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Committee on Commerce, Science and Transportation  
United States Senate  
Washington, DC**

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Honorable Chairman Inouye and Ranking Member Stevens and distinguished members of the committee, thank you for the invitation to testify before you today. I appreciate the opportunity to provide some insight on the extreme volatility and record setting prices seen in recent months on the energy commodity markets.

I am an officer on the Petroleum Marketers Association of America's (PMAA) Executive Committee. PMAA is a national federation of 46 state and regional associations representing over 8,000 independent fuel marketers that collectively account for approximately half of the gasoline and nearly all of the distillate fuel consumed by motor vehicles and heating equipment in the United States. 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, supporting my testimony here today is the New England Fuel Institute who represents over 1,000 heating fuel dealers in the New England area.

Last year, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. The retail motor fuels industry is one of the most competitive industries in the marketplace, which is dominated by small, independent businesses. Retail station owners offer the lowest price for motor fuels to remain competitive, 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 are approaching their limit due to the high costs of gasoline, heating oil and diesel. This creates a credit crisis with marketers' banks, which creates liquidity problems and may force petroleum marketers and station owners to close up shop.

Excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude oil prices. The rise in crude oil prices in recent weeks, which reached \$135.09 on May 22, 2008, has dragged with it every single refined petroleum product, especially heating oil. According to the Department of Energy, the cost of crude accounts for roughly 73 percent

of the pump price, up from 62 percent in January of 2008.<sup>1</sup> Wholesale heating oil prices from March 5, 2008 – May 28, 2008 have risen from \$2.97 to \$3.81.<sup>2</sup> The spike comes despite warmer temperatures in the Northeast and the end of the heating oil season. Interestingly, Colonial Group Inc. which provides wholesale/retail petroleum fuels announced May 7, 2008 that it had 150,000 barrels of surplus heating oil available for auction. That same day heating oil futures set yet another record high with a 9.3 cent gain at \$3.37 a gallon along with temperatures averaging in the upper 70s in the Northeast. The data doesn't add up.

Large purchases of crude oil futures contracts by speculators have created an additional demand for oil which drives up the prices of oil for future delivery. This has the same effect as the additional demand for contracts for delivery of a physical barrel today drives up the price for oil on the spot market. According to the Department of Energy, the amount of petroleum products shipped by the world's top oil exporters fell 2.5 percent last year, despite a 57 percent increase in prices.

According to a 2006 Senate Permanent Subcommittee on Investigations bipartisan report by Chairman Carl Levin (D-MI) and Ranking Member Norm Coleman (R-MN) entitled, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*, "Several analysts have estimated that speculative purchases of oil futures have added as much as \$20-25 per barrel to the current price of crude oil, thereby pushing up the price of oil from \$50 to approximately \$70 per barrel." Who would have thought that crude oil futures would rise to over \$130 a barrel?

Three weeks ago, Michael Masters, Managing Member and Portfolio Manager of Masters Capital Management, LLC, a hedge fund, argued before the Senate Committee on Homeland Security and Government Affairs that institutional investors are the cause of the recent run-up in commodity prices. Institutional investors are buying up all the commodity contracts (going long), especially energy commodities, and are not selling, thereby causing the demand for contracts to increase and putting further pressure on commodity prices. Institutional

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<sup>1</sup> Energy Information Administration, "Gasoline and Diesel Fuel Update," April 2008

<sup>2</sup> Energy Information Administration, "U.S. No. 2 Heating Oil Wholesale/Resale Prices," March 5 – May 28, 2008

investors allocate a portion of their portfolios into commodities since they are posting solid returns rather than traditional investments like stocks and bonds.

Since commodities futures markets are much smaller than equity markets, billions invested into commodity markets will have a far greater impact on commodity prices than billions of dollars invested in equity markets. Masters stated that while some economists point to China's demand for crude oil as the cause for the recent rise in energy costs, he disclaims that assumption. In fact, Masters' testimony highlights a Department of Energy report that annual Chinese demand for petroleum has increased over the last five years by 920 million barrels. Yet, over the same five-year period, index speculators' demand for petroleum futures has increased by 848 million barrels, thus the increase in demand from institutional investors is almost equal to the increase in demand from China! Wouldn't this demand by institutional investors have some effect on prices?

Also, many economists and financial analysts report that the weak dollar has put pressure on crude oil prices. While the weak dollar explanation is partly true because crude oil is denominated in dollars which reduces the price of oil exports for producers, leading them to seek higher prices to make up for the loss, this does not justify crude oil's move beyond \$130 a barrel. On May 1, 2008, the front month NYMEX WTI crude oil contract closed just under \$113 per barrel. Three weeks later the same front month NYMEX WTI contract was trading at over \$132 per barrel. In that same period of time the dollar traded between \$1.50 to \$1.60 against the Euro. While the Euro strengthened against the dollar, it doesn't justify that crude oil should have increased \$19. There were no significant supply disruptions during this time period.

