



NARUC Annual Convention
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Are Speculators Causing Price Increase in Natural Gas?

Committee on Consumer Affairs joint with Committee on Gas

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What's Behind the Crisis?



Are we really in so much trouble because people defaulted on mortgages?

- Sub-prime loans or bad credit?

Why is the current crisis so difficult to get out of, unlike the real estate crash of the '70s and '80s?



1970

1980

1990

2000

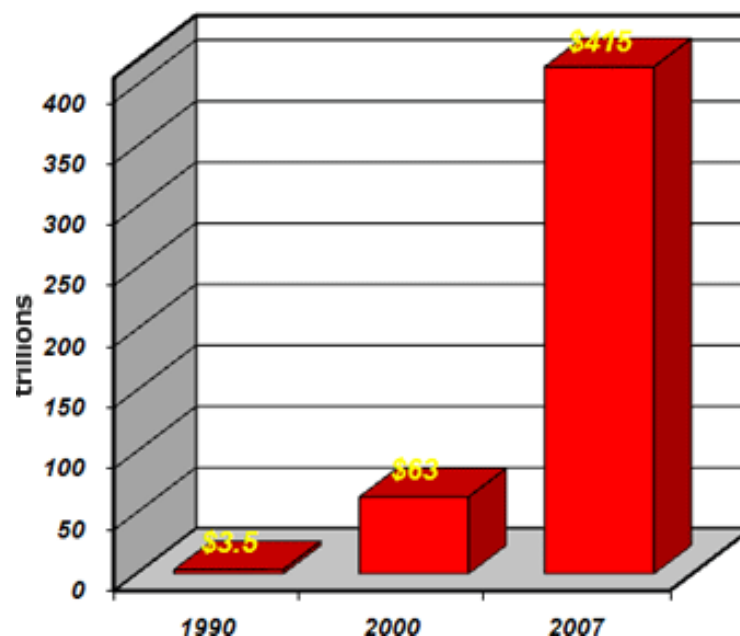
2010

Explosive Growth of Derivatives

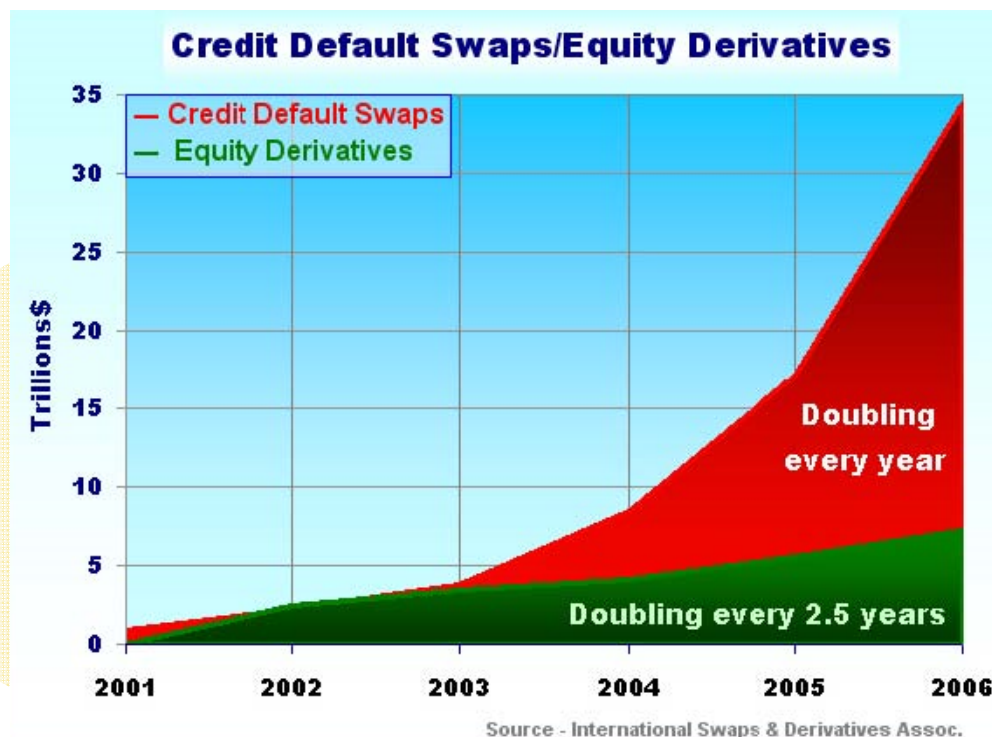


The Depository Trust & Clearing Corporation says there are \$33.6 trillion of Credit Default Swaps in outstanding debt.

