.e.*, the Department of Energy's Energy Information Administration and the U.S. Department of Agriculture) and academics. The final rule did not incorporate our concerns with estimation of deliverable supply.

## **8. PMAA-NEFI Support Delta Airlines' Stance on Position Limits**

We note that Delta Airlines Comment letter regarding the 2010 Proposed Rules on Speculative Position Limits (Apr. 26, 2010) pointed out that in 2000 the percentage of hedging open interest to speculative open interest in the oil market was estimated to have been approximately 61 percent hedgers to 39 percent speculators. During the 2000 to 2003 time period, which is the period immediately prior to the unprecedented run-up in speculative trading, the market functioned well and was orderly. There is no evidence of insufficient liquidity for hedgers during this period. In contrast, it is estimated that by 2009 the percentage of hedging open interest to speculative open interest essentially reversed, although the amount of hedging open interest stayed relatively constant.

Delta Air Lines offered an illustrative methodology for this calculation in its advance comment letter filed with the CFTC.<sup>3</sup> The basic concept is that speculative activity above the amount necessary to provide market liquidity for the trading of bona fide hedgers and to provide for efficient price discovery is, by definition, excessive. Specifically, for the oil futures market, the period between 2000 and 2003 is identified as the most recent period during which the futures market operated in an orderly manner. During this "base period," in the case of the oil futures market, hedgers constituted approximately 60 percent of the market open interest and speculators constituted the remaining approximately 40 percent. Delta Air Lines recommended establishing a "Speculative Open Interest Target" on an annual basis by looking at the immediately preceding year's hedging open interest and calculating the amount of speculative open interest that would be necessary to maintain the same ratio between hedging and speculative trading as existed during the base period. The speculative position limit level that applies to individual traders would then be set at a level intended in very rough terms to maintain this ratio of speculative to bona fide hedging trading, thus meeting the four criteria of the Dodd- Frank Act. PMAA and NEFI endorse Delta Air Lines suggested methodology.

### ***Conclusion***

Ultimately, affordable consumer energy will not result from what the CFTC finalized recently. A number of other factors play into affordable energy including an all of the above approach on energy policy which includes oil exploration, increased use of alternatives such as ethanol and biodiesel, and a sound monetary policy coupled with a well-regulated, transparent, and stable energy futures and swaps market.

We and our customers need you and the CFTC to take a stand against excessive speculation that artificially inflates energy prices. We appreciate the work that has been done to date and look forward to working with members of this Subcommittee and the CFTC to ensure that end-users are heard first, not Wall Street banks. Many PMAA members rely on these markets to hedge product for the benefit of their business planning and their consumers. Reliable futures markets are crucial to the entire petroleum industry. Let's make sure that these markets are competitively driven by supply and demand.

Thank you again for allowing me the opportunity to submit these comments on behalf of PMAA and NEFI.

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<sup>3</sup> Advance comment letter from Delta Air Lines, Inc. (Dec. 13, 2010) at 8-14, available at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission26\\_121310-1.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission26_121310-1.pdf)