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HEARING TO REVIEW TRADING OF ENERGY-BASED DERIVATIVES

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

COMMITTEE ON AGRICULTURE
HOUSE OF REPRESENTATIVES

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HEARING TO REVIEW TRADING OF ENERGY-BASED DERIVATIVES

THURSDAY, JULY 12, 2007

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND
RISK MANAGEMENT,
COMMITTEE ON AGRICULTURE,
Washington, D.C.

The Subcommittee met, pursuant to call, at 10 a.m., in Room 1300 of the Longworth House Office Building, Hon. Bob Etheridge [Chairman of the Subcommittee] presiding.

Members present: Representatives Etheridge, Scott, Marshall, Boyda, Space, Walz, Pomeroy, Peterson (*ex officio*), Barrow, Moran, Graves, Boustany, Conaway, Neugebauer, McCarthy, and Goodlatte (*ex officio*).

Staff present: Tyler Jameson, Scott Kuschmider, Clark Ogilvie, John Riley, Sharon Rusnak, Debbie Smith, Kristin Sosanie, Bryan Dierlam, Kevin Kramp, and Jamie Weyer.

OPENING STATEMENT OF HON. BOB ETHERIDGE, A REPRESENTATIVE IN CONGRESS FROM NORTH CAROLINA

The CHAIRMAN. This hearing of the Subcommittee on General Farm Commodities and Risk Management to review the trading of energy-based derivatives will come to order. Let me welcome you. After months of working on the farm bill, this Subcommittee turns its attention to an area that not only impacts our farmers, but every man, woman and child in America, the trading of energy-based derivatives.

The futures industry impacts our lives every single day. Derivatives trading provides customers with forms of price discovery and price hedging for a wide variety of commodities and financial instruments. We are talking about a trillion dollar industry that impacts the price of corn, wheat, soybeans that go into our food products; the price of meat at the grocery store; price of gas we are paying for at the pumps; price of energy to heat our homes; the interest rates we pay on our credit cards; the interest you pay on your mortgages; the price of metals that go into products that we buy and many other things that we use every single day.

In 2000 Congress took a bold step in dramatically amending the Commodities Exchange Act and changing our system of derivatives markets regulation. As you will recall, it wasn't easy. Congress was faced with several different and often conflicting paths toward change offered by a wide variety of industry participants, but boldness was necessary in the face of technological advances within the

industry and increased foreign competition in derivative business. With the Commodity Futures Modernization Act of 2000, Congress delivered.

And we have seen the results of the work of Congress. The volume of derivatives and option contracts traded have more than tripled; the number of tradable products have increased by almost as much. The number of participants trading in this area has likewise skyrocketed, all of which has provided more opportunities for price discovery and more opportunities to hedge against risk. Now here we are, almost 7 years removed from that point and perhaps naturally, people are starting to feel the 7 year itch. They are asking questions about whether the regulatory regime we created in 2000 is appropriate for every commodity; or whether we should increase the Commodity Futures Trading Commission's authority in some areas.

Therefore it is an appropriate time for us to review what is happening in the energies derivative market, as well as the CFTC's oversight of these markets. Today we hear from the regulators of these markets, as well as from the government's accounting arm, which has been conducting its own review of what has taken place in these markets. We will also hear from a variety of players who will bring different perspectives to what role the government should play in overseeing these markets.

I hope my colleagues will find this hearing informative. I know I am looking forward to hearing today's testimony from our witnesses; want to welcome all of you here this morning; and thank those of you who are going to testify for being here.

Now I turn to my colleague, the gentleman from Kansas, Mr. Moran, for his opening statement.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Mr. MORAN. Mr. Chairman, I am pleased to join you here this morning. I appreciate the opportunity to hear from these witnesses. I thank them for their time and their expertise. This Committee, the House Committee on Agriculture, takes its jurisdiction of the commodities futures industry seriously. This hearing is one more example of our efforts to make certain that adequate oversight is being provided to an industry that, as you described, is very important to the consumers in the U.S., as well as the world economy. So I am anxious to hear what our witnesses have to say and with that, Mr. Chairman, I would ask you to proceed.

[The prepared statement of Mr. Moran follows:]

PREPARED STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM KANSAS

Thank you Mr. Chairman. We are here today to gather information regarding energy markets in the United States. We have before us a diverse group that includes witnesses from the Commodity Futures Trading Commission (CFTC), which is tasked with overseeing the commodity futures and options markets; a designated contract market (DCM); an exempt commercial market (ECM); and industry users of energy products. It is my hope that we can have an open discussion about how energy markets function in this country and how oversight levels of those markets can be properly established, while at the same time maintaining vibrant markets that allow adequate risk management mechanisms for all market participants.

Recently, there has been much discussion about the level of market surveillance and position regulation needed in regard to ECM's. This Subcommittee has an important role in ensuring that the CFTC has the necessary tools it needs to monitor markets and provide enforcement against market participants that might choose to manipulate markets. In making determinations of whether existing oversight and enforcement tools are sufficient, however, Congress must proceed in a deliberate and adequately informed manner.

Issues regarding commodity markets are without doubt complex. In crafting market regulations, proper consideration must be given to the differences between ECM's and DCM's. For instance, we must recognize that DCM's involve commodities of finite supply that are subject to delivery upon contract expiration, whereas ECM's typically involve contracts where no deliverable commodity is involved. Furthermore, we must consider the type of participants that are involved in each respective market. The underlying fundamentals of the cash market should also be taken into account. Finally, it should be considered what affect imposing further limitations on ECM's will have on commodity and derivative markets. If position limits are imposed on ECM's will participants in these markets shift their business to fully exempt over-the-counter bilateral markets and result in less oversight; or will these market participants simply shift their transactions to foreign exchanges?

These are all questions that must be answered. Since passage of the Commodity Futures Modernization Act (CFMA), commodity markets have exponentially increased in size and scope. Arguably, this has helped to promote competitive markets and bring new liquidity to traditional commodity markets. It is Congress' responsibility to hear from today's witnesses and determine what action is needed to ensure that CFTC has the necessary authority to carry out its mission to protect the public and market users from manipulation and fraud and ensure competitive and open commodity markets. I would like to thank all the witnesses for appearing today and I look forward to your testimony.

The CHAIRMAN. I thank you and I now recognize the Chairman of full Committee, Mr. Peterson, for any comments he might have.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Mr. PETERSON. I thank you, Mr. Chairman, and I want to thank you and the Ranking Member for your leadership and continuing attention to this issue and others under your jurisdiction. And I want to associate myself with your and the Ranking Member's remarks. I have a statement I will just make part of the record because we all have plenty to do and we might as well get on with things.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Mr. Chairman, for calling this hearing today.

Today, we will look into trading of energy derivatives, the growth of the derivatives industry, and what that growth means in the establishment of fuel prices. Since 2000, the last time Congress addressed the derivatives markets, the volume of futures and options contracts trading on U.S. exchanges have more than tripled. The number of tradable products available on these exchanges has also increased dramatically.

We all recognize the importance of derivatives markets and the role that producers, hedgers, and yes, even speculators play in them. Active, transparent markets provide valuable benefits to the public in the form of efficient price discovery and the ability for businesses to hedge risks, allowing them to withstand periods of unfavorable or volatile prices. Every farmer, food processor and energy consumer benefits from open, transparent markets. Consequently, every one of us pays the price if the futures markets are manipulated or distorted. Farmers are especially affected by volatility and price run-ups in these markets and are not able to pass costs along to consumers the way other industries can in the form of surcharges. Throughout the farm bill debate, for example, I have heard from farmers everywhere that, yes, commodity prices are high, but so are input costs like gasoline, diesel fuel and fertilizer.

A major issue confronting futures market regulators is the growth of exempt commercial markets and the over-the-counter (OTC) market for energy derivatives, which are subject to different levels of oversight under the Commodity Futures Modernization Act of 2000. For example, trading on exempt commercial markets like IntercontinentalExchange is not subject to position limits like its competitor, the New York Mercantile Exchange.

The CFTC believes it has sufficient oversight capabilities through existing anti-fraud and anti-manipulation measures to deal with market problems. I am sure the members of our second panel will have points of view that both agree and disagree with this assessment. I look forward to their testimony and for their thoughts with regard to the structure of our regulatory system.

I welcome today's witnesses and I yield back my time.

The CHAIRMAN. I thank the gentleman and the chair would request that other Members submit their opening statements for the record so the witnesses may begin their testimony and will ensure ample time for questions.

[The prepared statement of Mr. Graves follows:]

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM MISSOURI

The natural gas trade concerns me greatly because of the impacts on the end-users including farmers, manufacturers, and seniors on a fixed income. Spikes in price that have been created artificially through speculation and manipulation should not be tolerated in any venue where the commodity is traded, including on exempt commercial markets (ECM) (i.e., ICE) and on over-the-counter (OTC) markets. For these reasons, I support expanding transparency and oversight to these areas. My intention is to eliminate market manipulation.

Please know that as we move forward in this debate that I plan to engage on this issue to see my concerns addressed.

Thank you,

SAM GRAVES,
Representative in Congress From Missouri.

The CHAIRMAN. We would like to welcome our first panel to the table, the Honorable Walter Lukken, Acting Chairman of the Commodity Futures Trading Commission, and Ms. Orice M. Williams, Director of Financial Markets and Commodity Investments of U.S. Government Accounting Office. Mr. Lukken, please begin when you are ready, sir, and your full statements will be made a part of the record and if you would, please, try to summarize your statement within 5 minutes.

STATEMENT OF HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Mr. LUKKEN. Thank you, Mr. Chairman, Representative Moran and Members of the Subcommittee. I am pleased to testify on behalf of the Commodity Futures Trading Commission, and I appreciate the opportunity to discuss the CFTC and our role with respect to the energy markets. The CFTC pays close attention to the futures trading in energy commodities because of the importance of energy prices and supplies to our nation's consumers, producers and the economy, in general. Our agency is well aware of the reli-

ance of the agricultural sector on various sources of energy. Based on our surveillance efforts today, we believe that energy futures have, over all, been reflecting the underlying fundamentals of supply and demand.

The futures industry plays a critical role in the U.S. and global economy. It provides risk management tools that producers, distributors and commercial users of commodities use to protect themselves from unpredictable price changes. These markets also play a price discovery role for commercial interests seeking a centralized price reflective of supply and demand. Both functions would be harmed by manipulation or the perception of foul play. The success of these markets can be attributed, in part, to the principles-based approach that Congress adopted with the Commodity Futures Modernization Act in 2000 under the leadership of this Subcommittee. Trading volume on U.S. futures markets has expanded 400 percent in less than 10 years due to the flexibility of the CFMA and the rejection of the one-size-fits-all prescriptive approach to regulation. As we discuss energy derivatives today, we must be mindful of how successful the U.S. futures industry has been under the current regulatory framework.

The Commission has exclusive jurisdiction over commodity futures and options contracts traded on Designated Contract Markets, or DCMs. The CFTC's market surveillance mission regarding DCM activity is to ensure that commodity futures and options operate in an open and competitive manner, free of price distortions. The CFTC fulfills this obligation through a comprehensive program that is designed to identify and mitigate the potential for manipulation and other market abuses. CFTC's staff closely monitors trading on exchanges to detect unusual activity or price aberrations that may indicate manipulation.

The cornerstone of our market surveillance program is a large trader reporting system which requires traders to file daily reports concerning their positions in a particular contract. Through large trader reports, the CFTC becomes aware of concentrated positions that might be used to manipulate the market. When the CFTC's surveillance staff identifies a problematic situation, the CFTC engages in an escalating series of communications to work to resolve the situation. The traders are advised of the CFTC's concern and reminded that they are expected to trade in a responsible manner. This activity by CFTC is usually quite effective. Should more action be needed, however, the CFTC has the authority to limit, liquidate or halt trading through its emergency powers.

Should a violation of our Act occur, the CFTC aggressively pursues any individual that intentionally seeks to disrupt the integrity of our markets. The CFTC's Division of Enforcement investigates and prosecutes violations of our Act, including manipulation, false reporting and trade practice abuses. Sanctions and prosecuted cases serve as a powerful deterrent for would-be violators and send a clear message that improper conduct will not be tolerated.

In addition to energy futures traded on a regulated exchange, Congress included a provision in the CMFA permitting a new type of trading facility known as an Exempt Commercial Market, or ECM, on which exempt commodities, such as energy products, may be traded. Only eligible commercial entities, generally, institutional

traders, may trade on ECMs, ensuring that these markets are open only to sophisticated parties. ECMs are exempt from most provisions of the Act, however, the CFTC does retain fraud and manipulation authority over ECMs. ECMs are subject to certain limited reporting requirements to the CFTC. In addition, ECMs must maintain, for 5 years, certain records, including audit trail information sufficient to reconstruct trading activity. The Commission also has the authority to issue what is known as a special call for any information that the ECM may have of interest to us.

The futures markets have changed dramatically since the passage of the CFMA and the creation of the ECM category. This designation has encouraged tremendous innovation and growth for these institutional markets, while attempting to calibrate the amount of oversight to the risks associated with them. These exempt markets have increased competition, advanced the adoption of electronic trading and lowered costs for derivatives trading. However, certain contracts on regulated futures markets and ECMs have become increasingly linked and as a result, the public risks associated with these products may have changed.

The CFTC has recognized this and exercised its existing authorities in order to keep pace. For example, through our special call authority, the CFTC is now obtaining, daily, natural gas trading information from the IntercontinentalExchange that is similar to our large trader reports, providing a more comprehensive picture of the marketplace. More recently, the CFTC proposed to clarify that large traders on DCMs are required to keep information regarding all their related positions, including over-the-counter data and to provide that information to the Commission upon request.

These measures have and will improve our oversight of these markets. However, the CFTC is nearing the boundaries of its authorities in this area. A part of the CFTC's reauthorization debate, and the broader energy policy discussion, has been the question of increased regulation of ECMs. Several legislative ideas have been suggested and all are worthy of thoughtful discussion. As this Committee fully understands, this is a complicated matter with difficult legal and policy issues. However, protecting the integrity of the price discovery process should be our utmost priority, given its broad impact on consumers and the Commission stands ready to lend its expertise in finding the right solutions.

Lawmakers should be precise when considering additional regulation, given these electronic markets can move off-shore or into more opaque venues. In our capital markets, policymakers are focusing on whether current regulatory structures are having a negative effect on U.S. competitiveness, as evidenced by three independent bipartisan studies on the subject. Fortunately, the U.S. derivatives markets enjoy a competitive advantage internationally and have grown their market shares since the passage of the CFMA.

As policy changes are contemplated, Congress should be mindful of these global market concerns and should not undo the broader benefits that the CMFA has provided this industry. In my new role as acting Chairman, I look forward to working with this Committee, others in Congress and my fellow regulators to ensure that the nation's energy markets remain open and competitive, free

from price distortions and fraud. The Commission will continue to devote all necessary resources and expertise to achieve this important national goal. Thank you and I look forward to your questions.

[The prepared statement of Mr. Lukken follows:]

PREPARED STATEMENT OF HON. WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, D.C.

Thank you, Mr. Chairman and Members of the Committee. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC or Commission), and I appreciate the opportunity to discuss the CFTC and our role with respect to energy derivatives trading.

The CFTC continues to pay close attention to futures and options trading in energy commodities because of the importance of energy prices and supplies to our nation's consumers, producers, and its economy in general. Our agency is also well aware of the reliance of the agricultural sector on various sources of energy that provide fuel for field implements, feedstock for fertilizer and power for grain-drying equipment, to name a few uses. Based on our surveillance efforts to date, we believe that energy futures markets have been reflecting the underlying fundamentals of these markets.

Futures and options markets play a critically important role in the U.S. economy. They provide risk management tools that producers, distributors, and commercial users of commodities use to protect themselves from unpredictable price changes. The futures and options markets also play a price discovery role as participants in related cash and over-the-counter markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors. Both functions would be harmed by manipulation of prices.

Overview of Energy Trading

Trading in energy commodities takes place principally in three different ways: (1) on designated contract markets (DCMs), such as the New York Mercantile Exchange (NYMEX); (2) on exempt commercial markets (ECMs), such as the IntercontinentalExchange (ICE); and (3) in over-the-counter bilateral transactions.

On-exchange trading of energy commodities takes place on DCMs, which operate as price discovery and risk management facilities. Off-exchange trading of energy commodities can take place on electronic trading facilities known as ECMs, which operate without being designated as contract markets by the CFTC. Transactions on ECMs are entered into on a principal-to-principal basis only between "eligible commercial entities" as defined by the Commodity Exchange Act (CEA). Finally, off-exchange trading of energy commodities among wealthy, sophisticated participants, "eligible contract participants" as defined by the CEA, can also occur in bilateral transactions that do not take place on a trading facility. Each of these three ways of trading energy commodities is subject to varying levels of CFTC regulation under the CEA.

CFTC Mission

The CFTC's mission is two-fold: to protect the public and market users from manipulation, fraud, and abusive practices; and to promote open, competitive and financially sound markets for commodity futures and options.

Congress created the CFTC in 1974 as an independent agency with the mandate to regulate commodity futures markets, and later option markets, in the United States. To do this, the Commission employs a highly-skilled and dedicated staff who work within three major programs—Market Oversight, Clearing and Intermediary Oversight, and Enforcement. These divisions have distinct and separate charges and standards to meet, while working in conjunction to ensure market integrity and economic opportunity. The three major Commission programs are complemented by other offices, including the Office of the Chief Economist, Office of the General Counsel, Office of International Affairs and Office of Proceedings. The Chairman and Commissioners' offices provide agency direction, and stewardship over CFTC's human capital, financial management, and information technology resources.