Over-the Counter Credit Derivatives Soaring!



OTC credit derivatives market jumps from \$3.5 trillion in 1990 to \$475 trillion in 2007.



Source - International Swaps & Derivatives Assoc.

Back in 2006



- One of the Funds favorite trades is the **March/April spread**
- Amaranth BOUGHT March contract, SOLD April
- Gambled on a repeat of the 2005 hurricane season
- Expected low inventories
- Hoped spread would widen
- Manipulated markets between NYMEX and ICE
- Result – no hurricanes – high inventories –spread narrowed

... \$7 billion in losses

Earlier This Year...



- Saracen SOLD March '09, BOUGHT April '09
- March Price **\$0.74** higher than April
- If March '09 weather was warm - high inventories - narrow spread
- Cold weather in February suggested year end low inventories
- Spread widened to **\$1.26** causing margin calls Saracen couldn't cover causing close to \$2 Billion in losses
- Others funds squeezed Saracen (similar to Amaranth) starting run up in prices

Playing the Spread



Natural Gas Columns					
Month	DTE	YClose ↕	N Last ↕	G Last ↕	G High / Low
Dec	9	6.405y	6.300	6.361	6.487 / 6.024
Jan-09	31	6.560y	6.320	6.512	6.639 / 6.2
Feb	51	6.633y	6.530	6.546	6.690 / 6.327
Mar	70	6.604y	7.040y	6.550	6.643 / 6.323
Apr	92	6.554y	6.400	6.554	6.603 / 6.334
May	113	6.614y	6.505	6.470	6.650 / 6.389
Jun	133	6.736y	6.630	6.742	6.770 / 6.459
Jul	155	6.868y	6.760	6.750	6.901 / 6.588
Aug	177	6.953y	6.860	6.744	7.000 / 6.744
Sep	198	6.986y	6.910	6.842	7.030 / 6.790
Oct	219	7.066y	6.980	7.075	7.103 / 6.8
Nov	241	7.411y	7.350	7.278	7.420 / 7.2
Dec	261	7.786y	7.710	7.810	7.810 / 7.5
Jan-10	283	8.031y	7.970	8.050	8.054 / 7.7
Feb	302	8.031y	7.970	7.915	8.065 / 7.701
Mar	321	7.856y	7.830	7.900	7.900 / 7.701
Apr	344	7.256y	7.230	7.152	7.332 / 7.152
May	365	7.226y	7.200	7.120	7.290 / 7.120

March-April Spread 2009

Feb	51	6.633y	6.530	6.546	6.690 / 6.327
Mar	70	6.604y	7.040y	6.550	6.643 / 6.323
Apr	92	6.554y	6.400	6.519	6.603 / 6.334
May	113	6.614y	6.505	6.470	6.650 / 6.389

March-April Spread 2010

Feb	302	8.031y	7.970	8.044	8.065 / 7.875
Mar	321	7.856y	7.830	7.900	7.900 / 7.701
Apr	344	7.256y	7.320	7.152	7.332 / 7.152
May	365	7.226y	7.200	7.120	7.290 / 7.120

Growing Open Interest



Contract	Settlement	Non-Commercial Open Interest
January 2008	\$ 7.17	258,967
February 2008	\$ 7.99	265,327
March 2008	\$ 8.93	379,695
April 2008	\$ 9.57	352,125
May 2008	\$ 11.28	351,831
June 2008	\$ 11.91	453,769
July 2008	\$ 13.10	506,760
August 2008	\$ 9.21	532,420
September 2008	\$ 8.39	563,384
October 2008	\$ 7.47	585,000
November 2008	\$ 6.469	

Influx of Funds



Research firm Ennis Knupp & Associates estimated that **\$139 billion** had been invested in energy commodities by the end of March, most of it from Pension Funds.

