Testimony of Howard Peterson, Jr.

Owner and President, Peterson's Oil Service

On behalf

The New England Fuel Institute

Before the

Subcommittee on Commodity Exchanges, Energy & Credit

Committee on Agriculture

U.S. House of Representatives

Public Hearing

"Reauthorizing the Commodity Futures Trading Commission: End-user Views"

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Chairman Austin Scott, Ranking Member David Scott and members of the committee, thank you for the opportunity to testify before you today. My name is Howard Peterson and I am Owner and President of Peterson's Oil Service of Worcester, Massachusetts. I am an "end-user" or more appropriately, a bona fide hedger, of energy commodities. I look forward to providing the committee with my perspective on the Commodity Future Trading Commission (CFTC) and its forthcoming reauthorization.

Introduction

Peterson's Oil Service is a fourth generation family-owned and operated company that has served the home heating needs of central Massachusetts since 1946. Our company sells BioHeat® Fuel, a blend of biodiesel and low sulfur heating oil. BioHeat has been shown to be the cleanest burning and most efficient home heating fuel on the market.[1] We purchase biodiesel that has been produced from waste vegetable oil by locally-owned and operated biodiesel manufacturing plants. We also provide a variety of other home energy services such as Heating, Ventilation and Air Conditioning (HVAC) system maintenance and repair, and market gasoline and other motor fuels. Peterson's Oil Service is a small business with little more than 80 employees. We are invested in and active members of the communities we serve and are personally acquainted with many of the customers. We hope the committee will benefit from the perspective of our company as it is a true "Main Street" end-user of commodity derivatives.

I am also testifying on behalf of the New England Fuel Institute (NEFI). Peterson's Oil Service is a long-time member of NEFI and I served as its Chairman for four years (2010-2014).

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[1] *Natural Gas Expansion Study: A Stakeholder Response*, Prepared by Exergy Partners Corp. for the Massachusetts Energy Marketers Association, Submitted to the Massachusetts Department of Energy Resources (DOER), December 18, 2013.

NEFI has been a leading voice and advocate for the home heating industry for more than 70 years, representing the industry on a variety of state, regional, and national public policy issues. Nationwide, approximately 8,000 home heating oil and Bioheat retailers serve more than 8 million households and employ over 50,000 people. Many of these retailers also market other heating fuels such as kerosene, propane and coal, and most offer a variety of home energy solutions designed to cut heating and cooling costs, including energy audits, efficiency upgrades and weatherization services.

In 2007, NEFI formed the Commodity Markets Oversight Coalition (CMOC), a diverse and non-partisan alliance of consumer, business and industry groups in the energy, transportation and agricultural sectors concerned with opacity in the commodity derivatives markets. This includes airlines, trucking companies, utilities, industrial manufacturers, food processors, farmers, and ranchers. CMOC members successfully advocated for many of the reforms included in the last reauthorization of the CFTC and, more recently, in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Like many in our coalition, my business relies on functional commodity futures, options and swaps markets as a hedging and price discovery tool. Peterson's Oil Service has long deployed a hedging program to insulate our business from volatility associated with the price of crude oil and refined petroleum products and to provide our customers with the most affordable product possible. Many home heating fuel dealers either hedge directly, or enlist the assistance of a broker, futures merchant or swaps dealer, in order to minimize their exposure to price volatility. Hedging programs are especially important for retailers that offer fixed price or prepay agreements to their customers, wherein a customer can lock-in a price for their fuel prior to the start of the heating season. Hedging affords our customers downside protection in the event that prices moves unexpectedly when the physical delivery is made in the winter time.

In order for our industry to hedge with confidence, security and protection from manipulation, a fully authorized and funded CFTC is essential. As such, let me begin by commending this committee on its efforts to reauthorize the CFTC and urge the Congress to fully fund the agency at the $322 million level as requested for Fiscal Year 2016. The importance of fully funding the CFTC cannot be overstated, especially given the mission it has been tasked with by Congress: that is, to protect businesses like mine from fraud, manipulation and wild price swings that can result from excessive speculation and disruptive trading practices. The CFTC must do all of this despite its limited resources, an unprecedented expansion of its responsibilities under the Dodd-Frank Act, constantly evolving markets, and ever-changing trading practices and technologies. CFTC Chairman Massad and Commissioners Wetjen, Bowen and Giancarlo should be commended for their commitment to transparent, accountable and functional markets that serve the needs of small hedgers like me. They are the cops on the beat and need proper resources to be successful. It is important that Congress continue to provide the Commission with the resources it needs and the authorities necessary to get the job done.