CFTC Division of Market Oversight

The CEA provides that the Commission has exclusive jurisdiction with respect to accounts, agreements, and transactions involving commodity futures and options contracts that are required to be traded or executed on a designated contract market, also known as a DCM or an exchange. One of the purposes of the CEA is "to serve the public interests . . . through a system of effective self-regulation of trad-

ing facilities . . . under the oversight of the Commission."[1] DCMs are regulated entities that are self-regulatory organizations (SROs) subject to comprehensive oversight by the CFTC. DCMs can list for trading any type of contract, they can permit intermediation, and all types of traders (including retail traders) are permitted to participate in their markets. The CFTC's Division of Market Oversight (DMO) is responsible for monitoring and evaluating a DCM's operations and it conducts surveillance of all activity on DCMs, as described below.

DCMs must comply with a number of designation criteria and core principles as a condition for initial CFTC approval and continuing operation. Once operational, DCMs, as SROs, must establish and devote resources toward an effective oversight program, which includes surveillance of all activity on their markets to detect and deter manipulation and trading abuses. That responsibility includes, among other things, ensuring that listed contracts are not readily susceptible to manipulation, addressing conflict of interest situations, ensuring fair trading, providing for the financial integrity of contracts, utilizing effective rules to deal with market emergencies, and complying with comprehensive reporting and record keeping requirements. DMO staff review all exchange new product and rule filings to ensure that they comply with the core principles set forth in the Act and the Commission's regulatory requirements.

DMO's market surveillance mission regarding DCM activity is to ensure market integrity and customer protection in the futures markets. Traders establishing positions on DCMs are subject to reporting requirements so that DMO staff and the DCM can evaluate position sizes to detect and deter manipulation. In addition, trade practice surveillance involves compilation and monitoring of transactional-level data by the Commission and the DCM to detect and deter abusive trading such as wash sales, money laundering and trading ahead of customers (trade practice surveillance). The surveillance staff conducts active market and trade practice surveillance of all futures and options trading activity that occurs on DCMs.

Under the CEA, the primary mission of market surveillance is to identify situations that could pose a threat of manipulation and to initiate appropriate preventive actions. Each day, for the estimated 1,400 active futures and option contracts in the U.S., DMO market surveillance staff monitors the activities of large traders, key price relationships, and relevant supply and demand factors to ensure market integrity.

The market surveillance staff focuses, for example, on looking for large positions, especially in comparison to potential deliverable supply of the commodity. Such a dominant position might provide a trader an opportunity to cause a price manipulation, such as in a "squeeze," in which, for example, a single trader might hold a large long (buy-side) position and demand delivery of more of a commodity than is available for delivery. In such a situation, traders holding short (sell-side) positions may have no alternative but to buy back their positions at artificially high prices dictated by the dominant long trader.

The market surveillance program uses many sources of daily market information. Some of this information is publicly available, including data on: the overall supply, demand, and marketing of the underlying commodity; futures, option and cash prices; and data on trading volume and open contracts. Some of the information is highly confidential, including position and trading data that the Commission regularly receives from DCMs, intermediaries, and large traders.

DCMs report to the Commission the daily positions and transactions of each of their clearing members. The data are transmitted electronically during the morning after the "as of" trade date. They show separately, for proprietary and customer accounts, the aggregate position and trading volume of each clearing member in each futures and option contract. The data are useful for quickly identifying the firms that clear the largest buy or sell volumes or hold the biggest positions in a particular market. The clearing member data, however, do not identify the beneficial owners of the positions.

To address this limitation, DMO uses a large-trader reporting system. Under this system, clearing members, futures commission merchants (FCMs), and foreign brokers (collectively called "reporting firms") electronically file daily reports with the Commission. These reports contain the futures and option positions of individual traders that hold positions above specific reporting levels set by Commission regulations, and allow DMO staff to review the beneficial owners of futures positions. If, at the daily market close, a reporting firm has a trader holding a position at or above the Commission's reporting level in any single futures month or option expiration, it reports that trader's entire position in all futures and options expiration months in that commodity, regardless of size.

[1] CEA Section 3(b), 7 U.S.C. § 5(b).

Since traders frequently carry futures positions through more than one FCM, and since individuals sometimes control or have a financial interest in more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate related accounts. Reporting firms file information with the CFTC to identify each new account that acquires a reportable position. In addition, once an account reaches a reportable size, the account owner periodically is required to file a more detailed report to further identify accounts and reveal any relationships that may exist with other accounts or traders.

Surveillance economists prepare weekly summary reports for futures and option contracts that are approaching their expiration periods. Regional surveillance supervisors immediately review these reports. Surveillance staff advises the Commissioners and senior staff of significant market developments at weekly surveillance meetings (which are non-public, closed meetings) so they will be prepared to take action if necessary.

Typically, the Commission gives the DCM, as the front-line regulator, the first opportunity to resolve any issue arising in its markets. If a DCM fails to take actions that the Commission deems appropriate, the Commission has broad emergency powers under the CEA to order the DCM to take specific actions. Such actions could include limiting trading, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or closing a market. Fortunately, most issues are resolved without the need to use the Commission's emergency powers. The fact that the Commission has had to take emergency action only four times in its history demonstrates its commitment to refrain from intervening in the futures markets unless all other efforts have been unsuccessful.

In addition to market surveillance, DMO staff monitors trading activity on DCMs in order to detect and prevent possible trading violations. To help accomplish this mission, staff engages in various analyses to profile trading activity and conducts trade practice investigations. These functions require the collection of trade data and the ability to process those in various ways for further analysis. In this regard, DMO currently operates the Electronic Database System (EDBS), a system developed in the mid-1980s, to process and maintain information concerning trading activity on DCMs. EDBS is an older system with limited capabilities, especially with respect to trading data collected from electronically traded markets. The Commission is in the process of replacing EDBS with a more robust tool, the Trade Surveillance System (TSS). The primary function of TSS is to collect and make all trade data accessible to staff so they can retrieve, organize, and analyze trade data to assess DCM compliance with the Act and Commission regulations. TSS will assist staff in conducting timely, customized analyses of all trading activity; examining side-by-side trading (same contract trading simultaneously on an exchange floor and an electronic trading platform) and cross-market activity (similar or identical contracts trading on different exchanges); and detecting novel and complex patterns of potential trading violations involving electronic trading. TSS also will allow DMO staff to respond to fast-moving market events, which is crucial to effective trade practice surveillance. The identification of potential trading violations results in referrals to relevant DCMs and to the Commission's Division of Enforcement.

It should be noted that surveillance of DCM trading is not conducted exclusively by the Commission. As SROs, DCMs have significant statutory surveillance responsibilities.[2] Typically, however, surveillance issues are handled jointly by Commission staff and the relevant DCM. Surveillance information is shared and, when appropriate, corrective actions are coordinated. Situations of particular surveillance interest are jointly monitored and, if necessary, verbal contacts are made with the brokers or traders who are significant participants in the market in question. These contacts may be for the purpose of asking questions, confirming reported positions, alerting the brokers or traders to the regulatory concern regarding the situation, or warning them to conduct their trading responsibly. Throughout its history, the Commission, together with the DCMs, has been quite effective in using these methods to resolve issues at an early stage.

Another key DMO oversight role involves staff oversight and assessment of the regulatory and oversight activities of DCMs. This involves periodic examinations of DCMs' self-regulatory programs on an ongoing, routine basis to evaluate their compliance with applicable core principles under the Act and the Commission's regulations. These examinations, known as "Rule Enforcement Reviews," result in reports that evaluate a DCM's compliance and surveillance capabilities. The reports set forth recommendations for improvement, where appropriate, with respect to a DCM's trade practice surveillance, market surveillance, disciplinary, audit trail, and dispute resolution programs. These reviews promote and enhance continuing, effec-

[2] *See, e.g.,* Sections 5(b)(2) and 5(d)(4) of the CEA, 7 U.S.C. §§ 7(b)(2), 7(d)(4).

tive self-regulation and ensure that exchanges rigorously enforce compliance with their rules. The reports are made public and are posted on the Commission's website.

In conclusion, the Commission has a comprehensive market oversight program to detect and prevent disruption of the economic functions of all the commodity futures and option markets that it regulates.

CFTC Division of Clearing and Intermediary Oversight

The Commission's Division of Clearing and Intermediary Oversight (DCIO) is responsible for and plays an integral role in ensuring the financial integrity of all transactions on the markets that the CFTC regulates.

DCIO meets these responsibilities through an oversight program that includes the following elements: (1) conducting risk-based oversight and examinations of industry SROs responsible for overseeing FCMs, commodity trading advisors, commodity pool operators, and introducing brokers, to evaluate their compliance programs with respect to requirements concerning fitness, net capital, segregation of customer funds, disclosure, sales practices, and related reporting and record keeping; (2) conducting risk-based oversight and examinations of all Commission-registered derivatives clearing organizations (DCOs) to evaluate their compliance with core principles, including their financial resources, risk management, default procedures, protections for customer funds, and system safeguards; (3) conducting financial and risk surveillance oversight of market intermediaries to monitor compliance with the provisions of the CEA and Commission regulations; (4) monitoring market events and conditions to evaluate their potential impact on DCOs and the clearing and settlement system and to follow-up on indications of financial instability; and (5) developing regulations, orders, guidelines, and other regulatory approaches applicable to DCOs, market intermediaries, and their SROs. Collectively, these functions serve to protect market users, the general public and producers, to govern the activities of market participants, and to enhance the efficiency and effectiveness of the futures markets as risk management mechanisms. DCIO's most important function is to prevent systemic risk and ensure the safety of customer funds.

The DCOs that the Commission currently regulates are located in New York, Chicago, Kansas City, Minneapolis and London, England. The intermediaries overseen by the Commission are located throughout the United States and in various other countries.

CFTC Division of Enforcement

At any one time, the Division of Enforcement (Enforcement) is investigating and litigating with approximately 700 to 1,000 individuals and corporations for alleged fraud, manipulation, and other illegal conduct. Working closely with the President's Corporate Fraud Task Force, Enforcement is staffed with skilled professionals who prosecute cases involving complex over-the-counter and on-exchange transactions. Enforcement also routinely assists in related criminal prosecutions by domestic and international law enforcement bodies.

During the last 5 years, Enforcement has maintained a record level of investigations and prosecutions in nearly all market areas, including attempted manipulation, manipulation, market squeezes and corners, false reporting, hedge fund fraud, off-exchange foreign currency fraud, brokerage compliance and supervisory violations, wash trading, trade practice misconduct, and registration issues.

In the energy sector alone, Enforcement investigated Enron and dozens of national and international energy companies, as well as hundreds of energy traders and hedge funds around the country. As a result of those efforts, the Commission prosecuted numerous traders and corporate entities. At the same time, in other market sectors, Enforcement prosecuted more than 50 hedge funds and commodity pool operators for various violations, and filed actions against more than 360 individuals and companies for off-exchange foreign currency fraud and misconduct.

Enforcement receives referrals from several sources: the CFTC's own market surveillance staff; the compliance staff at exchanges; market participants and members of the public; and other state, Federal, and international regulatory authorities. During an investigation, the CFTC may grant formal administrative subpoena authority, which enables Enforcement to obtain relevant materials (for example, audio recordings, e-mail and trade data) and testimony from witnesses.

If warranted, at the conclusion of its investigation, Enforcement will recommend to the Commissioners that the CFTC initiate a civil injunctive action in Federal district court or an administrative proceeding. The CFTC may obtain temporary statutory restraining orders and preliminary and permanent injunctions in Federal court to halt ongoing violations, as well as civil monetary penalties, appointment of a receiver, the freezing of assets, restitution to customers, and disgorgement of unlaw-

fully acquired gains. Administrative sanctions may include orders suspending, denying, revoking, or restricting registration; prohibiting trading; and imposing civil monetary penalties, cease and desist orders, and orders of restitution.

The CFTC also refers enforcement matters to the Department of Justice. Criminal activity involving commodity-related instruments can result in prosecution for criminal violations of the CEA and for violations of Federal criminal statutes, such as mail fraud or wire fraud.

Oversight of Exempt Commercial Markets

Congress included a provision in the Commodity Futures Modernization Act of 2000 (CFMA) to govern a new type of trading facility known as an ECM.[3] As outlined in Section 2(h)(5)(F) of the CEA, ECMs are not "registered with, or designated, recognized, licensed or approved by the Commission." ECMs, as well as transactions executed on ECMs, are statutorily exempt from most provisions of the CEA. Trading on an ECM such as ICE is not subject to regular, ongoing market surveillance oversight by the Commission. Under current law, the Commission does not have the legal authority to limit the size of a trader's position on an ECM. Nor are ECMs required to comply with the self-regulatory obligations required of DCMs, such as adopting position limitations or position accountability rules. The Commission does retain fraud and manipulation authority over ECMs. To assist the Commission in carrying out its fraud and manipulation authority, ECMs are required to maintain a record of allegations or complaints received by the trading facility concerning instances of suspected fraud or manipulation and to forward them to the Commission.[4]

ECMs are also subject to certain limited reporting requirements that are authorized under Section 2(h)(5)(B)(i) of the CEA and spelled out in Commission Regulation 36.3(b).[5] Pursuant to these provisions, an ECM is required to identify those transactions conducted on the facility with respect to which the ECM intends to rely on the statutory Section 2(h)(3) exemption, and which averaged five trades per day or more over the most recent calendar quarter. With respect to such transactions, the ECM is required to transmit weekly to the Commission certain basic trade information, including "the commodity, the [delivery or price-basing] location, the maturity date, whether it is a financially settled or physically delivered instrument, the date of execution, the time of execution, the price, [and] the quantity."[6] The reports filed pursuant to Regulation 36.3(b) can provide Commission surveillance staff with information regarding price spikes or unusual divergence between the price of a commodity traded on an ECM and the price of a related commodity traded on a DCM. The Regulation 36.3(b) reports, however, do not require ECMs to identify the individual traders holding positions on the ECM.

In addition, an ECM must maintain for 5 years, and make available for inspection upon request by the Commission, records of its activities related to its business as an electronic trading facility, including audit trail information sufficient to enable the Commission to reconstruct trading activity, and the name and address of each participant authorized to enter into transactions on the facility.[7] Should the Regulation 36.3(b) reports, or other information obtained by surveillance staff (including information from futures market large trader reports), indicate a need for further information from an ECM, Section 2(h)(5)(B)(iii) of the CEA and Commission Regulation 36.3(b)(3) give the Commission authority to issue what is known as a "special call." Under the CEA, the Commission can obtain from an ECM "such information related to its business as an electronic trading facility exempt under paragraph [2(h)](3) . . . as the Commission may deem appropriate." The issuance of a special call to an ECM is simply an indication that the Commission's staff is seeking additional information. A special call, in and of itself, is not evidence of improper or illegal market behavior.

Finally, if the Commission determines that an ECM performs a significant price discovery function for transactions in the cash market for the commodity underlying any agreement, contract, or transaction traded on the facility, the ECM must publicly disseminate, on a daily basis, information such as contract terms and conditions, trading volume, open interest, opening and closing prices or price ranges, or

[3] CEA Sections 2(h)(3)–(5), 7 U.S.C. §§ 2(h)(3)–(5).
[4] Commission Regulation 36.3(b)(iii), (iv), 17 C.F.R. § 36.3(b)(iii), (iv).
[5] 17 C.F.R. § 36.3(b).
[6] ICE has been submitting such trade data for natural gas transactions meeting the regulatory reporting threshold since January 1, 2005.
[7] CEA Section 2(h)(5)(B)(ii), 7 U.S.C. § 2(h)(5)(B)(ii).

other price information approved by the Commission.[8] To date, the Commission has not made such a determination.

Since the fall of 2006, the CFTC has been regularly utilizing its special call authority to request information from ICE. This information assists us in the regulation of activities on DCMs, and we believe it helps us to get a more comprehensive picture of the marketplace, given the similarity of ICE's natural gas contracts to those traded on NYMEX. On September 28 and December 1, 2006, respectively, the Commission issued two special calls to ICE that required ICE to provide position data to the Commission, on an ongoing basis, related to transactions in ICE's most heavily traded natural gas swap contracts. Specifically, these separately-issued special calls required that ICE provide the Commission with clearing member position data and individual trader position data in the various ICE natural gas contracts that are cash-settled based on NYMEX natural gas contracts.

The special call for clearing member position data was issued by the Commission on September 28, 2006, and the Commission has been receiving responsive data from ICE, on a daily basis, since October 10, 2006. The individual trader position data special call was issued on December 1, 2006. ICE found it necessary to make various technical adjustments to its systems in order to produce the requested materials, which it has done. Those adjustments are now in place, and the Commission received the first batch of individual trader daily position data on February 16 (showing positions as of February 15) and continues to receive that information on an ongoing basis.

These two special calls were issued primarily in order to assist Commission staff in its surveillance of the related NYMEX natural gas contracts. Compliance with special calls is not voluntary, but mandatory. The special calls were not issued as part of an investigation of any particular market participant or trading activity on either ICE or NYMEX. Nor were they issued in order to conduct regular market surveillance of ICE contracts themselves. The information provided by ICE through the special calls is comprehensive, but it does not duplicate the information that the Commission collects through its DCM surveillance programs.