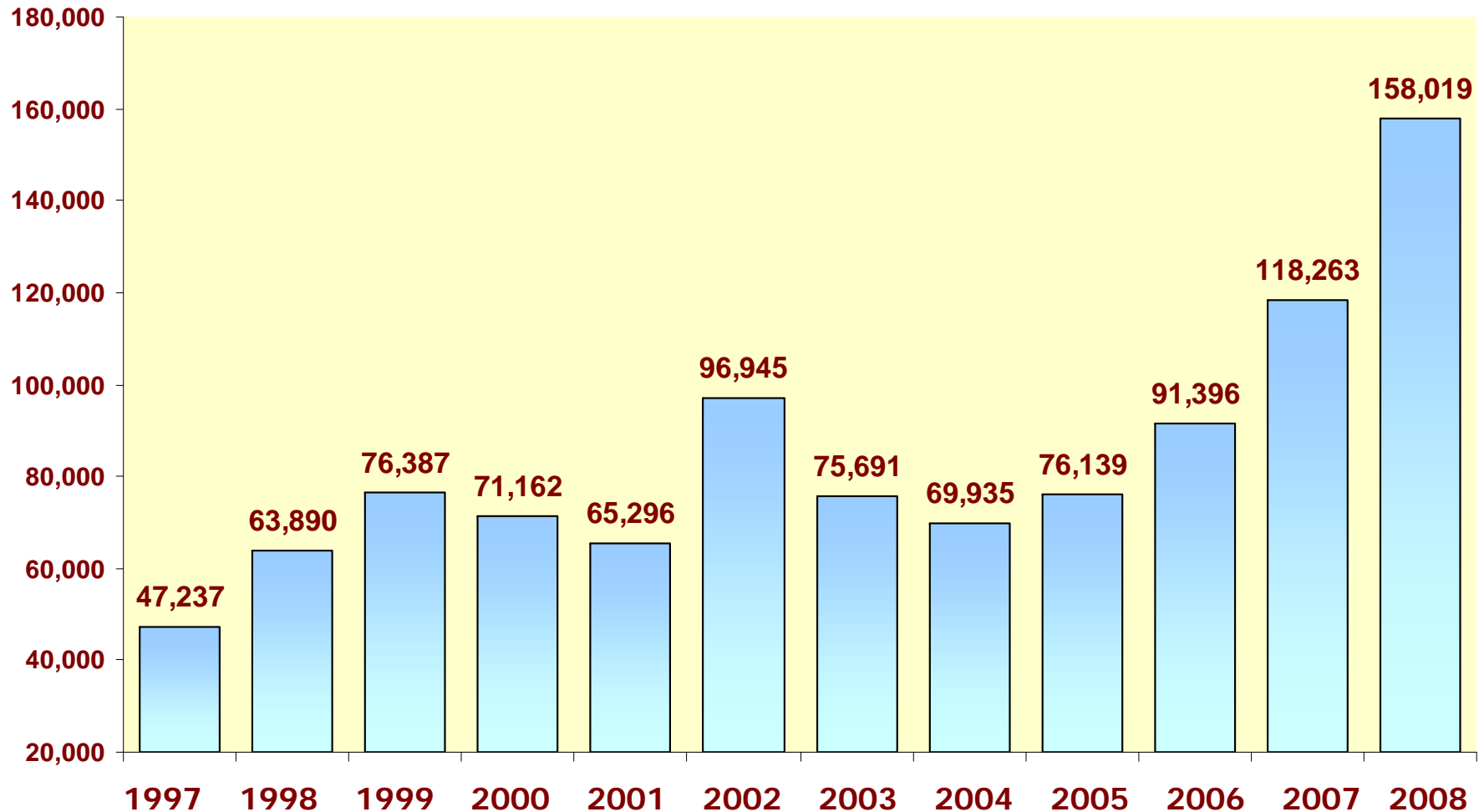
And why not...?

- The Dow, S&P and Nasdaq were all underperforming
- Weak Dollar: In March average \$ / € exchange rate = 1.5520
- Low Interest Rates:
 - In January 3-month \$ Libor was 3.99%
 - In March 3-month \$ Libor was 2.76%
 - In June 3-month \$ Libor was 2.80%
- The “Law of Diminishing Returns” ???

Do hedge funds provide much needed liquidity?



