

STATEMENT OF
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ON
ENERGY SPECULATION: IS GREATER REGULATION NECESSARY
TO STOP PRICE MANIPULATION

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES
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Thank you for the opportunity to appear before you today. As Chairman of the Board of Directors of the Air Transport Association and President and CEO of Northwest Airlines, I am here to discuss our concerns about the impact of speculation in the energy futures markets. We are also concerned about the supply of oil and the impact of the weakening dollar, but today's hearing is to address speculation and whether more regulation is necessary. The ATA carriers firmly believe additional regulation is necessary.

Northwest, like other ATA member airlines, is an experienced participant in the energy futures markets and we recognize the value of rational and efficient energy futures markets in managing our business. When functioning properly, they play an important role in price discovery and managing physical supply and financial risk.

I cannot overstate the importance to my company and the entire U.S. airline industry of immediate Congressional action to halt excessive speculation in oil futures markets. Fuel is now approaching 40 percent of our operating costs, and growing. In 2008, U.S. airlines are forecast to spend \$61.2 billion on jet fuel, \$20 billion more than in 2007, and are projected to incur losses

totaling close to \$10 billion. If the current pricing dynamic does not change, our industry will be severely challenged and will continue shrinking – to the detriment of customers and the communities we serve. It is as simple and stark as that.

The financial health and security of the United States depends, in part, on a commodities market structure that is stable, rational and predictable. Today’s energy commodities markets, however, do not display these characteristics.

The policy provisions of the Commodities Exchange Act (“CEA”) speak in terms of the public interest in deterring and preventing price manipulation or any other disruption to market integrity, ensuring the financial integrity of commodities transactions and avoiding systemic risk in commodities markets. More specifically, Section 6a of the CEA states that “sudden or unreasonable fluctuations or unwarranted changes in...price of [a] commodity is an undue and unnecessary burden on interstate commerce.” These established policies are a beacon for much needed reform.

Unfortunately, the U.S. airline industry has become the poster child for why reform is needed. The price of jet fuel, which as you know is tied to the price of oil, is out of control.

From 2002 through 2007, the annual average price of oil increased from \$26 per barrel to \$72 a barrel, an average annual increase of about \$10 per barrel. While this was not insignificant from the airlines’ point of view -- a \$10 increase in the price of oil adds about \$420M to Northwest’s

annual costs, for example – airlines were able to adjust to the increase given the time span during which these increases took place.

In the past 12 months, however, the price of oil has more than doubled – it has increased about \$70 a barrel. There is nothing that airlines can do to fully absorb this increase. Both the magnitude of the increase and the speed at which it has occurred are unprecedented. In a few short months the cost of jet fuel has turned industry profits into enormous losses and is adversely affecting the industry's liquidity.

In 2004, oil started the year at \$32.51 and ended the year at \$43.36, an increase for the year of \$10.85. Daily volatility was generally under \$1.00. On June 6, 2008, the price of oil rose \$10.58 in a single day, and daily volatility of \$3.00 or more has become the norm with no correlative changes in supply or demand. We believe this increase in volatility reflects the increase in speculation and the degree to which it is affecting oil prices.

The consequence of the meteoric rise in oil and jet fuel prices is self-evident. Since Christmas, eight airlines – Aloha, MAXjet, Big Sky, ATA, Champion, Air Midwest, Eos and Skybus – have shut down. Frontier Airlines has been operating under Chapter 11 since April and Gemini Air Cargo just filed for Chapter 11 protection for the second time in two years.

All six network carriers have announced significant capacity cuts and service reductions, as well as difficult headcount reductions, to take effect after the summer travel season. American Airlines intends to reduce fourth quarter domestic capacity 11-12 percent, retire 75 mainline and

regional aircraft and may eliminate thousands of jobs. United Airlines said it will ground at least 100 airplanes and is looking at shrinking staff. Delta is reducing domestic capacity by 13 percent in the second half of 2008, eliminating 4000 positions and shedding aircraft. Continental Airlines announced that it would reduce fourth quarter domestic mainline capacity by 11 percent, will eliminate 44 routes and cut 3000 jobs. US Airways will shrink domestic capacity in the fourth quarter by 6-8 percent. Northwest plans to reduce fourth quarter capacity by 8.5 percent to 9.5 percent.

Further bankruptcies, liquidations, capacity adjustments and layoffs are to be expected if these oil prices continue.

Supply and demand fundamentals alone do not explain the price increases and volatility experienced in the energy markets. While the worldwide daily demand for oil has been growing by about a million barrels every year since 2004, this does not explain an increase in oil prices of over 100 percent during the last 12 months. Demand increased about 2 percent during that period.

In March of this year, about 1.2 billion barrels of oil were traded on average every day on the NYMEX and the London Intercontinental Exchange. World consumption is only about 87 million barrels a day. This means that the volume of paper transactions every day is more than 13 times larger than the actual amount of oil used worldwide in a day.

What has caused this disconnect between prices and supply and demand fundamentals?