Despite the difference in regulatory authorities over DCMs and ECMs, the Commission is aware that when markets trade similar products or products that can be arbitraged, information regarding activity in one market tends to be incorporated into the other. This is almost certainly the case when large numbers of traders operate in both markets, as is the case between NYMEX and ICE.

CFTC Coordination With the Federal Energy Regulatory Commission

The Energy Policy Act of 2005 (EPAct) marked an important milestone in the ongoing debate over the appropriate policy for regulating trading activities in our nation's energy markets. The EPAct established the Federal Energy Regulatory Commission's (FERC) anti-fraud and anti-manipulation authority in the natural gas and electricity cash markets. At the same time the EPAct initiated this upgrade in FERC's authority, it also maintained the CFTC's longstanding anti-manipulation authority in these cash markets. Recognizing the CFTC's successes in combating abusive trading practices, the EPAct preserved the CFTC's exclusive jurisdiction over commodity futures and options transactions, and accordingly its enforcement authority to proceed against abusive energy trading and false reporting under the CEA.

As called for by the EPAct, the CFTC and FERC in October 2005 entered into a Memorandum of Understanding (MOU) to coordinate their activities. Accordingly, the respective staffs of the Commission and FERC are authorized to efficiently share information concerning various issues in the energy markets without the need for cumbersome access requests for each particular matter. To that end, designated Commission staff remain in regular contact with counterparts at FERC, and FERC staff is routinely invited to attend Commission enforcement briefings and surveillance meetings. The Commission's Enforcement staff also meets with FERC counterparts on a quarterly basis to share information on issues and matters of mutual interest.

While this inter-agency MOU has helped bridge some of the day-to-day matters that have arisen, certain issues remain. For instance, since the EPAct was enacted, the CFTC and FERC now have different legal standards required to prove a violation of their respective anti-manipulation provisions. The FERC anti-manipulation language parallels the language in Section 10(b) of the Securities Exchange Act of 1934. As a result, the elements of a manipulation case for FERC differ significantly from the elements of a manipulation action brought by the CFTC pursuant to the

[8] CEA Section 2(h)(4)(D), 7 U.S.C. § 2(h)(4)(D); Commission Regulation 36.3(c)(2), 17 C.F.R. § 36.3(c)(2).

CEA and related judicial precedent. Under the FERC legal standard, the language contemplates that in order to prove a violation, FERC must prove that a defendant intentionally or knowingly engaged in the proscribed conduct. It appears that the courts could interpret "reckless conduct" as an acceptable standard for FERC's "intent" requirement. In contrast, for manipulation cases under the CEA, the CFTC must prove specific intent, arguably a higher standard than "recklessness." The CFTC must also show that the defendant had the ability to influence market prices, that artificial prices existed, and that the defendant caused the artificial prices.[9]

We continue to work to resolve how each agency should enforce its mandate in the absence of a bright-line delineation of the boundaries of the respective agencies' authorities. These issues affect the agencies' regulatory efforts in the energy markets, and possibly undermine the effectiveness of Congress's intent to end those types of trading abuses that hurt energy consumers and undercut public confidence in fair and orderly energy markets. The CFTC will continue to monitor the ongoing interactions between our agencies in this area and will report to Congress as to whether it may be appropriate to harmonize FERC's and the CFTC's manipulation authorities.

CFTC Budget

The current budget that funds the divisions, the technology and surveillance operations, and other support staff, is approximately $98 million for the current Fiscal Year (FY). The FY 2008 President's Budget request for the CFTC is for an appropriation of $116 million and 475 staff—an increase of approximately $18 million and 17 staff over the FY 2007 continuing resolution appropriation which supports a level of 458 staff.

We are grateful for the Administration's recognition of the need for increased funding for our agency. The FY 2008 Budget request is a good down payment in an effort to reverse a recent downward trend in resources at the Commission, but it is, in perspective, a small recognition of the challenge we face.

Since the CFMA was enacted, there has been a seven-fold increase in the rate of new product listings by U.S. exchanges. Nine new DCMs and nine new DCOs have been approved by the CFTC. Electronic trading has soared to approximately 60 percent of total volume this year, and that percentage is steadily increasing. The competition, product innovation, and increasing use of technology fostered by the CFMA meant exponential growth in the futures and option markets, especially during the last few years. It has also meant continuing evolution of these markets in the form of new trading venues, new trading strategies, new risk management tools, and new customers.

The CFMA replaced the prior "one-size-fits-all" regulatory model with a flexible, practical, principles-based model for exchanges. U.S. exchanges also were given the authority to approve new products and rules through a self-certification process without prior CFTC approval, which encouraged innovation and enabled exchanges to act quickly in response to fast-changing market conditions. The CFMA also permitted the establishment of non-intermediated trading platforms such as ECMs, the growth of which has rapidly matured in recent years.

During this period of unprecedented growth for the futures industry, however, the CFTC's resources have been steadily diminishing. The CFTC needs additional staff resources in almost every program area. Currently, the Commission operates with a staff of 436—an historic low at a time when the industry we regulate is at an all-time high by almost any measure: more volume, more trading platforms, more products, more complexity and a more global marketplace. Commission employees work hard, work smart, and use technology effectively, but given the complexity of the markets we oversee, they are stretched. We have the resources to carry out the Commission's mission on a daily basis—by asking more of staff and putting off some technological needs and other programs—but it is clear that the agency can continue at this funding level only for the short-term.

With regard to the adequacy of our surveillance resources, it is useful to consider that the number of actively traded contracts trading on U.S. exchanges has more than quintupled in the last decade, with most of that growth seen in the last 5 years. Staff devoted to surveillance today is 46; ten years ago, it was 58.

As for Enforcement, staff has fallen from 154 to 110 during the same ten year period. The CFTC prides itself on its vigorous enforcement efforts. However, in derivatives markets that are exploding in size and complexity, coupled with its reduced staffing, the CFTC's enforcement professionals are struggling to keep up with the volume and size of its cases. For comparison purposes, the enforcement division

[9] *See In re Cox,* [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) 23,786 at 34,061 (CFTC July 15, 1987.

at the Securities and Exchange Commission is funded with a budget that is more than twenty times larger than that for the CFTC's enforcement operations. We are forced to make hard choices every day on how to prioritize our investigative and litigation efforts.

Technology is critical to enable our professional staff to adequately oversee the markets. However, budget constraints have required the Commission to put new systems development initiatives and hardware and software purchases on hold. For example, Commission investment in technology, as a percentage of total budget, has fallen from approximately 10 percent to around seven percent. This trend is unsustainable given that so much of the growth in the futures industry is directly attributable to investments in technology. It is important that the Commission not be overwhelmed by the technologically innovative industry we regulate.

Conclusion

The CFTC's last reauthorization expired in 2005, and Congress has worked hard during the past 2 years to try to reauthorize the CFTC and update our statutory mandate. We appreciate the efforts of this Subcommittee, the full Committee and your Senate counterparts, as you continue those efforts.

In order to clarify the CFTC's anti-fraud authority with respect to transactions in energy commodities, it is important that Congress clarify that the CFTC's primary anti-fraud provision in CEA Section 4b[10] applies to principal-to-principal transactions. We appreciate that such a clarification was included in H.R. 4473, the CFTC reauthorization legislation reported out of the House Agriculture Committee and adopted by the House of Representatives in December 2005.

Apart from enforcement, another part of the reauthorization debate has been about regulation of energy markets. It is a complicated policy decision that encompasses consideration of a number of issues, including: economic opportunity and competition at home and abroad; ensuring customer protections and market integrity; promoting growth and innovation of U.S. exchanges; and ensuring a level playing field for competitors. Congress, regulators and industry participants have varied opinions on the topic and the debate continues. It is important to hear all sides to strike the right balance in this complex economic and policy discussion.

This is truly a dynamic time in the futures markets, given the growth in trading volume, product innovation and complexity, and globalization—in all commodities, including energy. The Commission will continue to work to promote competition and innovation by proactively taking down unnecessary barriers to trading in our markets, while at the same time, fulfilling our mandate under the CEA to protect the public interest and to enhance the integrity of, and public confidence in, U.S. futures markets.

In closing, I appreciate the Committee's inquiries into this complex and important area as well as the opportunity to testify. I look forward to answering any questions you might have.

Thank you.

The CHAIRMAN. Thank the gentleman. Before we move to Ms. Williams, let me recognize the Ranking Member and welcome him and any comments he might have, before we move, if you have something.

Mr. GOODLATTE. Thank you, Mr. Chairman. I appreciate your holding this hearing.

The CHAIRMAN. And we thank you. And now we recognize Ms. Williams for her opening comments.

STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.

Ms. WILLIAMS. Mr. Chairman and Members of the Subcommittee, I am pleased to be here today to discuss our preliminary findings on the trading of derivatives for energy commodities. As energy prices have increased in recent years, the trading volume of exchange traded futures, off-exchange traded swaps and other types of derivatives have also experienced significant growth. Increased

[10] 7 U.S.C. § 6b.

energy prices have generally been attributed to normal market forces of supply and demand, but trends in energy derivatives markets have increased questions about whether this trading activity has placed additional upward pressure on the prices of physical energy commodities.

My remarks today focus on (1) trends in the energy derivatives and physical markets and the effect of those trends on energy prices; and (2) the regulatory structure of the various markets where energy commodities and derivatives are traded. The futures and physical markets for crude oil, unleaded gasoline, heating oil and natural gas have experienced substantial changes in recent years. First, from January 2002 to July 2006, monthly averaged futures and spot prices for crude oil, gasoline and heating oil registered an increase of over 200 percent.

Second, the volatility of energy prices generally remained above historic averages for most of the period, but declined for most energy commodities during 2006 to levels at or near their historical average.

And third, trading volumes for futures increased, at least in part, as a growing number of managed money traders, including hedge funds, began to see energy futures as attractive investment alternatives. While these changes were occurring in the futures market, the physical market was experiencing tight supply and increase in global demand, ongoing political instability in oil producing regions, limited refining capacity and other ongoing supply disruptions.

Some observers believe that higher energy prices were solely the result of supply and demand fundamentals, while others believe that increased derivatives trading activity may have also contributed to higher prices. Given the changes that have occurred in both markets over this period, the extent of impact of any one of the changes in either market is unclear.

Now, turning my attention to CFTC's authority: Energy products are traded on futures exchanges, exempt commercial markets and over-the-counter, or OTC, markets. Some of these markets are subject to CFTC oversight and some are largely unregulated. Under the Commodity Exchange Act, CFTC regulatory oversight is focused on the surveillance of futures exchanges, protecting the public and ensuring market integrity. CFTC does not, however, have oversight authority over exempt commercial markets, which are electronic trading facilities that trade exempt commodities, including energy commodities, on a principle-to-principle basis solely between persons that are eligible commercial entities.

Moreover, the volume of off-exchange transactions has increased significantly in recent years. Also, certain parties, those who qualify as eligible contract participants, can enter into contracts directly. Both the exempt commercial market and the OTC market are exempt from general CFTC oversight. However, both markets are subject to CFTC's enforcement of the CEA's anti-manipulation and where appropriate, anti-fraud provisions.

Given these varying levels of CFTC oversight, some market observers question whether CFTC needs additional resources and broader authority over all derivatives markets, particularly those involving exempt commodities. CFTC generally believes that the

Commission has sufficient authority over OTC derivatives and exempt energy markets, however, CFTC has recently taken an important step in clarifying its authority to obtain information about pertinent off-exchange transactions.

In closing, our work to date shows that the derivatives and physical markets have both undergone substantial change and evolution and warrants ongoing monitoring and analysis to protect the public and ensure the integrity of the markets. Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions that you or other Members of the Subcommittee may have. Thank you.

[The prepared statement of Ms. Williams follows:]

PREPARED STATEMENT OF ORICE M. WILLIAMS, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, D.C.

Energy Derivatives

Preliminary Views on Energy Derivatives Trading and CFTC Oversight

What GAO Found

Rising energy prices have been attributed to a variety of factors, and recent trends in the futures and physical markets highlight the changes that have occurred in both markets from 2002 through 2006. Specifically:

- Inflation-adjusted energy prices in both the futures and physical markets increased by over 200 percent during this period for three of the four commodities we reviewed.
- Volatility (a measurement of the degree to which prices fluctuate over time) in energy futures prices generally remained above historic averages during the beginning of the time period but declined through 2006 for three of the four commodities we reviewed.
- The number of noncommercial participants in the futures markets including hedge funds, has grown; along with the volume of energy futures contracts traded; and the volume of energy derivatives traded outside traditional futures exchanges.

At the same time these changes were occurring in the futures markets for energy commodities, tight supply and rising demand in the physical markets pushed prices higher. For example, while global demand for oil has risen at high rates, spare oil production capacity has fallen since 2002, and increased political instability in some of the major oil-producing countries has threatened the supply of oil. Refining capacity also has not expanded at the same pace as the demand for gasoline. The individual effect of these collective changes on energy prices is unclear, as many factors have combined to affect energy prices. Monitoring these changes will be important to protect the public and ensure market integrity.

Based on its authority under the Commodity Exchange Act (CEA), CFTC primarily focuses its oversight on the operations of traditional futures exchanges, such as NYMEX, where energy futures are traded. However, energy derivatives are also traded on other markets, namely exempt commercial markets and over-the-counter (OTC) markets—both of which have experienced increased volumes in recent years. Exempt commercial markets are electronic trading facilities that trade exempt commodities between eligible participants, and OTC markets involve eligible parties that can enter into contracts directly off-exchange. Both of these markets are exempt from general CFTC oversight, but they are subject to the CEA's anti-manipulation and anti-fraud provisions and CFTC enforcement of those provisions. Because of these varying levels of CFTC oversight, some market observers question whether CFTC needs broader authority over all derivative markets. CFTC generally believes that the Commission has sufficient authority over OTC derivatives and exempt energy markets. However, CFTC has recently taken additional actions to clarify its authority to obtain information about pertinent off-exchange transactions.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our preliminary views on the trading of derivatives for energy commodities such as natural gas and crude oil. As energy prices have increased in recent years, the trading volume of exchange-traded futures, off-exchange traded swaps, and other types of derivatives have also experienced significant growth.[1] Increased energy prices generally have been attributed to normal market forces of supply and demand, but these trends in energy derivatives markets have raised questions about whether this trading activity has placed additional upward pressure on the prices of physical energy commodities. The prices of futures contracts, like those of all derivatives, are in large part based on prices in the physical spot (cash) market where commodities are sold. At the same time, buyers and sellers of natural gas, crude oil, gasoline, and other energy products use exchange-traded futures prices, which are published daily, when determining prices in the physical markets. The extent to which off-exchange prices are used for determining prices of the underlying commodity, however, is unclear. The growth in energy futures trading since 2001 has in part been fueled by new market participants such as hedge funds and by increased investment in commodity index funds, which are funds whose prices are tied to the price of a basket of various commodity futures.

My testimony today is based on an ongoing engagement on trading activity in energy derivatives markets—primarily the futures market—and the oversight role of the Commodity Futures Trading Commission (CFTC). Because of the broad interest in this subject, our ongoing work has been initiated under the authority of the Comptroller General. My remarks today present our preliminary views on (1) trends in the energy derivatives and physical markets and the effect of those trends on energy prices, and (2) the regulatory structure of the various markets where energy commodities and derivatives are traded.

In conducting this work, we obtained and analyzed energy futures prices and trading volumes from the New York Mercantile Exchange, Inc. (NYMEX). Specifically, we collected data for crude oil, heating oil, natural gas, and unleaded gas for the period January 2002 through December 2006. We also obtained and analyzed data on market participants and the outstanding trading positions of different categories of traders from CFTC. In addition, we reviewed publicly available information, including academic studies and reports and market data. Finally, we interviewed a broad range of market participants and observers, representatives of energy trading markets, and government regulators and agencies involved with the energy markets. This work is being done in accordance with generally accepted government auditing standards.

In summary, derivatives and physical markets for crude oil, unleaded gasoline, heating oil, and natural gas have experienced substantial changes in recent years. From January 2002 to July 2006, monthly average futures and spot prices for crude oil, gasoline, and heating oil registered increases of over 200 percent.[2] The volatility of energy prices also generally remained above historic averages for most of the period but declined during 2006 to levels at or near the historical average. At the same time, trading volumes for futures increased, at least in part because a growing number of managed-money traders (including hedge funds) began to see energy futures as attractive investment alternatives. While these changes were occurring, the physical market was experiencing tight supply and rising demand from increasing global demand, ongoing political instability in oil-producing regions, limited refining capacity, and other ongoing supply disruptions. Some observers believe that higher energy prices were solely the result of supply and demand fundamentals while others believe that increased futures trading activity may also have contributed to higher prices. But the effect on energy prices of individual changes in these markets is unclear, as many factors have combined to affect energy prices. Monitoring these changes in the future will be important in protecting the public and ensuring market integrity.

Energy derivatives are traded on futures exchanges, exempt commercial markets, and over-the-counter (OTC). Some of these markets are subject to CFTC oversight and some are largely unregulated. Under the Commodity Exchange Act (CEA), CFTC regulatory oversight is focused on the surveillance of futures exchanges, protecting the public, and ensuring market integrity. CFTC does not, however, have oversight authority over exempt commercial markets—electronic trading facilities that trade exempt commodities, including energy commodities, on a principal-to-principal basis solely between persons that are eligible commercial entities—and the

[1] Our analysis of energy prices and energy financial markets is generally limited to the time period from January 2002 to December 2006.