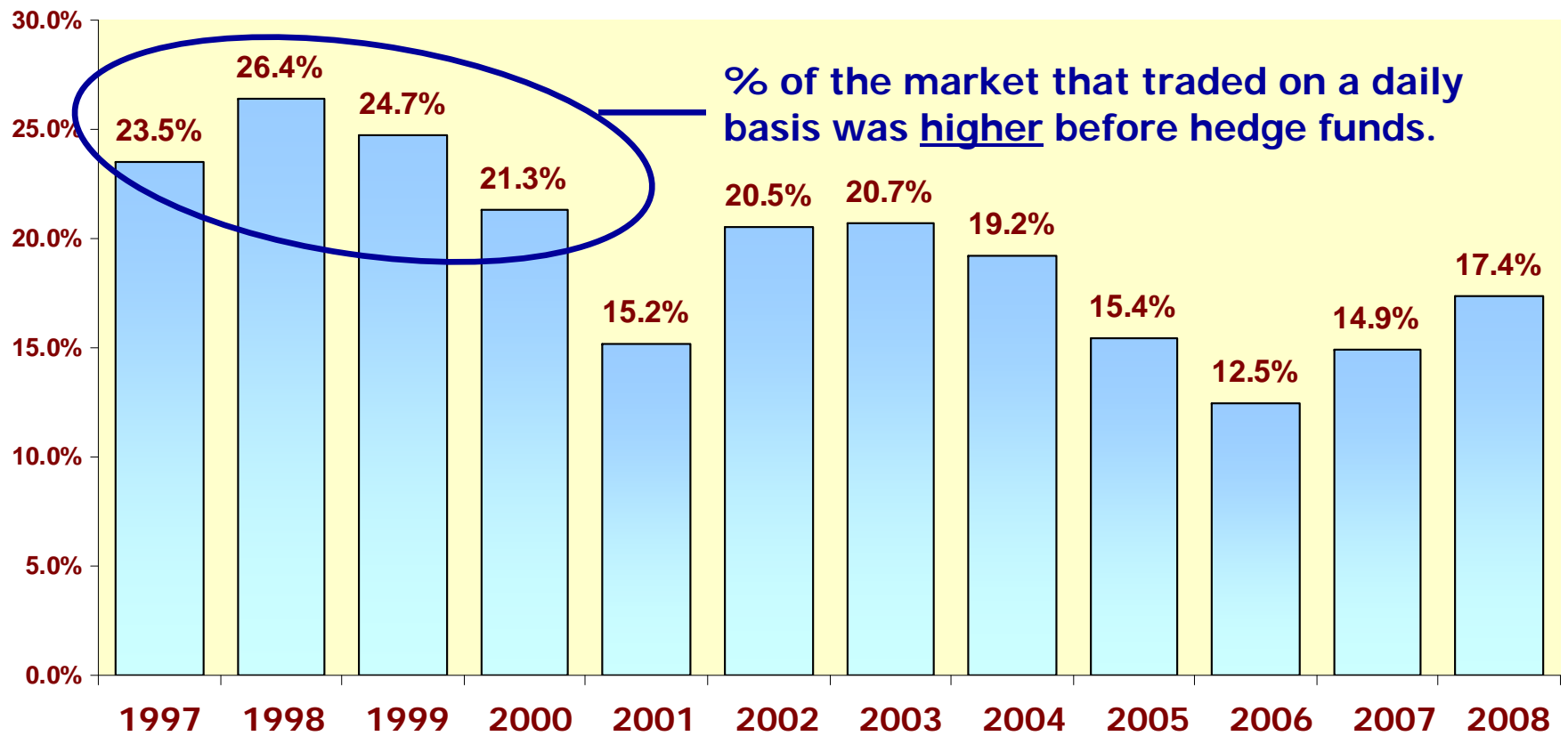
Avg. Daily Volume - NYMEX Natural Gas Futures (All Contracts)



Do hedge funds facilitate trading?



Avg. Daily Volume as a Percent of Avg. Total Open Interest
(NYMEX Natural Gas Futures - All Contracts)



% of the market that traded on a daily basis was higher before hedge funds.

The Past and the Present



The Washington Post

Oil speculators held great sway over prices, data suggest

At one point in July, a Swiss trading firm is believed to have held 11% of futures contracts on the New York Mercantile Exchange for profit rather than for lining up fuel supplies.

August 21, 2008

...when the Commodity Futures Trading Commission examined Vitol's books last month, it found that the firm was in fact more of a speculator..... rather than a means of lining up the actual delivery of fuel. **Even more surprising was the massive size of Vitol's portfolio -- at one point in July, the firm held 11% of all the oil contracts** on the regulated New York Mercantile Exchange.

The CFTC, which learned about the nature of Vitol's activities only after making an unusual request for data from the firm, now reports that financial firms speculating for their clients or for themselves account for about **81%** of the oil contracts on the Nymex.