Perspectives on Dodd-Frank

Through Title VII reforms in the Dodd-Frank Act, Congress sought to address the root causes of the 2008 financial crisis – but this was not the only crisis that Congress sought to address. Many of the Title VII reforms also sought to address a crisis of opacity, instability and diminished confidence in the derivatives markets following an historic bubble in commodity prices. In the four years leading up to the passage of Dodd-Frank, this committee and others in Congress held countless hearings on the causes of this bubble and unprecedented volatility in energy and other commodities. During these hearings, business groups like ours joined with other like-minded industries and called upon Congress to bring greater transparency,

accountability and oversight to the commodity derivatives markets. Since the crisis in 2008, these derivative markets have become even larger and need for oversight even greater.

In response to these requests from end-users of derivatives and other commodity-dependent businesses, Congress did three important things. First, in an attempt to improve price transparency and market surveillance and to further protect end-users against fraud and manipulation, it expanded CFTC jurisdiction to the $700 trillion (notional value) over-the-counter swaps markets.[2] Swap dealer registration, data collection, price transparency, and central clearing helps to promote greater competition in these markets and is necessary in order to hold parties responsible for violations of the Act. Prior to the enactment of Dodd-Frank, these markets were almost entirely opaque and on several occasions had given cause to alleged or proven cases of market manipulation.[3]

Secondly, Congress also strengthened the CFTC's ability to prosecute instances of manipulation and attempted manipulation, including expanded authority to prevent disruptive trading practices and the inclusion of Senator Cantwell's "Anti-manipulation Amendment." The Cantwell Amendment provided the CFTC with new authority to more effectively prosecute and deter manipulation by changing the burden of proof from "specific intent" to the same fraud-based "reckless conduct" standard employed by the Securities & Exchange Commission (SEC) and other financial regulators. The effects of these measures to bolster the policing and prosecution of fraud and manipulation are clear. Since 2009, penalties imposed by the CFTC have increased from $100 million in Fiscal Year 2009 to 1.8 billion in Fiscal Year 2014.[4]

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[2] Source: Testimony of CFTC Commissioner Timothy Massad before the U.S. House of Representatives, Committee on Appropriations, February 11, 2015.
[3] Examples of energy market manipulation or alleged manipulation include the copper markets (Bankers Trust, 1996), natural gas (Amaranth, 2006), Propane (BP North America, 2007), crude oil (Parnon Energy, et.al., 2008), gasoline and heating oil (Optiver Holding BV, 2007) and electricity (JP Morgan, 2010-2012).
[4] Source: Written Testimony of CFTC Commissioner Timothy Massad before the U.S. House of Representatives, Committee on Appropriations, February 11, 2015.

Lastly, Congress included in Dodd Frank a requirement that the CFTC impose speculative position limits across all commodities in the futures and swaps markets. This includes energy futures and OTC energy and agricultural swaps which had been exempt from such limits since the enactment of the Commodity Futures Modernization Act of 2000. The "position limits mandate" was included in response to concerns raised by NEFI, its coalition allies and other bona fide hedgers that excessive speculation was harming price discovery and their ability to effectively manage commodity price risks. Congress included the mandate as a prophylactic measure to help prevent a repeat of the 2007-2008 commodity market bubble, to minimize wild price swings and extreme market volatility, and to prevent market manipulation.

It is also important to note that this rule was included with broad bipartisan support. In fact, as far back as the 110th Congress, a stand-alone bill that would have mandated the imposition of speculation limits was passed with broad bipartisan support. The bill, known as the Commodity Markets Transparency and Accountability Act of 2008, passed with the support of 69 Republicans. Several of those Republicans remain in Congress and are members of this committee, including past Chairman Frank Lucas of Oklahoma and current Vice Chairman Bob Goodlatte of Virginia.

Congress had required that the CFTC promulgate a position limits rule by mid-January 2011. Four years have now passed and the CFTC has still not finalized a rule. A revised rule was proposed in December of 2013 that addresses the concerns of the court and that seeks additional input from bona fide hedgers on the proper structure of the hedge exemption. This is the third position limits rule to be considered by the CFTC since January, 2009. Over the last fifteen months the current proposal has been opened up to public comments at least four times. Most recently the CFTC has opened up the rule to comments following a meeting of the Energy & Environmental Markets Advisory Committee (EEMAC) on February 26th with comments due on Saturday, March 28th.

NEFI is concerned with a suggestion made at the recent EEMAC meeting that the Commission cede to the exchanges its authority to set speculative position limits and issue bona fide hedge exemptions. Commodity exchanges are not regulatory agencies tasked with protecting the public interest. They are publically-traded, for-profit entities. As such, they benefit from higher trading volumes and a large number of market participants. Therefore the exchanges have a profit motive to make positon limits voluntary or unreasonably high, and to institute broad hedge exemptions that may include non-commercial market participants (such as financial speculators). NEFI strongly opposes these suggestions. They clearly run contrary to the intent of Congress, which is that the CFTC – not the exchanges or self-regulatory organizations – should be tasked with the responsibility to set position limit levels and define who should be eligible for bona fide hedge exemptions. Congress should watch developments closely and take action as necessary to ensure that this intent is preserved.