[2] To account for the effects of inflation on prices, prices are adjusted to reflect prices in the base year of 2006.

volume of off-exchange transactions has increased significantly in recent years. Also, certain parties—those who qualify as eligible contract participants—can enter into contracts directly (over-the-counter). Both the exempt commercial market and the OTC market are exempt from general CFTC oversight. However, both markets are subject to CFTC's enforcement of the CEA's anti-manipulation and, where applicable, anti-fraud provisions. Because of these varying levels of CFTC oversight, some market observers question whether CFTC needs broader authority over all derivative markets, particularly those involving exempt commodities. CFTC generally believes that the Commission has sufficient authority over OTC derivatives and exempt energy markets. However, CFTC has recently taken additional actions to clarify its authority to obtain information about pertinent off-exchange transactions.

Background

Energy commodities are bought and sold on both the physical and financial markets. The physical market includes the spot market where products such as crude oil or gasoline are bought and sold for immediate or near-term delivery by producers, wholesalers, and retailers. Spot transactions take place between commercial participants for a particular energy product for immediate delivery at a specific location. For example, the U.S. spot market for West Texas Intermediate (WTI) crude oil is the pipeline hub near Cushing, Oklahoma, while a major spot market for natural gas operates at the Henry Hub near Erath, Louisiana. The prices set in the specific spot markets provide a reference point that buyers and sellers use to set the price for other types of the commodity traded at other locations.

In addition to the cash markets, derivatives based on energy commodities are traded in financial markets. The value of the derivative contract depends on the performance of the underlying asset—for example, crude oil or natural gas. Derivatives include futures, options, and swaps. Energy futures include standardized exchange-traded contracts for future delivery of a specific crude oil, heating oil, natural gas, or gasoline product at a particular spot market location. An exchange designated by CFTC as a contract market standardizes the contracts, which participants cannot modify. The owner of an energy futures contract is obligated to buy or sell the commodity at a specified price and future date. However, the contractual obligation may be removed at any time before the contract expiration date if the owner sells or purchases other contracts with terms that offset the original contract. In practice, most futures contracts on NYMEX are liquidated via offset, so that physical delivery of the underlying commodity is relatively rare.

Options give the purchaser the right, but not the obligation, to buy or sell a specific quantity of a commodity or financial asset at a designated price. Swaps are privately negotiated contracts that involve an ongoing exchange of one or more assets, liabilities, or payments for a specified time period. Like futures, options can be traded on an exchange designated by CFTC as a contract market. Both swaps and options can be traded off-exchange if the transactions involve qualifying commodities and the participants satisfy statutory requirements. Options and futures are used to buy and sell a wide range of energy, agricultural, financial, and other commodities for future delivery.

Market participants use futures markets to offset the risk caused by changes in prices, to discover commodity prices, and to speculate on price changes. Some buyers and sellers of energy commodities in the physical markets trade in futures contracts to offset, or "hedge," the risks they face from price changes in the physical market. Exempt commercial markets and OTC derivatives can serve the same function. Price risk is an important concern for buyers and sellers of energy commodities, because wide fluctuations in cash market prices introduce uncertainty for producers, distributors, and consumers of commodities and make investment planning, budgeting, and forecasting more difficult. To manage price risk, market participants may shift it to others more willing to assume the risk or to those having different risk situations. For example, if a petroleum refiner wants to lower its risk of losing money because of price volatility, it could lock in a price by selling futures contracts to deliver the gasoline in 6 months at a guaranteed price. Without futures contracts to manage risk, producers, refiners, and others would likely face greater uncertainty.

The futures market also helps buyers and sellers determine, or "discover," the price of commodities in the physical markets, thus linking the two markets together. Price discovery is facilitated when (1) participants have current information about the fundamental market forces of supply and demand, (2) large numbers of participants are active in the market, and (3) the market is transparent. Market participants monitor and analyze a myriad of information on the factors that currently affect and that they expect to affect the supply of and demand for energy commodities. With that information, participants buy or sell an energy commodity contract at the

price they believe the commodity will sell for on the delivery date. The futures market, in effect, distills the diverse views of market participants into a single price. In turn, buyers and sellers of physical commodities may consider those predictions about future prices, among other factors, when setting prices on the spot and retail markets.

Other participants, such as investment banks and hedge funds, which do not have a commercial interest in the underlying commodities, use the futures market strictly for profit. These speculators provide liquidity to the market but also take on risks that other participants, such as hedgers, seek to avoid. In addition, arbitrageurs attempt to make a profit by simultaneously entering into several transactions in multiple markets in an effort to benefit from price discrepancies across these markets.

Multiple Factors in the Derivatives and Physical Markets Have Impacted Energy Prices

Both derivatives and physical markets experienced a substantial amount of change from 2002 through 2006. These changes have been occurring simultaneously, and the specific effect of any one of these changes on energy prices is unclear.

The Energy Futures Markets Experienced Rising Prices, High Volatility, Increased Trading Volume, and Growth in Some Types of Traders

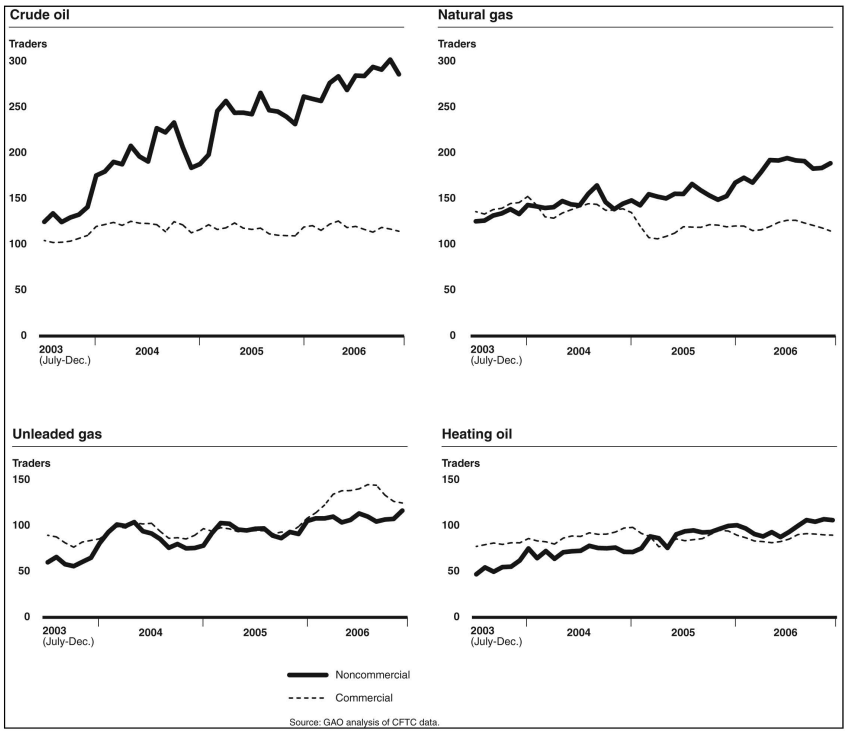
Several recent trends in the futures markets have raised concerns among some market observers that these conditions may have contributed to higher physical energy prices. Specifically from January 2002 to July 2006, the futures markets experienced higher prices, relatively higher volatility, increased trading volume, and growth in some types of traders. During this period, monthly average spot prices for crude oil, gasoline, and heating oil increased by over 200 percent, and natural gas spot prices increased by over 140 percent.[3] At the same time that spot prices were increasing, the futures prices for these commodities showed a similar pattern, with a sharp and sustained increase. For example, the price of crude oil futures increased from an average of $22 per barrel in January 2002 to $74 in July 2006. At the same time, the annual historical volatilities—measured using the relative change in daily prices of energy futures—between 2000 and 2006 generally were above or near their long-term averages, although crude oil and heating oil declined below the average and gasoline declined slightly at the end of that period. We also found that the annual volatility of natural gas fluctuated more widely than that of the other three commodities and increased in 2006 even though prices largely declined from the levels reached in 2005. Although higher volatility is often equated with higher prices, this pattern illustrates that an increase in volatility does not necessarily mean that price levels will increase. In other words, price volatility measures the variability of prices rather than the direction of the price changes.

We also observed that at the same time that prices were rising and that volatility was generally above or near long-term averages, futures markets saw an increase in the number of noncommercial traders such as managed money traders, including hedge funds.[4] The trends in prices and volatility made the energy derivatives markets attractive for the growing number of traders that were looking to either hedge against those changes or profit from them. Using CFTC's large trader data, we found that from July 2003 to December 2006 crude oil futures and options contracts experienced the most dramatic increase, with the average number of noncommercial traders more than doubling from about 125 to about 286. As shown in *Figure 1,* while the growth was less dramatic in the other commodities, the average number of noncommercial traders also showed an upward trend for unleaded gasoline, heating oil, and natural gas.

[3] To account for the effects of inflation on prices, prices are adjusted to reflect prices in the base year of 2006.

[4] CFTC collects data on traders holding positions at or above specific reporting levels set by the Commission. This information is collected as part of CFTC's Large Trader Reporting System.

Figure 1: Average Daily Number of Large Commercial and NonCommercial Traders per Month, July 2003 through December 2006



Not surprisingly, our preliminary work also revealed that as the number of traders increased, so did the trading volume on NYMEX for all energy futures contracts, particularly crude oil and natural gas. Average daily contract volume for crude oil increased by 90 percent from 2001 through 2006, and natural gas increased by just over 90 percent. Unleaded gasoline and heating oil experienced less dramatic growth in their trading volumes over this period.

Another notable trend, but one that is much more difficult to quantify, was the apparently significant increase in the amount of energy derivatives traded outside exchanges. Trading in these markets is much less transparent, and comprehensive data are not available because these energy markets are not regulated. While the Bank for International Settlements publishes data on worldwide OTC derivative trading volume for broad groupings of commodities, this format can be used only as a rough proxy for trends in the trading volume of OTC energy derivatives.[5] According to these data, the notional amounts outstanding of OTC commodity derivatives excluding precious metals, such as gold, grew by over 850 percent from December 2001 to December 2005.[6] In the year from December 2004 to December 2005 alone, the notional amount outstanding increased by more than 200 percent to over $3.2 trillion. Despite the lack of comprehensive energy-specific data on OTC derivatives, the recent experience of individual trading facilities further reveals the growth of energy derivatives trading outside of futures exchanges. For example, according to its annual financial statements, the volume of non-futures energy contracts traded on the IntercontinentalExchange, also known as ICE, including financially set-

[5] The Bank for International Settlements (BIS) is an international organization that fosters international monetary and financial cooperation and serves as a bank for central banks.

[6] The notional amount is the amount upon which payments between parties to certain types of derivatives contracts are based. The notional amount is not exchanged between the parties but instead represents a hypothetical underlying quantity upon which payment obligations are computed. The BIS data on OTC derivatives includes forwards, swaps, and options.

tled derivatives and physical contracts, increased by over 400 percent to over 130 million contracts in 2006.

Further, while some market observers believe that managed money traders were exerting upward pressure on prices by predominantly buying futures contracts, CFTC data we analyzed revealed that from the middle of 2003 through the end of 2006, the trading activity of managed money participants became increasingly balanced between buying (those that expect prices to go up) and selling (those that expect prices to go down). That is, our preliminary view of these data suggests that managed money traders as a whole were more or less evenly divided in their expectations about future prices than they had been in the past.

We found that views were mixed about whether these trends had any upward pressure on prices. Some market participants and observers have concluded that large purchases of oil futures contracts by speculators could have created an additional demand for oil that could lead to higher prices. Contrary to this viewpoint, some Federal agencies and other market observers took the position that speculative trading activity did not have a significant impact on prices. For example, an April 2005 CFTC study of the markets concluded that increased trading by speculative traders, including hedge funds, did not lead to higher energy prices or volatility. This study also argued that hedge funds provided increased liquidity to the market and dampened volatility. Still others told us that while speculative trading in the futures market could contribute to short-term price movements in the physical markets, they did not believe it was possible to sustain a speculative "bubble" over time, because the two markets were linked and both responded to information about changes in supply and demand caused by such factors as the weather or geographical events. In the view of these observers and market participants, speculation could not lead to artificially high or low prices over a long period of time.

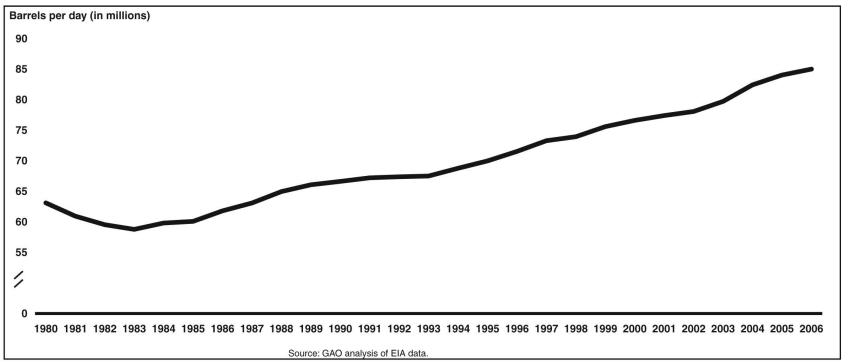
Various Patterns in the Physical Markets Also Explain Rising Energy Prices

The developments in the derivatives markets in recent years have not occurred in isolation. Conditions in the physical markets were also undergoing changes that could help explain increases in both derivative and physical commodity prices. As we have reported, futures prices typically reflect the effects of world events on the price of the underlying commodity such as crude oil.[7] For example, political instability and terrorist acts in countries that supply oil create uncertainties about future supplies that are reflected in futures prices in anticipation of an oil shortage and expected higher prices in the future. Conversely, news about a new oil discovery that would increase world oil supply could result in lower futures prices. In other words, futures traders' expectations of what may happen to world oil supply and demand influence their price bids.

According to the Energy Information Administration (EIA), world oil demand has grown from about 59 million barrels per day in 1983 to more than 85 million barrels per day in 2006 (*Fig. 2*). While the United States accounts for about a quarter of this demand, rapid economic growth in Asia has also stimulated a strong demand for energy commodities. For example, EIA data shows that from 1983 to 2004, China's average daily demand for crude oil increased almost fourfold.

[7] *See* GAO, *Motor Fuels: Understanding the Factors that Influence the Retail Prices of Gasoline,* GAO–05–525SP (Washington, D.C.: May 2005).

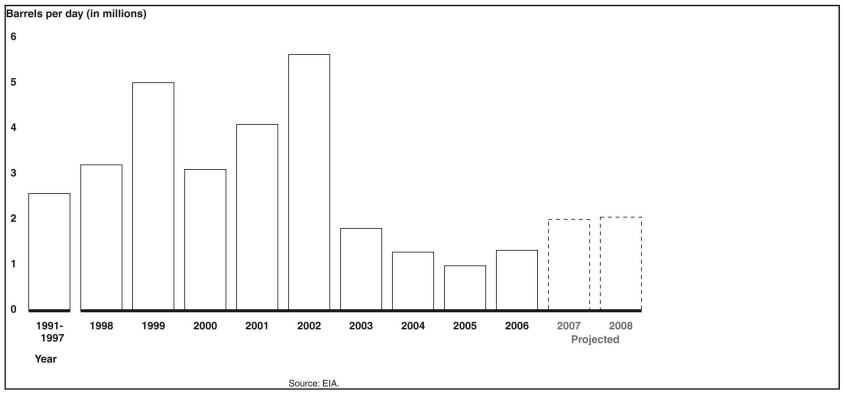
Figure 2: Increase in World Demand for Crude Oil, 1980-2006



Note: The world oil demand data for 2006 represent a preliminary estimate.

The growth in demand does not, by itself, lead to higher prices for crude oil or any other energy commodity. For example, if the growth in demand were exceeded by a growth in supply, prices would fall, other things remaining constant. However, according to EIA, the growth in demand outpaced the growth in supply, even with spare production capacity included in supply. Spare production capacity is surplus oil that can be produced and brought to the market relatively quickly to rebalance the market if there is a supply disruption anywhere in the world oil market. As shown in *Figure 3*, EIA estimates that global spare production capacity in 2006 was about 1.3 million barrels per day, compared with spare capability of about 10 million barrels per day in the mid-1980s and 5.6 million barrels a day as recently as 2002.

Figure 3: Estimates of World Oil Spare Production Capacity by the Energy Information Administration



Note: The spare capacity data for 1991–1997 represent an average over those years.

Major weather and political events can also lead to supply disruptions and higher prices. In its analysis, EIA has cited the following examples:

- Hurricanes Katrina and Rita removed about 450,000 barrels per day from the world oil market from June 2005 to June 2006.
- Instability in major oil-producing countries of the Organization of Petroleum Exporting Countries (OPEC), such as Iraq and Nigeria, have lowered production in some cases and increased the risk of future production shortfalls in others.
- Oil production in Russia, a major driver of non-OPEC supply growth during the early 2000s, was adversely affected by a worsened investment climate as the government raised export and extraction taxes.

The supply of crude oil affects the supply of gasoline and heating oil, and just as production capacity affects the supply of crude oil, refining capacity affects the supply of those products distilled from crude oil. As we have reported, refining capacity in the United States has not expanded at the same pace as the demand for gasoline.[8] Inventory, another factor affecting supplies and therefore prices, is particularly crucial to the supply and demand balance, because it can provide a cushion against price spikes if, for example, production is temporarily disrupted by a refinery outage or other event. Trends toward lower levels of inventory may reduce the costs of producing gasoline, but such trends may also cause prices to be more volatile. That is, when a supply disruption occurs or there is an increase in demand, there are fewer stocks of readily available gasoline to draw on, putting upward pressure on prices. However, others noted a different trend for crude oil inventories. That is, prices have remained high despite patterns of higher levels of oil in inventory.