According to numerous experts, the fundamental difference between the oil market today and the market of a few years ago is the increase in speculative investment in the futures market by financial institutions such as pension funds, investment banks and hedge funds. Lehman Brothers, for example, in its May 29 Energy Special Report, Oil Dot-com, stated:

"We have argued recently that some of the price buoyancy during Q1 reflected financial flows and investments in oil and other commodities. In our Energy Special Report on May 16, Is it a Bubble, we argued that large investor purchases of commodity indices and other structured products had a measurable effect on prices during the period leading up to the beginning of Q2. The motivation of investors—mostly institutional investors from pension, endowment, and sovereign wealth funds — was to take advantage of current commodity fundamentals with the expectation that commodities would outperform equities and bonds in the period ahead."

As Senator Carl Levin of Michigan, the home state of my company's largest hub, noted in a floor statement on June 12, the number of futures and options contracts held by speculators in oil on the New York Mercantile Exchange has increased from 100,000 contracts in 2001 to 1.2 million contracts today. He noted that this represents 40 percent of the oil futures and options contracts on the exchange, compared with 20 percent in 2001.

From the perspective of the airline industry, which has observed the oil market closely for many years because of the significance of fuel costs to our industry, the volume of speculative activity

has greatly exacerbated the volatility of the market. In our view, the volume of speculative activity has translated directly into speculative momentum that has placed upward pressure on oil prices irrespective of market fundamentals.

The original purpose of the futures market – to allow end users and producers to hedge against future price fluctuations – has been subverted. When futures prices are driven by speculative activity, hedging becomes a high-risk activity for producers and users. Because futures prices are a determinant of spot prices, end users of petroleum products, such as airlines, are forced to pay prices which bear a certain relation to the economics of oil production or consumption and therefore cannot be planned for.

Several factors, including changes in the law, have combined to induce this phenomenon. A primary culprit is the ability to trade energy commodities on unregulated markets – exchanges that the CFTC does not regulate. This is known as the “Enron Loophole,” which was codified by the Commodities Futures Modernization Act of 2000. The Enron Loophole created a specific exemption from regulation for certain electronic exchanges trading energy products.

A second culprit is the so-called “London Loophole,” which exempts foreign exchanges from CFTC regulation even when facilitating trades in U.S. WTI crude oil futures. Under both loopholes, transactions are not subject to U.S. margin requirements, position limits or reporting requirements. Regulation also is avoided using the so-called “Swaps Loophole,” which has allowed certain bilateral transactions to escape CFTC regulation and oversight, and which has

led index funds to obtain administrative exemptions from CFTC position limits that are imposed on other speculative investors.

The surge of investment money from pension and other investment funds into the oil futures markets cannot be ignored. Money from pension and other passive investment funds has poured into the commodities markets as the stock markets have suffered from a weak economy and a weak dollar. Indeed, as reported in the Wall Street Journal, the head of NYSE Euronext, Duncan Niederauer, recently acknowledged that “pension funds have made commodities a part of their investment portfolios and are investing in them regularly... Frankly, that completely alters the supply and demand for these commodities...I think that’s what’s driving it.” (WSJ, June 18, 2008).

All of these factors have combined to encourage excessive speculative trading that has resulted in “unwarranted changes” – to quote the CEA – in oil futures prices and, as a result, the spot market for oil.

We recognize that other factors are at play, including supply and demand fundamentals and the declining value of the U.S. dollar. Consequently, we support an energy policy that also addresses our nation’s oil supply and consumption. A sound energy policy will encourage the development of alternative fuels for transportation use and enable the United States to increase its supply of crude oil in a way that respects environmental concerns; we support the exploration and

development of our own natural supplies of oil and natural gas. A sound energy policy also will encourage efficiency and measures to moderate demand over time.

We need to address the declining value of the U.S. dollar. Because of the weak value of the dollar, U.S. airlines are, at times, paying a 50% premium for jet fuel.

But our immediate concern is the purpose of today's hearing - energy speculation. We firmly believe that additional regulation is, in fact, required. To address this situation, the ATA has developed a list of common-sense measures that will level the playing field between regulated and unregulated exchanges and which, as a consequence, should squeeze from the market the speculator premium.

ATA's recommendations are:

- Enact legislation to prohibit pension funds, long recognized as public-purpose entities, from investing in energy commodities. It would relieve the upward pressure on oil prices in the futures markets. This will protect both the individuals who rely on their pensions to fund their retirements and the Pension Benefit Guaranty Corporation, who would have to take over failed pension plans.
- Close the Enron, London and Swaps loopholes that permit institutional investors to avoid CFTC regulations and oversight by trading on unregulated and foreign exchanges.

- Require CFTC to reclassify all the positions in the “commercial trader” category of its “Commitments of Traders Reports” to distinguish between positions held by “bona fide physical hedgers” and passive institutional investors (speculators).
- Require the commodity exchanges, and the CFTC in emergencies, to increase the margin requirements for institutional investors. This will help reduce the volume of speculative trading.
- Require more transparency and give the CFTC more authority to obtain transaction information and price reports. This will allow better monitoring by CFTC, enabling it to actively enforce its rules and regulations.
- Require CFTC to work with the United Kingdom and other countries with commodity futures exchanges to promote efforts to make sure that traders using exchanges or trading bilaterally outside of exchanges are subject to the same limits and reporting requirements. This will improve oversight and help ensure fair and equal treatment for all participants.
- Increase funding to the CFTC to ensure it has the resources it needs to investigate and regulate the increasingly complex U.S. and world energy markets.

In conclusion, we urge swift, bipartisan action to address skyrocketing oil prices that are adversely affecting the U.S. airline industry.