Recommendations for Reauthorization

Again, we commend Chairmen Scott and Conway and Ranking Members Scott and Peterson their commitment to moving forward with CFTC reauthorization. We further commend the committee for its interest in giving the CFTC the necessary authority to preserve market integrity and to protect small hedgers like myself from fraud and manipulation or from inadvertently being "caught in the net" by CFTC rules and regulations meant for financial firms and large commercial entities. The reauthorization process also provides an opportunity to correct imperfections either in Dodd-Frank reforms themselves or in their implementation. In order to better serve bona fide hedgers and businesses like mine, we urge Congress to:

- <u>Provide Greater Protections for Customer Funds.</u> The committee should most certainly include the same robust customer protections found in Title I of H.R.4413 last year.

While my company was not directly affected, several of my peers in the heating oil industry were victims of the collapse of MF Global. Their accounts were frozen and in some cases their market positions were jeopardized. If the effect of the crisis were more widespread it could have had a dramatic impact on my industry and the ability of some companies to serve their customers. Congress, CFTC and the exchanges should be commended for their efforts to strengthen consumer protections and prevent a repeat of "MF Global."

- Reinforce Congressional Intent Regarding End-users. In enacting the Dodd-Frank Act, Congress did not intend for many of its rules and regulations to adversely impact bona fide end-users of commodity derivatives, including businesses like mine. Therefore, we commend this committee for reinforcing end-user protections in Title III of H.R.4413 last year. However, NEFI and its coalition allies would like to caution this committee against inadvertently creating new loopholes or regulatory exclusions that might benefit financial institutions and other large market participants by weakening exemptions meant only for bona fide commercial hedgers.
- Prevent Cross-Border Regulatory Arbitrage. We also caution the committee against intervening in CFTC negotiations with its overseas counterparts regarding the harmonization of cross-border regulation of derivatives transactions. Systemically significant market participants, especially large financial institutions, should not be allowed to evade U.S. oversight and regulation by trading through off-shore branches, subsidiaries and affiliates. As we learned from the 2008 financial crisis and the LIBOR scandal, the Amaranth case and other instances of market manipulation, cross-border derivatives transactions can have significant consequences for American businesses and consumers and the broader U.S. economy.

- Expand the Study into High-Frequency Trading. The committee was wise to include a study into High-frequency Trading in H.R.4413 last year, however this study should be expanded. Congress should require a broad inquiry into the role of new trading technologies and practices that utilize complex algorithms and conduct automated trading, and the development new transmission technologies.[5] It should also examine the cyber-security and national security implications of such technologies and activities, their impact on market volatility, and whether or not they could (intentionally or unintentionally) disrupt or manipulate futures and swaps markets.
- Increase Penalties for Fraud and Manipulation. The previous reauthorization in 2008 strengthened antifraud provisions and increased civil monetary penalties for manipulation from $500,000 to $1 million per violation. As a matter of course, these penalties have become insignificant when compared to the overall profits of large market participants and have become part of the "cost of doing business." The committee should take a "zero tolerance" approach to such behavior. We urge you to include in reauthorization an increase in fines and penalties for fraud, manipulation and other severe violations of the law, and include jail time as appropriate in order to further deter such acts.
- Remove Expanded Cost-benefit Requirements. As a heavily regulated business I understand and appreciate the importance of thoroughly weighing potential costs and benefits of any federal rule or regulation. However, unlike many federal agencies, the CFTC is already subject to robust cost-benefit requirements. In many of its final rulemakings, the commission "quantified a variety of costs, considered alternative approaches, sought to mitigate costs and responded to significant comments" and in one

[5] Examples include fiber optic, wireless and microwave- and satellite-based transmissions.

instance the quantification of costs ran on for 24 pages in the Federal Register.[6] Furthermore, costs and benefits with respect to certain financial regulations can be difficult to quantify, especially in the case of prophylactic regulations such as the position limits rule. The dramatic expansion of cost-benefit requirements proposed under Section 203 of H.R.4413 last year would establish unreasonable hurdles for the CFTC to overcome, including a requirement that the CFTC analyze abstract and theoretical cost impacts and that it list all of the ambiguously defined "alternatives." This could lead to *more* litigation, *not less*, and result in the significant and unwarranted delay of many new rules, including those meant to protect small hedgers.

Conclusion

We commend the committee for holding hearings to solicit the input of bona fide hedgers and other market stakeholders before it moves forward with CFTC reauthorization. Congress should not miss this opportunity to expand protections for small hedgers and strengthen prohibitions against fraud and manipulation. Markets function best when they are fair, transparent, competitive and accountable; and the commodity derivatives markets are no exception. Thank you again for the opportunity to appear before you today. I would be happy to answer any questions you might have and our industry would be happy to provide further input to the committee as things progress.

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[6] Berkovtiz, Dan M., "Swaps Provisions of Dodd-Frank Act: Cost-Benefit Analysis and Judicial Review," *Banking & Financial Services*, September 2014, Page 8.