In addition to the supply and demand factors that generally apply to all energy commodities, specific developments can affect particular commodities. For instance, the growth of special gasoline blends—so-called "boutique fuels"—can affect the price of gasoline. As we have reported, it is generally agreed that the higher costs associated with supplying special gasoline blends contributed to higher gasoline prices, either because of more frequent or more severe supply disruptions or because the costs were likely passed on, at least in part, to consumers.[9]

Like the futures market, the physical market has undergone substantial changes that could affect prices. But market participants and other observers disagree about the impact of these changes on increasing energy prices. Some observers believe that higher energy prices were solely the result of supply and demand fundamentals, while others believe that increased futures trading activity contributed to higher prices. Another consideration is that the value of the U.S. dollar on open currency markets could also affect crude oil prices. For example, because crude oil is typically denominated in U.S. dollars, the payments that oil-producing countries receive for their oil are also denominated in U.S. dollars. As a result, a weak U.S. dollar decreases the value of the oil sold at a given price, and oil-producing countries may wish to increase prices for their crude oil in order to maintain the purchasing power in the face of a weakening U.S. dollar. The relative effect of each of these changes remains unclear, however, because all of the changes were occurring simultaneously. Monitoring these trends and patterns in the future will be important in order to better understand their effects, protect the public, and ensure market integrity.

CFTC Oversees Exchanges and Has Some Authority Over Other Derivatives Markets

Energy products are traded on multiple markets, some of which are subject to varying levels of CFTC oversight and some of which are not. This difference in oversight has caused some market observers to question whether CFTC needs broader oversight authority. As we have seen, under the CEA CFTC's regulatory authority is focused on overseeing futures exchanges, protecting the public, and ensuring market integrity. But in recent years two additional venues for trading energy futures contracts that are not subject to direct CFTC oversight have grown and become increasingly important—exempt commercial markets and OTC markets. However, traders in these markets are subject to the CEA's anti-manipulation and anti-fraud provisions, which CFTC has the authority to enforce. Also, exempt commercial markets must provide CFTC with data for certain contracts.[10]

Futures exchanges such as NYMEX are subject to direct CFTC regulation and oversight. CFTC generally focuses on fulfilling three strategic goals related to these exchanges. First, to ensure the economic vitality of the commodity futures and options markets, CFTC conducts its own direct market surveillance and also reviews the surveillance efforts of the exchanges. Second, to protect market users and the public, CFTC promotes sales practice and other customer protection rules that apply to futures commission merchants and other registered intermediaries.[11] Finally, to ensure the market's financial integrity, CFTC reviews the audit and financial surveillance activities of self-regulatory organizations.

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[8] *See* GAO, *Energy Markets: Factors Contributing to Higher Gasoline Prices,* GAO–06–412T (Washington, D.C.: Feb. 1, 2006) and GAO–05–525SP.

[9] GAO, *Gasoline Markets: Special Gasoline Blends Reduce Emissions and Improve Air Quality, but Complicate Supply and Contribute to Higher Prices,* GAO–05–421 (Washington, D.C.: June 17, 2005).

[10] 17 C.F.R. § 36.3; see 7 U.S.C. § 2(h)(4)(D).

[11] See 17 C.F.R. Parts 155, 166.

CFTC conducts regular market surveillance and oversight of energy trading on NYMEX and other futures exchanges.[12] Oversight activities include:

- detecting and preventing disruptive practices before they occur and keeping the CFTC Commissioners informed of possible manipulation or abuse;
- monitoring NYMEX's compliance with CFTC reporting requirements and its enforcement of speculative position limits;
- investigating traders with large open positions; and
- documenting cases of improper trading.

In contrast to the direct oversight it provides to futures exchanges, CFTC does not have general oversight authority over exempt commercial markets, where qualified entities may trade through an electronic trading facility. According to CFTC officials, these markets have grown in prominence in recent years. Some market observers have questioned their role in the energy markets and the lack of transparency about their trading activities. Trading energy derivatives on exempt commercial markets is permissible only for eligible commercial entities—a category of traders broadly defined in the CEA to include firms with a commercial interest in the underlying commodity—as well as other sophisticated investors such as hedge funds. These markets are not subject to CFTC's general direct oversight but are required to maintain communication with CFTC. Among other things, an exempt commercial market must notify CFTC that it is operating as an exempt commercial market and must comply with certain CFTC informational, record-keeping, and other requirements.

Energy derivatives also may be traded OTC rather than via an electronic trading facility. OTC derivatives are private transactions between sophisticated counterparties, and there is no requirement for parties involved in these transactions to disclose information about their transactions. Derivatives transactions in both exempt commercial markets and OTC markets are bilateral contractual agreements in which each party is subject to and assumes the risk of nonperformance by its counterparty. These agreements differ from derivatives traded on an exchange where a central clearinghouse stands behind every trade.

While some observers have called for more oversight of OTC derivatives, most notably for CFTC to be given greater oversight authority over this market, others consider such action unnecessary. Supporters of more CFTC oversight authority believe that more transparency and accountability would better protect the regulated markets and consumers from potential abuse and possible manipulation. Some question how CFTC can be assured that trading on the OTC market is not adversely affecting the regulated markets and ultimately consumers, given the lack of information about OTC trading. However, in 1999 the President's Working Group on Financial Markets concluded that OTC derivatives generally were not subject to manipulation because contracts were settled in cash based on a rate or price determined in a separate highly liquid market and did not serve a significant price discovery function.[13] Moreover, the market is limited to professional counterparties that do not need the protections against manipulation that CEA provides to retail investors. Finally, the group has recently noted that if there are concerns about CFTC's authority, CFTC's enforcement actions against energy companies are evidence that the CFTC has adequate tools to combat fraud and manipulation when it is detected.[14]

The lack of reported data about off-exchange markets makes addressing concerns about the function and effect of these markets on regulated markets and entities challenging. CFTC officials have said that while they have reason to believe these off-exchange activities can affect prices determined on a regulated exchange, they also generally believe that the Commission has sufficient authority over OTC derivatives and exempt energy markets. However, CFTC has recently begun to take steps to clarify its authority to obtain information about pertinent off-exchange transactions. In a June 2007 proposed rulemaking, CFTC noted that having data about the off-exchange positions of traders with large positions on regulated futures exchanges could enhance the Commission's ability to deter and prevent price manip-

[12] NYMEX conducts its own surveillance activities and may bring enforcement actions when violations are found.

[13] The President's Working Group was established by executive order in 1988 following the 1987 stock market crash. Its purpose was to enhance the continued integrity, competitiveness, and efficiency of U.S. financial markets and maintain the public's confidence in those markets. See the Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (Washington, D.C.: 1999).

[14] June 11, 2003, letter signed by the members of the President's Working Group to the Honorable Senator Michael D. Crapo and the Honorable Zell B. Miller.

ulation or any other disruptions to the integrity of the regulated futures markets.[15] According to CFTC officials, the Commission has also proposed amendments to clarify its authority under the CEA to collect information and to bring fraud actions in principal-to-principal transactions in these markets, enhancing CFTC's ability to enforce anti-fraud provisions of CEA.

In closing, our work to date shows that the derivatives and physical markets have both undergone substantial change and evolution. Given the changes in both markets, causality is unclear, and the situation warrants ongoing review and analysis. We commend the Subcommittee's efforts in this area. Along with the overall concern about rising prices, questions have also been raised about CFTC's authority to protect investors from fraudulent, manipulative, and abusive practices. CFTC generally believes that the Commission has sufficient authority over OTC derivatives and exempt energy markets. However, CFTC has taken an important step by clarifying its authority to obtain information about pertinent off-exchange transactions.

GAO Contacts

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Staff Acknowledgments

Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions include John Wanska (Assistant Director), Kevin Averyt, Ross Campbell, Emily Chalmers, John Forrester, and Paul Thompson.

The CHAIRMAN. Thank you, Ms. Williams, and the chair will recognize Members, those who were present at the fall of the gavel and others as they came to the meeting, but before we begin the questions, I would ask unanimous consent that the gentleman from Georgia may sit with the panel during this hearing. No objection, so ordered. I will now recognize myself for 5 minutes.

Commissioner Lukken, during your appearance before the Senate Permanent Investigations Subcommittee, you said that the CFTC decided that the markets on New York Merc and ICE were linked with respect to certain types of traded energy-based derivatives, that one affected the other. Wouldn't such linkage call for a review by the Commission as to whether ICE is performing a significant price discovery function with regard to the affected derivatives?

Mr. LUKKEN. Mr. Chairman, absolutely. We do have a rule on the books dealing with whether the statute requires that if there is a significant price discovery function being performed by one of these ECMs, that that could trigger reporting of volume, open interest, high and low closing ranges, so forth. We need to review that rulemaking to make sure. When this was put on the books, this was prior to the phenomena of these linked contracts between regulated exchanges and exempt exchanges. Obviously, now that the two interplay with each other, there is a relationship there, an important relationship. This is one of our rules that we need to review to make sure that it encompasses that type of relationship that has developed rather recently over the last couple years.

The CHAIRMAN. Let me follow that up a bit because I would appreciate you talking with us about the process the Commission

[15] According to CFTC, the purpose of the proposed regulation is to make explicit that persons holding or controlling reportable positions on a reporting market must retain books and records and make available to the Commission upon request any pertinent information with respect to all other positions and transactions in the commodity in which the trader has a reportable position, including positions held or controlled or transactions executed over-the-counter and/or pursuant to Sections 2(d), 2(g) or 2(h)(1)–(2) of the Commodity Exchange Act (Act) or Part 35 of the Commission's regulations, on exempt commercial markets operating pursuant to Sections 2(h)(3)–(5) of the Act, on exempt boards of trade operating pursuant to Section 5d of the Act, and on foreign boards of trade; and to make the regulation clearer and more complete with respect to hedging activity. 72 *Fed. Reg.* at 34413.

uses to evaluate ECMs for that function. Also, what is the standard that the Commission uses to determine it?

Mr. LUKKEN. The rulemaking, itself, looks to whether outside entities are utilizing, on a regular basis, prices on an exempt commercial market. So if a utility or somebody is quoting those prices or basing contracts on those prices, on an ongoing basis, that is evidence that somebody is discovering prices from that marketplace. Again, that was not thought through with this linkage idea, however. This was looking only at ICE and whether people were discovering products off of ICE and now that the two interact with each other in some ways, we didn't consider this link sufficiently and weren't aware of it when we put together this rulemaking. So, I think this might be an area we might need to clarify in this rule and they may be, after review, serving as a significant price discovery market.

The CHAIRMAN. I think this Committee would be very interested in that information as you develop it.

Mr. LUKKEN. Well, we are going to make this a priority.

The CHAIRMAN. All right. Thank you, sir. Ms. Williams, I understand that GAO will be issuing a report looking at trading of energy derivatives in the near future. Can you give us a timeline as to when we can expect the report, and will it include recommendations? Can you give us any sense of what those could be so we might get a glimpse of what the future is going to look like?

Ms. WILLIAMS. We do hope to issue a report later this year in terms of the areas that we focused on in addition to the two areas that I discussed today in my prepared statement.

The CHAIRMAN. I hate to interrupt you. When you say later this year, can you give me a little bit better window?

Ms. WILLIAMS. In the next several months.

The CHAIRMAN. I agree with the Ranking Member, you are good. And that could be 3 to 6 months.

Ms. WILLIAMS. That is a safe range. Hopefully, closer to the 3.

The CHAIRMAN. That is close. Any thoughts of what kind of——

Ms. WILLIAMS. Well, in addition to looking at trends in the futures and physical market that I briefly discussed, we also are looking at, kind of, the CFTC's authority and also their surveillance and enforcement activities. So to the extent that we do have any recommendations, it would be focused on those last two areas.

The CHAIRMAN. Well, certainly this Committee would be quite interested in that.

Ms. WILLIAMS. Absolutely.

The CHAIRMAN. And sooner rather than later.

Ms. WILLIAMS. We understand.

The CHAIRMAN. Even with the preliminary report, it would be quite helpful, given that we operate on a timeline here.

Ms. WILLIAMS. Okay. Right.

The CHAIRMAN. It is pretty tight now and the days of the legislative calendar are drawing nigh, they are running out.

Ms. WILLIAMS. We understand.

The CHAIRMAN. Thank you. With that, I yield to the Ranking Member.

Mr. MORAN. Mr. Chairman, thank you very much. Commissioner Lukken, welcome back to the House Agriculture Committee. My

thought would be this is your debut appearance as the acting Chairman and so welcome. First of all, I would like for you just to describe for me, for the Committee, the function, the manner in which the Commission is currently functioning. I would be happy to have your reassurance, but the Commission has been short of Commissioners. There has been change and turnover in regard to its Chairman and there are constant concerns about the level of the budget and appropriations for the CFTC. And so as we look at your capabilities, the CFTC's capabilities, I would like to have your report on the current status of how the Commission is functioning given the lack of Commissioners, perhaps lack of money and an acting Chairman.

Mr. LUKKEN. Thank you, Congressman. Obviously, that was mentioned by the Chairman's opening statement and your statement. Our industry has experienced significant growth since the passage of the CFMA. Markets were experiencing really flat growth coming into the CFMA. Since then, they have taken off; 343 percent since 2000 through 2006. We have gained market share globally; 34 percent in 2000. We are now at 43 percent, globally, the U.S. So we are gaining on the world in futures volume and that is great.

You know, we are also seeing more contracts than ever before. Where 250 contracts may have been listed at any one time, we are experiencing over 1,400 actively traded futures contracts. As an industry, we should applaud that growth. But that has to be juxtaposed with what we are doing, as a Commission, which we are struggling with the resources we have. We are at historically low levels. In the 1970s, when this industry was much smaller, we were over 500 individuals, as an agency. Now we are at historical lows of 450 or so individuals at the CFTC.

Budgets have been flat recently, as has ours. It is almost a demographic phenomenon, but our agency, as it approaches 35 or so years of service, people who are in the agency are starting to retire and that institutional knowledge is walking out the door when we have been under a hiring freeze. So we are struggling to keep pace and we are keeping pace because we have talented individuals, but we are stretched. And so thankfully, the Senate, yesterday, gave us an appropriations mark of $116 million for our annual budget, which is the same as what the President had asked for. I am hopeful today that the House does the same.

You also mentioned what the Commission is doing as a Commission, itself. The Commissioners, and we are down to two, in fact, Commissioner Mike Dunn is in the audience supporting me today and it is just the two of us. And the Sunshine laws prevent us from talking to each other, which is problematic. You know, we want to, just as the House and Senate want to, collaborate and discuss. These are serious issues that we need important discussions about and we are not able to do that. We have to relay messages through staff. It is difficult. The President has nominated two individuals. I hope that the Senate is able to move on those individuals quickly so that we have a full or nearly full complement of Commissioners and we are able to do the serious business before the Commission.

Mr. MORAN. I am confused as to how you can speak for the Commission when you and Mr. Dunn can't communicate with each

other, but there was some, at least in the press, criticism may be too strong of a word, but there was some exception taken to your testimony recently in the Senate. It was as if you were close minded to, at least this is my impression, close minded to additional regulation of the energy markets.

My impression of what you said today is that that is not the case, and my impression is also that you are saying something that every Commission Chairman that has testified before this Committee in past years has said something very similar. So I wanted to give you the opportunity to clarify your thoughts or your statement about this topic, but also to tell me whether you are deviating in your remarks or testimony today from past testimony of the Commission and whether you and Commissioner Dunn, as Commissioners are generally in agreement, to your testimony today.

Mr. LUKKEN. My written testimony is the testimony of the Commission in its entirety, Mike and myself. But I think a good mark of a regulator is somebody who is open to ideas, that can adapt with change. And certainly, this market is evolving and we have to keep pace with that change. We have tried to do things within our existing authority to keep pace with that change. However, as I note, we are nearing the outer edges of that authority. So I think the ideas that are being discussed are important ideas, but as this Committee knows, and you have the battle scars from 2000, these are complex matters.

If we start to wade into this, there are questions of whether that provides additional uncertainty to the swaps markets. Do we only go after this one market we are talking about and limited products within that market? Are we only talking natural gas or are we talking energy products? Are we talking metals, which are also an exempt commodity? A lot of these smaller ECMs are incubator exchanges. They are innovative, they are growing. We want to encourage that. Additional regulation on these exchanges might shut them down.

There is a potential that a regulation could drive markets overseas or maybe into the more opaque over-the-counter markets. So this shouldn't deter us from trying to ask these questions and trying to find solutions. But I am just saying that this is complex and we just have to be cautious and precise as we approach these things. I am open to all ideas, including the ideas that were suggested in the PSI report on Monday, but it is going to take some precision and some caution and a lot of discussion before we can reach the right solution.

Mr. MORAN. Commissioner, thank you very much for your testimony and for your leadership at the CFTC.

The CHAIRMAN. I thank the gentleman and the chair would now be happy to yield 5 minutes to the gentleman from Virginia, Mr. Goodlatte.

Mr. GOODLATTE. Mr. Chairman, thank you very much. Commissioner, Ms. Williams, welcome. Let me start with you, Commissioner Lukken. I would like to follow up on the gentleman from Kansas' questions. What would be the impact on your budget and staffing if you are required to regulate more markets?