U.S. destined crude oil contracts could be trading DAILY at a rate that is multiple times the rate of annual consumption, and U.S. destined heating oil contracts could be trading daily multiple times the rate of annual consumption. Imagine the impact on the housing market if every single house was bought and sold multiple times every day. An October 2007 Government Accountability Office report, *Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight*, determined that futures market speculation could have

an upward effect on prices; however, it was hard to quantify the exact totals due to lack of transparency and recordkeeping by the CFTC.

To be able to accurately “add up” all of the numbers, you must have full market transparency. This is perhaps the biggest barrier to obtaining an accurate percentage calculation of the per barrel cost of non-commercial speculative investment in crude oil, natural gas and other energy products. Much of the non-commercial (i.e. speculators that have no direct contact with the physical commodity) involvement in the commodities markets is isolated to the over-the-counter markets and foreign boards-of-trade, which, due to a series of legal and administrative loopholes, are virtually opaque.

PMAA would like to thank Congress for passing the Farm Bill (H.R. 2419), specifically, Title XIII, which will bring some transparency to over-the-counter markets. However, the Farm Bill is only a first step.

What the Farm Bill language does not do is repeal a letter of “no action” issued by the CFTC to the London based International Petroleum Exchange (IPE) which was subsequently purchased by the Intercontinental Exchange (ICE). The letter of no action was issued since the IPE was regulated by the United Kingdom’s Financial Services Authority (FSA), which theoretically exercised comparable oversight of the IPE as CFTC did to NYMEX. Recently, however, whether or not the FSA exercises “comparable oversight” was brought into question by CFTC Commissioner Bart Chilton. Congress needs to investigate whether or not oversight by foreign regulators is “comparable.” Currently, FSA doesn’t monitor daily trading to prevent manipulation, publish daily trading information, or impose and enforce position limits that prevent excessive speculation.

ICE is the exchange most often utilized by those who exploit the Enron Loophole. ICE is a publicly traded exchange whose shareholders are primarily investment funds. In recent years ICE’s trading volume has exploded at the expense of the regulated NYMEX. According to the Securities and Exchange Commission filings, traders on ICE made bets on oil with a total

paper value of \$8 trillion in 2007, up from \$1.7 trillion in 2005.<sup>3</sup> ICE purchased IPE and will continue to claim exemptions on various contracts whether or not the Farm bill becomes law since they effectively have a “get out of jail free card.”

While PMAA applauds the recent CFTC announcement that it will expand information sharing with the U.K.’s Financial Services Agency and ICE Futures Europe to obtain large trader positions in the West Texas Intermediate crude oil contract, more needs to be done to prevent and deter market manipulation on all foreign boards of trade.

Congress and the Administration might also consider:

1. Closing the Administrative Foreign Boards-of-Trade Loophole via review or elimination of CFTC “no action letters” to overseas energy trading platforms. PMAA supports any legislative remedy that would ensure that all off-shore exchanges be subject to the same level of oversight and regulation as domestic exchanges such as the NYMEX when those exchanges allow U.S. access to their platforms, trade U.S. destined commodities, or are owned and operated by U.S. based companies.
2. Raising margin requirements (or necessary collateral) for non-commercial entities or so-called “non-physical players,” i.e. commodities traders and investors that do not have the ability to take physical possession of the commodity, or otherwise incurs risk (including price risk) associated with the commodity either in connection with their business or that of a client. In other words, anyone who does not meet the definition of “eligible commercial entity” under 7 USC §1a (11). Currently, margin requirements in futures trading are as low as three percent for some contracts. To buy U.S. equities, margin requirements are a minimum of 50 percent.
3. Requiring non-commercial traders (e.g. financial institutions, insurance companies, commodity pools) to have the ability to take physical delivery of at least some of the product. (Rep. John Larson (D-CT) is considering such a proposal).

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<sup>3</sup> Herbst, Moira; *Speculation -- but Not Manipulation: Financial News*, Business Week, May 30, 2008.

4. Banning from the market any participant that does not have the ability to take direct physical possession of a commodity, is not trading in order to manage risk associated with the commodity, or is not a risk management or hedging service (again, anyone that does not meet the statutory definition of “commercial entity” under 7 §USC 1a(11)).

5. Significantly increase funding for the CFTC. The FY 2009 President’s budget recommendation is for \$130 million. While this is an increase from previous years, CFTC staff has declined by 12 percent since the commission was established in 1976, yet total contract volume has increased over 8,000 percent. Congress should appropriate sufficient funding to keep up with the ever changing environment of energy derivatives markets.

We and our customers need our public officials, including those in Congress and on the CFTC, to take a stand against excessive speculation that artificially inflates energy prices. PMAA strongly supports the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of laws and accountability. 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 testify before you today.