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Data from the CFTC show that at the end of July, just four swap dealers held one-third of all Nymex oil contracts that bet prices would increase. Energy analysts say the data are evidence of the concentration of power in the markets.

... CFTC documents show Vitol was one of the most active traders of oil on the Nymex as prices reached record levels...

...By June 6, for instance, Vitol had acquired a huge holding in oil contracts, betting prices would rise....

....The contracts were equal to **57.7 million barrels of oil -- about three times the amount the United States consumes daily....**

....That day, the price of oil soared \$11 to settle at \$138.54. Oil prices eventually peaked at \$147.27 a barrel July 11; crude closed at \$114.98 on Wednesday.....

Consequences



- Prices fall off margin calls
- Collateral needed for swaps
- Letters of Credit
- Scrutiny from rating agencies
- Possible downgrades
- Junk Bond status (especially for Muni's)
- Can't raise capital or issue debt (get credit)
- Long term financing out of question
- Secular vs. Cyclical

Where We Stand Today...



Planalytics - CommOfTraders - Microsoft Internet Explorer

Commitment of Traders

Natural Gas

[Help](#)

Natural Gas		Non-Commercial Positions					Commercial Positions					Total Open Interest
Week Ending		Long	Short	Net	% Long	% Short	Long	Short	Net	% Long	% Short	
Previous	28 Oct 2008	101,251	267,309	-166,058	27.5%	72.5%	331,080	202,260	128,820	62.1%	37.9%	785,492
Latest	4 Nov 2008	93,982	254,303	-160,321	27.0%	73.0%	319,263	198,448	120,815	61.7%	38.3%	763,236
	Change	-7,269	-13,006	5,737	-.5%	-.5%	-11,817	-3,812	-8,005	-.4%	.4%	-22,256

		Non-Reportable Positions					Total-Reportable Positions					Non Comm Spread
Week Ending		Long	Short	Net	% Long	% Short	Long	Short	Net	% Long	% Short	
Previous	28 Oct 2008	72,035	34,797	37,238	67.4%	32.6%	713,457	750,695	-37,238	48.7%	51.3%	281,126
Latest	4 Nov 2008	71,199	31,693	39,506	69.2%	30.8%	692,037	731,543	-39,506	48.6%	51.4%	278,792
	Change	-836	-3,104	2,268	1.8%	-1.8%	-21,420	-19,152	-2,268	-.1%	.1%	-2,334

Source: US Commodity Futures Trading Commission.

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Summary for Congress



- Regulate ALL markets, including OTC similar to FSA in the UK
- One suggestion would be daily reporting of all trades/transactions by speculators
- Break out clearly, commercial (hedgers) from non-commercial (hedge funds, etc... banks are traders as are unregulated utilities)
- Differentiate commodities by human need/consumption (essentials)
- Create a “Czar” for essential commodities
- Increase margin on essential commodities for hedge funds and traders to 30% - 50% of total amount of contract
- Stop trading for a longer period of time on large price moves

Summary for Congress



For Producers/Consumers:

- Have CEO/CFO provide statements based upon an historical annual average (then adjusted for capacity changes... weather, demand, etc. as needs grow)
- Have these companies pay different levels of margin based upon consumption (as provided by written statements)

For example, Dow Chemical will pay more than a company with \$50 million annual revenues

- These can ONLY be used for hedging transactions, not speculating (trades have to match)... If large producer wants to run a speculative book then that book will be subject to speculative requirements (higher margin based upon speculative limits)
- Have all counterparties keep accounts of hedge offsets
For example, if J.P. Morgan does a trade with XXZ LD Company, keep a record of the counter trade
- Make ALL brokers, electronic and voice, keep records of all trades and names
- Have CFTC Commitments Report become a daily requirement for speculators and have it broken down by participant and contract

Summary for Regulators



- Mandatory hedging for utilities
- Outline objectives with utilities
- Sign off/agree on program before each season
- Smooth pricing and volatility (not aim for bottom)
- Allow timing strategies
- Agree on benchmarks beforehand
- No “Monday Morning Quarterbacking” (apply for a job in the NFL)
- Make federal regulators understand volatility hurts ratepayer
- Increased volatility makes option/defensive strategies very expensive
- Make federal regulators understand volatility increases with hedge fund activity
- Make federal regulators understand that 2008 prices have NOT been driven by supply/demand fundamentals



THANK YOU

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