Mr. LUKKEN. It depends on what the breadth of the new authority might be, but it would be significant. Currently, we had looked

at maybe, if extended to ECMs and other over-the-counter products, of having to hire 30 or 40 new surveillance economists. Some of the legislation covers products not even traded on futures exchanges, so this would be a significant amount of new resources that would have to be devoted to this. As we approach this, I think these two have to go hand-in-hand, that if new authority is given, there has to be assurance that resources come along with that authority.

Certainly, we don't want to have to choose between what we do, as an agency, because all of our mission is important. I would hate to pursue energy manipulations but allow fraud on forex markets, allow that to occur. So right now our plate is full and we are approaching having to make those decisions currently, given our budget situation. I think the new budget number is appropriate and will help with that. But new authority will again task us and this is going to be difficult, but it is something I think we can do.

Mr. GOODLATTE. The CFTC has previously testified that you do continual oversight of market conduct. Have you stepped up that oversight and surveillance efforts in response to the increase in energy prices?

Mr. LUKKEN. Absolutely. More economists are now being devoted to the energy complex than ever before. We have developed software to allow better analytical tools when looking at the energy complex. The data we see is being analyzed differently and more in-depth by our economists, looking at different types of information that may interact into these markets. Our chief economist office is now doing more studies, primarily in the energy area, so that we know trends, understand price relationships better, understand the role of speculation volatility. And certainly, with energy, we should also mention our enforcement section because they are complementary to any of our regulatory functions, as well. We have taken significant steps to take enforcement actions; over 55 individuals and entities have been prosecuted over the last several years.

Mr. GOODLATTE. Let me interrupt you. You mentioned the types of evidence you look at. What kind of market anomaly would trigger greater oversight attention?

Mr. LUKKEN. Well, typically, an expiration month of a futures contract, it is a large position going into that with tight, deliverable supply. Also there are trading ranges, when prices are being set. If we see anomalies in trading activity, that will raise the eyebrows of our surveillance economists and we will look further into that, that type of an issue.

Mr. GOODLATTE. And have you found any evidence of manipulation in the trading of gasoline or oil contracts?

Mr. LUKKEN. Absolutely. We have taken several actions at any one time. Currently, in fact, we have over a hundred individuals and entities under investigation for attempting to manipulate the energy markets. Not all of those turn into an actual case, but we are turning over the rocks to make sure that manipulation is not occurring and if it does, we are ready to take real-time enforcement action against that.

Mr. GOODLATTE. Ms. Williams, your testimony describes how the CFTC conducts market oversight. Do you think that they do it effectively?

Ms. WILLIAMS. At this point, given that our work is ongoing in the area, we will be in a position, in our final report, to discuss CFTC's oversight program and get into greater detail exactly what they do in terms of oversight, surveillance and enforcement.

Mr. GOODLATTE. And Mr. Lukken, we have heard, in fact, you mention in your testimony the success that we have had with U.S. markets in trading futures, generally. How do these futures markets compete internationally with other markets and what could help or hinder that?

Mr. LUKKEN. Well, part of it is the success of the principles-based system that this Committee helped to implement. We need flexibility when going into other markets. Part of my charge, as Chairman of the Global Markets Advisory Committee, is to seek out markets overseas that our futures markets can enter into. Again, we are gaining on the world in this area, so that is important. But some of it is just making sure you understand regulatory frameworks around the world so that they are compatible, that we are engaged with the International Organization of Securities Commissions so that we are setting high global standards for regulation in these areas.

It is interesting because, 10 years ago, when we looked at whether to allow foreign competitors to come into the United States and compete with domestic exchanges, there was a lot of resistance from domestic exchanges to allow that to occur. When we recently reviewed this, they were in full support of allowing global competition because they knew that they were at a competitive advantage. They didn't want foreign markets to raise barriers for them getting into their marketplace. So the fear was if we raised our barriers that others would do the same and the right call was made, that competition, whether it is domestic or global, is important and really lets our markets grow.

Mr. GOODLATTE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank the gentleman. The gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman, and welcome, Mr. Lukken and Ms. Williams. I would like to talk a minute about these recent calls for additional regulation and it seems that these calls for more regulation of the over-the-counter markets have risen out of two specific situations, namely, Enron and the Amaranth situation. Let me first talk about the Enron situation, Mr. Lukken. Is there anyone operating, to your knowledge, under what is referred to as the "Enron Loophole" at this time?

Mr. LUKKEN. I am a little unclear of what the "Enron Loophole" is. It was discussed, actually, on Monday. There is some uncertainty of what people term the Enron Loophole. But I think what Enron was performing in 2000, in 2001, was a one-to-many market, where they were dealer and everybody was transacting with them as sort of the hub of the spoked wheel system. I am unaware, most of the trading has moved to a multi-lateral type system, which is like what exchanges currently perform where anybody can hit a bid or an offer in order to make a contract. So I am unaware of anybody performing a dealer-like market in energy similar to Enron was doing in 2000.

Mr. SCOTT. On that line, do you believe that you have the authority necessary to monitor the activities that brought about the Enron situation in an effort to prevent another Enron disaster from happening? Do you think that you have sufficient tools and authority to make sure that this kind of disaster does not happen again?

Mr. LUKKEN. Well, we have, in that area, broad fraud and manipulation authority to take action. In fact, against Enron we took action and over $35 million of civil monetary penalties. The markets, as they exist today, as we have talked about, ECMs, where most of this trading is occurring, we have limited authorities where we do see trading positions every day. We see where large traders might be, both on the regulated market and the ECMs. But as I mentioned, we are nearing the outer limits of that authority. That is something that is worthy of discussion.

Mr. SCOTT. A more recent situation with Amaranth presents some interesting situations. I am not so sure that that there was an attempt to have market manipulation, but rather, the situation at Amaranth might have been simply created by a fund manager who was not very good at his job and bet wrong. Am I off on that analysis?

Mr. LUKKEN. I think you point out correctly that market discipline worked in this area, especially, we are talking about more market surveillance issues today. But from a financial integrity side, Enron made the wrong decision. We like speculators in our markets because they provide liquidity to our markets and allow commercials to get in and out of the markets when they need to. However, Amaranth made the wrong decision and the market disciplined it in a brutal fashion.

Mr. SCOTT. Let me ask you this. Would additional regulation of the over-the-counter market have helped prevent this sort of situation with Amaranth?

Mr. LUKKEN. I think with Amaranth, a lot of this was occurring on the regulated exchanges. Prices were moving against them regardless of whether it was on-exchange or off-exchange. I think, by the time they did shift to ICE in the latter parts of August and September, that the market was already moving against them. It is still important to point out, that there was this shift which we weren't able to see at the time and now we see it. But I don't think it would've changed the Amaranth situation at all.

Mr. SCOTT. Would an additional regulation push investors to an even less regulated or transparent overseas market?

Mr. LUKKEN. Possibly.

Mr. SCOTT. And so in essence, it seems that if someone wants to act foolishly investing other people's money, there will always be a way to do so. No amount of regulation can prevent this.

Mr. LUKKEN. Absolutely.

Mr. SCOTT. Okay. Thank you, Mr. Chairman.

The CHAIRMAN. Thank the gentleman. The gentleman from Texas, Mr. Conaway, for 5 minutes.

Mr. CONAWAY. Thank you, Mr. Chairman. Mr. Lukken, you made a startling statement a second ago. What I heard was a startling statement that the crude oil and gasoline markets have been manipulated?

Mr. LUKKEN. Correct.

Mr. CONAWAY. There have been people who tried to manipulate it and you are looking into whether or not they——

Mr. LUKKEN. I have just been informed by my enforcement director that we have evidence of manipulation in these markets, but we are still building cases in this area.

Mr. CONAWAY. Okay.

Mr. LUKKEN. You know, this is a very legal and evidence intensive process and something that we are looking into.

Mr. CONAWAY. Okay. What is the average length of time it takes you to open a case and close a case on these manipulations?

Mr. LUKKEN. It is significant. If not months, years.

Mr. CONAWAY. And are there ways to shorten that time?

Mr. LUKKEN. Well, we have tried to through different methods, to make it more real-time, as I have said, to try to make sure that the crime and the punishment were more timely together. We try by devoting significant staff resources to certain cases that we find, our public policy interest, and other methods to try to move up those time-frames.

Mr. CONAWAY. But you do acknowledge a keen interest in shortening that length of time that those cases are open? I mean, that doesn't do anybody any good, particularly the markets, themselves. What is your relationship with the exchanges, themselves? Do you have an ongoing relationship with them? And how do you assess their self-disciplinary actions?

Mr. LUKKEN. We have a very close relationship with the exchanges and this is built over the 150 years of self-regulation that the exchanges have had in place. We check our surveillance economists, talk to exchanges daily about what they are seeing. A lot of our eyes and ears are the exchanges, themselves. We do duplicate certain things, such as the surveillance of the markets, themselves; also, trade practice abuses, whether traders are trading ahead of other traders with certain information, because that is very important to our mission. However, a lot of things we defer to the exchanges and talk to them on a regular basis.

Mr. CONAWAY. But you would characterize your relationship as generally positive and appropriate at this stage?

Mr. LUKKEN. Yes, and it has to be. We have to work hand-in-hand with the exchanges in order to police these markets.

Mr. CONAWAY. Okay. Ms. Williams, you used the phrase "some observers" and then you would follow that phrase by some negative information. Is that just open source information that you are conveying to this or "some observers," is that code for GAO?

Ms. WILLIAMS. No. We actually, as we have conducted our work in the area, we have talked to a broad cross-section of market observers. We have talked to investment banks, we have talked to energy companies, we have talked to various Federal regulators, academics, so it is a cross-section.

Mr. CONAWAY. All right. And then, I am assuming that you will follow up, in your report that is coming, within 3 to 6 months, as to your findings or your evaluation of the validity of those observations of these outsiders.

Ms. WILLIAMS. We hope to be able to speak to the trends and patterns that we have observed.

Mr. CONAWAY. All right. Back to Mr. Lukken again. Back to the enforcement. My background is with regulating CPAs and so you mentioned 55 cases that have actually gone completely through the process. Is that since 2000?

Mr. LUKKEN. I think it is since 2002, actually.

Mr. CONAWAY. 2002?

Mr. LUKKEN. Roughly, the time of the California energy crisis, when a lot of this was going on.

Mr. CONAWAY. Okay. Can you give us some sense, a little more detail? You said evidence of manipulation in the markets. Can you give us some sort of a range as to what the impact of that manipulation was that you are looking at?

Mr. LUKKEN. Well, this is 55 individuals and entities, so there may have been fewer——

Mr. CONAWAY. No, no. I am talking about the cases that are currently under investigation, the evidence of manipulation. Can you give us some sense of what impact, unproven at this point, but what impact it had on the markets dollar-wise? Did it move crude oil $10 a barrel? What did the manipulation do that you think happened?

Mr. LUKKEN. Well, the policy of the Commission is not to openly discuss, in public——

Mr. CONAWAY. No, I am not asking for any names.

Mr. LUKKEN. Right.

Mr. CONAWAY. We have a hundred cases out there. I don't know that anything you could tell us right now would link back to that hundred, but can you give us some sense of what the range of the impact on the market was for the manipulations that you are investigating?

Mr. LUKKEN. I will be honest. I am not aware of the ranges of some of these manipulations, but what I can do is I can certainly brief you privately with our enforcement director on what is going on and we can get into details of some of these investigations.

Mr. CONAWAY. Okay. That is fair. Thank you. I yield back.

The CHAIRMAN. I thank the gentleman. The gentleman from Georgia, Mr. Marshall, for 5 minutes.

Mr. MARSHALL. Thank you, Mr. Chairman. Ms. Williams, did you testify before the Senate the other day?

Ms. WILLIAMS. No.

Mr. MARSHALL. Okay. So are you familiar with the testimony that was given to the Senate?

Ms. WILLIAMS. Generally.

Mr. MARSHALL. Later this morning, Arthur Corbin, who is with the Municipal Gas Authority of Georgia, is going to be testifying and he will testify, and he has already testified, that he believes that gas consumers in Georgia were essentially, I don't know whether it would be defrauded or what, but essentially, they had to pay about an additional $18 million as a result of the Amaranth speculation. And what would be helpful, perhaps, to GAO, but certainly, to me and to many others, is if in the course of GAO completing its investigations into this entire area, you spoke specifically to Mr. Corbin and specifically took him to account what he believes occurred in Georgia.

Ms. WILLIAMS. Okay.

Mr. MARSHALL. And whether it is in your report or it is somewhere else, if you would specifically comment upon not only what happened, but also the suggested fixes that Mr. Corbin is offering so that this sort of thing does not happen again, if, in fact, something inappropriate did occur. The argument, effectively, is that somebody who has a legitimate need for natural gas, the Municipal Gas Authority of Georgia is just one of many, is almost a pawn sort of caught and tossed by these much larger forces that are speculating upon the future where natural gas is concerned.

And if you have one large, very large trader heading in a very bad direction, just making a big mistake, that big mistake made by that trader not only affects the trader, but it affects an awful lot of legitimate hedgers, entities that actually consume and actually take delivery as opposed to just playing the financial end of it. And so if you would specifically work with him, I would appreciate that.

Ms. WILLIAMS. Absolutely. We will contact him.

Mr. MARSHALL. Mr. Lukken, I guess, congratulations on your chairmanship. I will call you Mr. Chairman. The questions I had for you have already been asked by Mr. Moran and Mr. Goodlatte. I would like to elaborate a little bit, though, on the problem that you identified in your Senate testimony. I took it to be your view that perhaps some additional regulation should be considered, but that we should go slow in trying to figure out what that regulation might be and in response to Mr. Goodlatte, you specifically said, "We have to be very cautious and precise," and it is not just the Commission, it is also the lawmakers here.

And being cautious and precise requires that we understand the possible impacts, very sophisticated possible impacts, that any move that we make might have that could be detrimental to a wide range of individuals, including consumers. And you have already listed, for our benefit, in your testimony, in response to questions from Mr. Moran and Mr. Goodlatte, the various things that need to be taken into account. And I guess, as I listened to that and I think about our current status, it seems to me we ought not to be trying to do these things piecemeal, a little dabble here, a little dabble there, let us do something with energy over here with a little piece of legislation maybe in another Committee, *et cetera*. Maybe we ought to be trying to consider this as a whole cloth when we do CEA reauthorization.

And among the things we have to take into account is if we give you additional responsibilities or requirements, what your additional needs will be. What do you think? Should this be CEA reauthorization and all folded into that or should we be doing it piecemeal?

Mr. LUKKEN. I think that is logical, to try to do this as part of CEA reauthorization. This is the Committee of jurisdiction and expertise in this area. Many of you worked in 2000 on this bill and understand the participants, the players and the concerns of this industry, so I think that that would make perfect sense to try to do, along with GAO's recommendations. Certainly, the Commission, hopefully, if we have a full complement of Commissioners, can provide some expertise and views on this, as well, to make sure that we avoid these pitfalls in trying to find the right solution.

Mr. MARSHALL. I appreciate that. Back to Ms. Williams very briefly. In addition, could GAO, assuming that the Georgia Municipal Gas Authority and consumers in Georgia were specifically hurt by Amaranth, could you make suggestions for how to avoid that kind of thing in the future? I yield back.

The CHAIRMAN. I thank the gentleman. Let us see. Mr. Graves for 5 minutes.

Mr. GRAVES. Thank you, Mr. Chairman. I have to tell you, I appreciate you having this hearing. I just got a call. My daughter got a Reserve Grand Champion Marking Guild at the fair and I would much rather be there than here, but regardless, I do appreciate this hearing and I don't know if I have so much a question as a statement. Mr. Barrow and I introduced a bill last year and he has introduced it again this year, with me on there, that increased transparency considerably and oversight, and I hope you take a good close look at that.

Your lack of staff or shortage of staff is well noted and we understand that and you talk, too, about the prosecutions being up. The only thing that concerns me about that is once it gets to, at least the majority, to prosecutions, the impact on the market has already been felt. We would much rather see this prevented rather than it getting that far and that is the reason for the oversight and more surveillance, and that is what this bill specifically deals with. But I would very much like to keep moving in that direction and improve that considerably and I hope you will do that. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman yields back?

Mr. GRAVES. Yes.

The CHAIRMAN. I thank the gentleman. Mr. Boustany.

Mr. BOUSTANY. Thank you, Mr. Chairman. Ms. Williams, on page 12 of your testimony, you talk about, in addition to supply and demand factors that generally apply to energy commodities, specific developments can affect particular commodities, and you talk about special gasoline blends, the so-called boutique fuels. We all know that the presence of a number of boutique fuels does run up the cost because you have a segmented market and so forth. Can you talk a little bit about how does this complicate the work of the CFTC in terms of looking for price manipulation?

Ms. WILLIAMS. Well, I think the bottom line in our statement is that it complicates the analysis and it makes establishing causality unclear because in the futures market, as well as the physical market, you have a number of dynamics going on and you have a lot of changes going on in each marketplace, so it does complicate the analysis.

Mr. BOUSTANY. Thank you. Commissioner Lukken, do you want to comment on that?

Mr. LUKKEN. Well, traditionally, our job was much easier. There was number two corn, there was wheat, these products. But as these niche products have developed and the interconnectedness between those products has increased, it makes our surveillance economists' job much more difficult. They have to look at much more information, trying to find out where correlations might occur, so it is difficult. Technology helps. We are able to, hopefully,

bring some analytical tools, with computers, to help bring some of these issues to bear, but it is definitely a difficult job.

Mr. BOUSTANY. Thank you. Since we last had you before the Committee, we have seen the advent of ethanol futures. Can you give us some observations, any ongoing issues with your work with regard to monitoring ethanol futures?

Mr. LUKKEN. I think they were listed on the Chicago Board of Trade, was it a year and a half ago or so? Yes, it is not currently a very active contract on the Board of Trade, but I think the thinking is that if there is a product there for risk management, that those are involved in either the purchasing or production of ethanol, have a risk mitigation device in the futures markets that they can develop and be a part of. We think it is a product that maybe hasn't reached its day, but certainly will as ethanol production increases.

Mr. BOUSTANY. Thank you. Given that most oil transactions, I guess all oil transactions have been conducted in dollars, but Iran recently made the announcement that they were going to switch to Euros. Do you see this broadening on international markets and how will this complicate what you do?

Mr. LUKKEN. Well, there are Middle East futures exchanges now being developed. NYMEX is in partnership with the Dubai Mercantile Exchange and there is now a Middle East crude oil contract being traded there and these are all linked and cleared through the United States. So it is bringing money and dollars back into the United States as a result of that. So this again, as you noted earlier, makes our job more difficult because the more products, the more interconnectedness of these products, the more difficult it is to surveil them. But we have, hopefully, the analytical tools in place to keep an eye on these markets.

Mr. BOUSTANY. Thank you. Mr. Chairman, I yield back.

The CHAIRMAN. I thank the gentleman. Mr. Pomeroy for 5 minutes.

Mr. POMEROY. Pass.

The CHAIRMAN. Wow. Thank you. Mr. Neugebauer for 5 minutes.

Mr. NEUGEBAUER. Mr. Pomeroy's response has left me speechless, Mr. Chairman.

The CHAIRMAN. But he did not yield his 5 minutes to you.

Mr. NEUGEBAUER. I really just have one question, Mr. Lukken. Of the cases of manipulation that you are currently investigating, how many of those were brought to you by the exchanges themselves or are those cases you originated on your own?

Mr. LUKKEN. About 35 percent come from the exchanges or the ECMs and the rest are developed either on our own or from tips.

Mr. NEUGEBAUER. And since 100 is a good number to work with percentages on, so on cases where you have manipulation alleged or you open up a case on that, what would you say the percentage of cases that you close and say, "Well, in fact, after further investigation, there was no manipulation." What are the percentage of the cases where you said there was manipulation?

Mr. LUKKEN. I would say a majority we end up closing. I don't know percentage-wise what that might be, but it is significant. It is more than 50 percent that we don't have the evidence to prove that manipulation or attempted manipulation occurred.

Mr. NEUGEBAUER. And you may now have this number and you could get it to me, I would be interested to know of the, say, 30 percent of the cases that the exchanges bring you, what the closure rate is on that, also. I do have a second question. Are you in any way alarmed right now that there is not currently a system in place with the industry regulating itself? Obviously, they have a vested interest in protecting the integrity of their marketplaces or their exchanges because if it is perceived that on a certain exchange that there is not appropriate protection, would cause folks maybe not want to trade with that exchange, but are you concerned? Obviously, we would like to see nobody trying to manipulate markets and in many cases, 50 percent of the people really aren't, but it appears, because of their trading patterns, that they might be doing something, so are you concerned?

Mr. LUKKEN. Well, we do the best we can. Our mission is to detect and deter and try to prevent manipulations from ever occurring. Oftentimes our surveillance, itself, deters this from occurring. We talk people off the ledge and we call them up and ask them what are they doing. Why are you doing it. So oftentimes we never get to that hundred that I mentioned earlier.

But once they get to that, there is evidence that something occurred. We have to take strong enforcement action and look into it vigorously and that is the complement of trying to prevent it while also going after it once it does occur. And oftentimes, this is coming from things outside the marketplace, information or activities outside the marketplace that we weren't able to surveil. We have to go after that vigorously and we have done so, so I am very confident in our staff and what we are doing in this area.

Mr. NEUGEBAUER. That was a good answer, but that wasn't the question. The question was are you concerned, currently? I mean in other words, at the level of activity going on right now, do you see any trend that makes you believe that we are out of control, that we aren't policing the markets appropriately. Or do you think that there is adequate protection and transparency in the system today?

Mr. LUKKEN. I think we are adequately protecting the regulated futures marketplace, yes.

Mr. NEUGEBAUER. Thank you.

The CHAIRMAN. The gentleman yields back? I thank you. The gentleman from Georgia, Mr. Barrow, for 5 minutes.

Mr. BARROW. Thank you, Mr. Chairman. I want to thank you, Mr. Chairman, and the Ranking Member and all the other Members of this Committee for the courtesy you extended me today of allowing me to participate in your proceedings, knowing, as you do, of mine and Mr. Graves' keen interest in this subject. Thank you for your thoughtfulness.

The CHAIRMAN. With that, we would just remind you, we are not going to extend more than 5 minutes.

Mr. BARROW. I am not going to take more than 5 minutes. And I appreciate that reminder, too. I need that.

Mr. Commissioner, I just want to take the Amaranth situation as a starting point, just to make sure I understand at least part of what is going on here. Am I correct in understanding that they

had an over-the-counter position that was a whole lot bigger than their market position, their exchange position?

Mr. LUKKEN. Well, over time, Amaranth first began exchanging on NYMEX and had a position on NYMEX and that position, over time, shifted.

Mr. BARROW. My point is at the time of its collapse, their over-the-counter position was a whole lot bigger than their position in any regulated exchange?

Mr. LUKKEN. That is correct.

Mr. BARROW. And what kind of real-time notice did you all have of that?

Mr. LUKKEN. We were not aware of the shift to ICE at the time.

Mr. BARROW. Now, Mr. Graves and I are introducing a bill today which really doesn't do very much, but I would like your assessment of it. All it does is give you guys the direction to go out there and pass a rule that defines what a "large position trade" is or a "large position trader." It gives you all the discretion to say how big is enough to be reported and how small is small enough not to be reported. It gives you all the flexibility and the discretion to do that, but then it tells you to go forth and do that and imposes a record keeping requirement on folks.

Now, it seems to me just to be common sense that if folks who had been trading without your notice and occupying much larger positions in a completely unregulated marketplace, just to know that someone has the opportunity to know what their position is, if it is growing. But if someone obtains a legal right to demand a whole lot more than any existing supply, or any real world demand is, that someone is going to be able to notice that as it is going on. It seems to me that would deter a lot of misbehavior at the front end. What is wrong with that? Can't you all handle that?

Mr. LUKKEN. I think the concept that you mention of additional transparency in record keeping is a good one. Since Amaranth, we have started to receive additional data from ICE.

Mr. BARROW. And I want to commend the representatives of ICE, who will be testifying on the next panel, for their initiative in this. My point is, they are only dealing with the next level of lack of transparency outside the regulated exchange. Beyond that are the bilaterals and the folks who want any kind of regular exchange, regulated or otherwise. And my question to you is, is it important to know, since the game is now pretty much out there—isn't it important to know what kind of position folks have so we can monitor or at least measure the gap between the legal right to demand something and the real demand for the commodity?

Mr. LUKKEN. Obviously, we have identified a similar risk here with trying to get more information from ICE on the regulated exchanges. As I mentioned earlier, and I am not sure if you were here at the time, but by extending it more broadly to the over-the-counter market raises concerns about us only having jurisdiction over futures contracts and there had been, in 2000, this debate over swaps *versus* futures. By trying to pull them into our jurisdiction, that might have the reaction of sending these markets overseas or to London or anywhere where those markets can exist. And so I understand what you are trying to do to bring greater transparency and record keeping in this area. All I would ask is that

this Committee, when it considers these things, be precise, that there are difficult legal questions here. But we would certainly welcome, our staff would welcome, an opportunity to look at your legislation, give views on what might be necessary to improve it.

Mr. BARROW. If it would put you all in the driver's seat in deciding what has to be reported and what doesn't, can you handle that?

Mr. LUKKEN. Again, within our current legal authorities, yes. We are stretched to our legal bounds at the moment.

Mr. BARROW. Thank you, and thank you, Mr. Chairman. I yield back.

The CHAIRMAN. I thank the gentleman. Commissioner Lukken, Ms. Williams, thank you both for your testimony. We appreciate you being with us and my guess is, as this is ongoing, you will be together again in the not-too-distant future. Thank you.

Now we will welcome our second panel, if they get set up, *et cetera*. Just so Members will know and you will know, we are anticipating a vote somewhere around 11:30 plus. We are not real sure exactly what time, depending on the action on the floor. So hopefully, we will get through the opening statements before we have to take a break.

Okay, I think we got everybody seated. Thank you and we welcome the second panel to the table. Our first panelist is Dr. James Newsome, President and CEO of the New York Mercantile Exchange, New York. We welcome you here. And the next two I am going to ask Mr. Scott, if he will, to introduce those since they are from his home district in the State of Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman, and it certainly is a great pleasure to welcome a couple of very fine Georgians to this Committee; first of all, Mr. Jeff Sprecher, who is the Chairman and CEO of IntercontinentalExchange. Welcome and we are delighted to have you. And also, Mr. Arthur Corbin of the Municipal Gas Authority of Georgia. We are delighted to have you before this Committee and we look forward to your testimony and thank you for coming.

The CHAIRMAN. Thank you. Mr. Robert Pickel, Executive Director and CEO of the International Swaps and Derivatives Association of New York. Welcome. We are glad to have you. Mr. Paul Cicio, Industrial Energy Consumers of America in Washington. And Mr. Craig Eerkes, President of Sun Pacific Energy on behalf of the Petroleum Marketers Association of America. Thank you for coming and Dr. Newsome, please begin when you are ready. And please try to limit your testimony, as much as you can, to 5 minutes. Your testimony and your full statement will be included in the record. Thank you. Dr. Newsome.

STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT AND CEO, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY

Dr. NEWSOME. Thank you, Mr. Chairman and Members of the Committee. I am Jim Newsome and I have the honor of serving as President and the Chief Executive Officer of the New York Mercantile Exchange, which is the world's largest forum for trading, clearing physical commodity-based futures contracts, including both energy and metals. NYMEX is fully regulated by the CFTC under

the Commodity Exchange Act, both as a clearing organization and as a designated contract market, or DCM, which is the highest and most comprehensive of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

Mr. Chairman, I thank you and the Members of the Committee for the opportunity to participate in today's hearing on energy derivatives trading. Prior to joining NYMEX, I served as CFTC Chairman. Mr. Chairman, I led the CFTC's implementation of the Commodity Futures Modernization Act of 2000 and worked very closely with this Committee in doing so. I tend to agree completely with acting Chairman Lukken that the vast majority of the CFMA has been very, very successful.

The CFMA streamlined and modernized the regulatory structure of the derivatives industry and also permitted bilateral trading of energy on electronic platforms. Under CFTC rules, these electronic trading platforms are called ECMs, or exempt commercial markets, and are subject only to the CFTC's anti-fraud, anti-manipulation authority. Unlike the designated contract market, the ECM is exempted from some statutory CFTC regulation and also has no self-regulatory obligations to monitor its own markets.

A series of significant changes has occurred in the natural gas market since the passage of the CFMA, including advancements in trading technology, such that NYMEX, the regulated DCM, and the IntercontinentalExchange, ICE, an unregulated ECM, have become highly linked trading venues. As a result, which could not have been reasonably predicted just a few short years ago, the current statutory structure, in my opinion, no longer works for certain markets now operating as ECMs. Specifically, the regulatory disparity between NYMEX and ICE, which are functional equivalents, has created serious challenges for the CFTC, as well as for the NYMEX in its capacity as an SRO.

In August of 2006, NYMEX proactively took steps to maintain the integrity of its markets by ordering Amaranth to reduce its positions in the natural gas futures contract. However, Amaranth then increased its positions on the unregulated and non-transparent ICE electronic trading platform. Because the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive with each other, they are, in essence, components of a broader natural gas derivatives market. Therefore Amaranth's response to NYMEX's regulatory directive did not reduce Amaranth's overall market risk. Furthermore, the integrity of NYMEX markets continued to be affected by, and exposed, to Amaranth's positions in the natural gas market.

Finally, NYMEX had no means to monitor Amaranth's positions on ICE, or to take steps to have Amaranth reduce its participation on that trading venue. Based upon these experiences, I believe that ECMs such as ICE, that function more like a traditional exchange, and that trade products that are linked to an established exchange, should be subject to regulation of the CFTC. Consequently, legislative change may be necessary to address the real public interest concerns created by the current structure of the natural gas market and the potential for systemic risk.

Mr. Chairman, I would like to address two additional things that were brought out with the previous panel. One, there was quite a

bit of discussion about the special call authority and that is the authority that I used when I was Chairman of the CFTC. It is very effective authority, particularly from an enforcement standpoint, that allows the enforcement agency to collect information and to use that information to build an enforcement case. But the role of the Market Oversight Division of the CFTC is to prevent that manipulation or that systemic risk from occurring in the first place, and it is impossible to do so when you only collect information after the fact. So that was a point that I wanted to bring out.

The second point is with regard to the fear of flight to offshore markets. Certainly, that is a potential risk and it is a risk in a number of markets and situations that we talked about. But I think here today we are specifically talking about natural gas and the way that natural gas has evolved related to other markets. In natural gas, I think one of the things that is really different is the fact that even in the over-the-counter space, 90 percent of the natural gas markets are now cleared. They are cleared either at NYMEX or they are cleared on Jeff's exchange at ICE. Because of that you are aggregating that risk in an exchange type manner, but customers want to clear those contracts. So I think because of the high percentage of cleared contracts in natural gas, the fear of that offshore risk is much decreased as compared to other markets.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Newsome follows:]

PREPARED STATEMENT OF JAMES E. NEWSOME, PH.D., PRESIDENT AND CEO, NEW YORK MERCANTILE EXCHANGE, INC., NEW YORK, NY

Introduction

Mr. Chairman and Members of the Subcommittee, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. NYMEX has been in the business for more than 135 years and is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a "derivatives clearing organization" and as a "designated contract market" (DCM), which is the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

Prior to joining NYMEX, I served as a CFTC Commissioner and, subsequently, from 2001 to 2004, as the Chairman. As Chairman, I led the CFTC's implementation of the Commodity Futures Modernization Act of 2000 (CFMA). The CFMA streamlined and modernized the regulatory structure of the derivatives industry and provided legal certainty for over-the-counter (OTC) swap transactions by creating new exclusions and exemptions from substantive CFTC regulation for bilateral transactions between institutions and/or high net-worth participants in financial derivatives and exempt commodity derivatives, such as energy and metals.

On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the Members of the General Farm Commodities and Risk Management Subcommittee for the opportunity to participate in today's hearing on energy-related derivatives trading.

Statutory Background

In order to better understand the situation regarding energy-based derivatives, it is useful to review a bit of history leading up to the CFMA. For many years, the CFTC has had exclusive jurisdiction over the regulation of contracts for a commodity for future delivery, *i.e.,* futures contracts. Moreover, a longstanding requirement was that futures contracts could only be traded on a futures exchange that was directly regulated by the CFTC. A contract deemed by the CFTC to be a futures contract that was not executed on a regulated futures exchange was viewed as an illegal off-exchange transaction and would be subject to CFTC enforcement action. Additionally, there was legal uncertainly concerning the execution of swaps, includ-

ing energy swaps, on an electronic trading facility. During the 1990s, the OTC swap market began to increase substantially in size, and swap agreements began to be more standardized and strikingly similar to futures contracts. This transition created additional legal uncertainty around the trading of OTC swaps.

Because of the growing legal uncertainty regarding whether such products were or were not futures contracts, Congress directed the President's Working Group on Financial Markets (PWG) to conduct a study of OTC derivatives markets and to provide legislative recommendations to Congress. The PWG Report entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," was issued in 1999 and focused primarily on swap and other OTC derivatives transactions executed between eligible participants. Among other things, the PWG Report recommended exclusion from the Commodity Exchange Act (CEA) for swap transactions in financial products between eligible swap participants. However, the PWG Report explicitly noted that "[t]he exclusion should *not* extend to any swap agreement that involved a non-financial commodity with a finite supply." (Report of the PWG, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act" (November 1999) at p. 17.) The collective view at the CFTC at that time was that the jury was still out as to whether or not energy commodities were susceptible to manipulation and, therefore, energy commodities should not be excluded from the Act.

In December 2000, Congress enacted the CFMA, which is widely credited for the phenomenal growth and innovation of the futures industry. The CFMA provided greater legal certainty for derivatives executed in OTC markets; established a number of new statutory categories for trading facilities; and shifted away from a "one-size-fits-all" prescriptive approach to futures exchange regulation to a more flexible approach that included use of core principles for DCMs.

The Congress included provisions in the CFMA which exempted energy commodities from CFTC regulation and allowed the trading of energy swaps on an electronic trading platform. Under CFTC rules, these trading facilities are known as "Exempt Commercial Markets" (ECM). While transactions executed on an ECM generally are subject to anti-fraud and anti-manipulation authority, the ECM itself is essentially exempt from all substantive CFTC regulation and oversight and has no self-regulatory responsibilities.

NYMEX's Role and Responsibilities as a DCM

NYMEX is fully regulated by the CFTC as a DCM, which is the highest level of regulation for a trading platform under the CEA. As a DCM, NYMEX has an affirmative responsibility to act as a self-regulatory organization (SRO) and to monitor and to police activity in its own markets. The CFMA established a number of "Core Principles" for DCM regulation. The CFMA also permitted bilateral trading of energy on electronic platforms. Under CFTC rules, ECMs are subject only to the CFTC's anti-fraud and anti-manipulation authority. Unlike the DCM, the ECM is completely unregulated by the CFTC and thus has no self-regulatory obligations to monitor its own markets or otherwise to prevent market abuses. The IntercontinentalExchange (ICE) is an ECM.

As the benchmark for energy prices around the world, trading on NYMEX is transparent, open and competitive and fully regulated by the CFTC. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts and, being price neutral, does not influence price movement. Instead, NYMEX provides trading fora that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information. Transactions can also be executed off-Exchange, *i.e.,* in the traditional bilateral OTC arena, and submitted to NYMEX for clearing via the NYMEX ClearPort® Clearing website through procedures that will substitute or exchange a position in a regulated futures or options contract for the original OTC product.

Unlike securities markets, which serve an essential role in capital formation, organized derivatives venues such as NYMEX provide a very different, but equally important economic benefit to the public by serving two key functions: (1) competitive price discovery and (2) hedging by market participants.

The public benefits of commodity markets, including increased market efficiencies, price discovery and risk management, are enjoyed by the full range of entities operating in the U.S. economy, whether or not they trade directly in the futures markets. Everyone in our economy is a public beneficiary of vibrant, efficient commodity markets, from the U.S. Treasury, which saves substantially on its debt financing costs, to every food processor or farmer, every consumer and company that uses energy products for their daily transportation, heating and manufacturing needs, and anyone who relies on publicly available futures prices as an accurate benchmark.

Under the CFMA, NYMEX must comply with a number of broad, performance-based Core Principles applicable to DCMs that are fully subject to the CFTC's regulation and oversight. These include eight Core Principles that constitute initial designation criteria, as well as 18 other ongoing Core Principles for DCMs.

NYMEX has an affirmative obligation to act as a SRO. As such, NYMEX must police its own markets and maintain a program that establishes and enforces rules related to detecting and deterring abusive practices. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. A DCM can list for trading only those contracts that are not readily susceptible to manipulation. In addition, a DCM must monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability for a listed contract, where necessary or appropriate.

NYMEX has numerous surveillance tools that are used routinely to ensure fair and orderly trading on our markets. The large trader reporting system is the principal tool that is used by DCMs to monitor trading for purposes of ensuring market integrity. For energy contracts, the reportable position levels are distinct for each contract listed by the Exchange for trading. The levels are set by NYMEX and are specified by rule amendments that are submitted to the CFTC, typically following consultation and coordination with the CFTC staff.

The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing, among other things, on whether the futures markets are converging with the spot physical market as the NYMEX contract nears expiration. Large trader data are reviewed daily to monitor customer positions in the market. On a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff. These data are also published in aggregate form for public display by the CFTC on its website in a weekly report referenced as the Commitments of Traders (COT) report. Historically at NYMEX, the open interest data included in large trader reports reflects approximately 80% of total open interest in the applicable contracts.

Any questionable market activity results in an inquiry or formal investigation. NYMEX closely monitors its futures market at all times in order to enforce orderly trading and liquidations. NYMEX staff additionally increases its market surveillance reviews during periods of heightened price volatility.

By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on NYMEX. It is the tradition in futures markets that futures and options contracts generally are listed as a series of calendar contract months. When position accountability levels are exceeded, exchange staff conducts heightened review and inquiry, which may result in NYMEX staff directing the market participant to reduce its positions. Breaching the position limit can result in disciplinary action being taken by the Exchange. Finally, NYMEX also maintains a program that allows for certain market participants to apply for targeted exemptions from the position limits in place on expiring contracts. Such hedge exemptions are granted on a case-by-case basis following adequate demonstration of *bona fide* hedging activity involving the underlying physical cash commodity or involving related swap agreements.

Beyond the formal regulatory requirements, NYMEX staff works cooperatively and constructively with CFTC staff to assist them in carrying out their market surveillance responsibilities. NYMEX staff and CFTC staff regularly engage in the informal sharing of information about market developments. In addition to the Exchange's self-regulatory program, the CFTC conducts ongoing surveillance of NYMEX markets, including monitoring positions of large traders, deliverable supplies and contract expirations. The CFTC also conducts routine "rule enforcement" reviews of our self-regulatory programs. NYMEX consistently has been deemed by the CFTC to maintain adequate regulatory programs and oversight, in compliance with its self-regulatory obligations under the Commodity Exchange Act.

Moreover, NYMEX staff can and do make referrals to CFTC staff for possible investigation, such as with respect to activity by a market participant that is not a NYMEX member or member firm. Thus, for example, in an investigation of a non-member market participant, the Exchange would lack direct disciplinary jurisdiction and the consequent ability to issue effective sanctions (other than denial of future access to the trading of our products). In that situation, NYMEX staff could and has in the past turned over the work files and related information to CFTC staff. All

such referrals are made on a strictly confidential basis. Similarly, CFTC staff on occasion makes confidential referrals to NYMEX staff as well.

Overall, there is a strong overlap between the CFTC's regulatory mission and NYMEX's SRO role in ensuring the integrity of trading in NYMEX's contracts. NYMEX itself has a strong historic and ongoing commitment to its SRO responsibilities. As noted in the Report, the NYMEX regulatory program has a current annual budget of approximately $6.2 million, which reflects a significant commitment of both staff and technology.

Linked Trading Venues

At the time that the CFMA was being formulated in Congress, there may have been a notion that the public interest was not implicated by trading on markets such as ICE because larger market participants did not need a regulatory agency to protect them from trading with each other. Yet, what has become clear in the last several years is that the changing nature and role of ECM venues such as ICE do now trigger public interest concerns in several ways, including with respect to the multiple impacts on other trading venues that are regulated as well as through the exchange-like aggregation of financial risk.

A series of profound changes have occurred in the energy markets since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the unregulated ECM, ICE, have become highly linked trading venues. As a result of this phenomenon, which could not have been reasonably predicted only a few short years ago, the current statutory structure no longer works for certain markets now operating as ECMs. Specifically, the regulatory disparity between the NYMEX and the ICE, which are functionally equivalent, has created serious challenges for the CFTC as well as for NYMEX in its capacity as an SRO.

We do not believe that the case has been made and, thus, we do not support any new regulation of derivatives transactions that are individually negotiated and executed off-exchange *i.e.,* not on a trading facility, between eligible participants in the traditional bilateral OTC market. On the other hand, we do believe that ECMs such as ICE that function more like a traditional exchange and that are linked to an established exchange should be subject to the full regulation of the CFTC. In addition, the continuing exchange-like aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple effects for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change may be necessary to address the real public interest concerns created by the current structure of the natural gas market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

In 2001, when the CFTC was proposing and finalizing implementing regulations and interpretations for the CFMA, and shortly following the Enron meltdown in late 2001, the natural gas market continued to be largely focused upon open outcry trading executed on the regulated NYMEX trading venue. At that time, NYMEX offered electronic trading on an "after-hours" basis, which contributed only approximately 7–10% of overall trading volume at the Exchange. Electronic trading (of standardized products based upon NYMEX's natural gas contracts) was at best a modest proportion of the overall market. Moreover, it was more than 6 months following the Enron meltdown before the industry began to offer clearing services for OTC natural gas transactions.

In determining to compete with NYMEX, ICE copied all of the relevant product terms of NYMEX's core or flagship natural gas futures contract, and also misappropriated the NYMEX settlement price for daily and final settlement of its own contracts. ICE's misappropriation of NYMEX's intellectual property remains a matter of dispute in ongoing litigation between the two exchanges that is now under judicial appeal. However, as things stand today, natural gas market participants have the assurance that they can receive the benefits of obtaining NYMEX's settlement price, which is now the established industry pricing benchmark, by engaging in trading either on NYMEX or on ICE.

For some period of time following the launch of ICE as a market, ICE was the only trading platform that offered active electronic trading during daytime trading hours. In September 2006, NYMEX began providing "side-by-side" trading of its products—listing products for trading simultaneously on the trading floor and on the electronic screen. Since that time, there has been active daytime electronic trading of natural gas on both NYMEX and ICE. The share of electronic trading at NYMEX as a percentage of overall transaction volume has shifted dramatically to the extent that electronic trading now accounts for 80–85% of overall trading vol-

ume at the Exchange. The existence of daytime electronic trading on both NYMEX and ICE has fueled the growth of arbitrage trading between the two markets. Thus, for example, a number of market participants that specialize in arbitrage activity have established computer programs for electronic trading that automatically transmit orders to one market when there is an apparent price imbalance with the other market or where one market is perceived to offer a better price than the other market. As a result, there is now a relatively consistent and tight spread in the prices of the competing natural gas products. Hence, the two competing trading venues are now tightly linked and highly interactive and in essence are simply two components of a broader derivatives market. No one could have predicted in 2000, when the exemption was crafted for energy swaps, how this market would have evolved.

When the price of a product trading on one venue (ICE) is linked to the final settlement price of a product trading on another venue (NYMEX), trading on one venue contributes or influences the price of that product trading on the other venue. The CFTC acknowledged in its recent proposed rule-making that there is "a close relationship among transactions conducted on reporting markets and non-reporting transactions." (72 *Fed. Reg.* 34413, at 34414 (2007) (proposed June 22, 2007.) It is also relevant to consider the recent statement issued on June 14, 2007 by the Department of Justice (DOJ) Antitrust Division announcing the closure of its review of the proposed acquisition by Chicago Mercantile Exchange Holdings Inc. of CBOT Holdings Inc. based upon the DOJ's determination that neither that acquisition nor the clearing agreement between the two exchanges was likely to reduce competition substantially. NYMEX believes that this announcement is based upon a tacit recognition by the Antitrust Division that, with regard to analysis of the relevant market, at a minimum, regulated futures trading and over-the-counter trading are simply components of a broader market (that also might be defined to include some cash market activity as well).

In addition to the misappropriation of NYMEX's settlement price, the ICE market now has a significant market share of natural gas trading, and a number of observers have suggested that most of the natural gas trading in the ICE Henry Hub swap is subsequently cleared by the London Clearing House, the clearing organization contracted by ICE to provide clearing services. Thus, there is now a concentration of market activity and positions occurring on the ICE market as well as the exchange-like concentration and mutualization of financial risk at the clearing house level from that activity.

A clear illustration of the negative implications of unregulated ECMs linked to regulated DCMs can be seen in the demise of Amaranth, a hedge fund that actively traded natural gas on both NYMEX and ICE. In August 2006, NYMEX proactively took steps to maintain the integrity of its markets by ordering Amaranth to reduce its open positions in the Natural Gas futures contract. However, Amaranth then sharply increased its positions on the unregulated and nontransparent ICE electronic trading platform. Because the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive with each other and essentially are components of a broader natural gas derivatives market, Amaranth's response to NYMEX's regulatory directive admittedly reduced its positions on NYMEX but did not reduce Amaranth's overall market risk nor the risk of Amaranth's guaranteeing clearing member. Furthermore, the integrity of NYMEX markets continued to be affected by and exposed to Amaranth's outsize positions in the natural gas market. Moreover, NYMEX had no efficient means to monitor Amaranth's positions on ICE or to take steps to have Amaranth reduce its participation in that trading venue.

Because ICE price data are available only to market participants, NYMEX does not have the means to establish conclusively the extent to which trading of ICE natural gas swaps contributes to or influences or affects the price of the related natural gas contracts on NYMEX. However, what is clear is that, as a consequence of the extensive arbitrage activity between the two platforms and ICE's use of NYMEX's settlement price as well as other factors, the two natural gas trading venues are now tightly linked and highly interactive. These two trading venues serve the same economic functions and are now functionally equivalent to each other. NYMEX staff has been advised that, during most of the trading cycle of a listed futures contract month, there is a range of perhaps only five to twelve ticks separating the competing NYMEX and ICE products. (The NYMEX NG contract has a minimum price fluctuation or trading tick of $.001, or .01¢ per mmBtu.) NYMEX staff has also been advised by market participants who trade on both markets that a rise (fall) in price on one trading venue will be followed almost immediately by a rise (fall) in price on the other trading venue. This may occur because prices rise first on ICE and then follow on NYMEX, or because prices rise first on NYMEX and then follow on ICE. These observations of real-world market activity support the conclusion that

trading of ICE natural gas swaps do in fact contribute to, influence and affect the price of the related natural gas contracts on NYMEX.

Aside from a lawsuit brought by NYMEX against ICE for the use of NYMEX's settlement prices, which as noted is a matter that remains under appeal in a Federal court of appeals, NYMEX does not otherwise have any other ongoing formal relationship with ICE. In particular, as ICE and NYMEX are in competition with each other, there are currently no arrangements in place, such as information-sharing, to address market integrity issues. As stated previously, NYMEX as a DCM does have affirmative self-regulatory obligations; ICE as an ECM has no such duties. Yet, from a markets perspective, the ICE and NYMEX trading venues for natural gas are tightly linked and highly interactive; trading activity and price movement on one venue can quickly affect and influence price movement on the other venue.

In a recent report by the Senate Committee on Homeland Security and Government Affairs' Permanent Subcommittee on Investigations regarding "Excessive Speculation in the Natural Gas Market", the Subcommittee made a number of findings concerning the demise of Amaranth. Among other things, the Subcommittee report concluded that in August 2006 Amaranth traded natural gas contracts on ICE rather than on NYMEX so that it could trade without any restrictions on the size of its positions. The report also concluded that ICE and NYMEX affect each other's prices in natural gas trading. Furthermore, the report found that the CFTC lacked effective statutory authority to establish or enforce speculative position limits for the trading of natural gas on ICE or on other exempt commercial markets. The report then called for the CFTC to receive such additional authority.

The lack of effective position limits is of broader significance because the issue also arises with respect to energy products other than natural gas. Specifically, ICE Futures (a subsidiary of ICE and a foreign board of trade regulated by the UK Financial Services Authority) lists for trading a crude oil contract that replicates the terms of the NYMEX West Texas Intermediate Crude Oil (WTI) contract, including the daily and final settlement prices. ICE Futures has no direct regulatory relationship with the CFTC, and continues to rely on a "no action" letter that the CFTC issued to its predecessor back in 1998. ICE Futures now has a market share of approximately 40 percent of the WTI crude oil futures volume, but none of that volume is subject to U.S. regulation. Under the U.K. Financial Services Authority regulatory structure, trading of the WTI contract on ICE Futures is not subject to any position limit requirements. Thus, there is also a regulatory imbalance in crude oil trading that provides a clear incentive for market participants to shift trading in order to be able to trade without any effective restrictions on the size of their positions.

NYMEX Natural Gas Expiration Advisory

On February 16, 2007, in an effort to cooperate with the Federal Energy Regulatory Commission and following consultation with CFTC staff, NYMEX issued a compliance advisory in the form of a policy statement related to exemptions from position limits in NYMEX Natural Gas (NG) futures contracts NYMEX adopted this new policy on an interim basis in a good faith effort to carry out its self-regulatory responsibilities and to address on an individual exchange level the market reality demonstrated by Amaranth's trading on both regulated and unregulated markets. However, as detailed below, this experience has had an adverse impact on NYMEX's trading venues and is seemingly creating the result of shifting trading volume (during the critically important NG closing range period at NYMEX on the final day of trading) from our regulated trading venue to unregulated trading venues.

Pursuant to that advisory, NYMEX instituted new uniform verification procedures to document market participants' exposure justifying the use of an approved hedge exemption in the NG contract. These procedures apply to all market participants who carry positions above the standard expiration position limit of 1,000 contracts going into the final day of trading for the expiring contract. Specifically, prior to the market open of the last trading day of each expiration, NYMEX now requires all market participants with positions above the expiration position limit of 1,000 contracts to supply information on their complete trading "book" of all natural gas positions linked to the settlement price of the expiring NG contract. Positions in excess of 1,000 contracts must offset a demonstrated risk in the trading book, and the net exposure of the entire book must be no more than 1,000 contracts on the side of the market that could benefit by trading by that market participant during the closing range.

NYMEX has now experienced five expirations of a terminating contract month in the NG futures contract since this new compliance advisory went into effect. To date, only two market participants have participated in this advisory and supplied information to the Exchange on their complete trading book. By comparison,

NYMEX staff has observed a number of instances where market participants have reduced their positions before the open of the final day of trading rather than share sensitive trading information about proprietary trading with Exchange staff. As a result, NYMEX has observed reduced trading volume on the final day of trading in an expiring contract month relative to the final day of trading for the same calendar contract month in the prior year. The average volume on the final day of trading for the March, April, May, June and July 2007 NG contracts was 30,400 *versus* 37,122 for the corresponding contract month in the prior year, or an 18% reduction

Even more significantly, the closing range volume for the 30 minute closing period on the final day of trading is sharply lower than for volume during the final day closing range for the same calendar contract month in the prior year. In most instances, the volume in the closing range is less than half of the volume in the closing range for the same calendar contract month in the prior year. The average closing range volume on the final day of trading for the March, April, May, June and July 2007 NG contracts was 14,048 *versus* 23,165 for the corresponding contract month in the prior year, or a 39% reduction.

Overall market volatility in the natural gas market is somewhat lower this spring and summer than from comparable periods a year ago. This lower volatility stems from a lack of price volatility in the underlying physical cash commodity and in our opinion not from our implementation of this advisory. That stated, the lower volumes seen during the recent 30 minute closing ranges on the final day of trading since the implementation of the new policy actually create the potential for even greater volatility in the event of any significant market move. Thus, the new interim policy implemented by NYMEX on a good-faith basis has not only led to reduced volume on NYMEX during the critical 30 minute closing range period, which presumably has shifted to the unregulated trading venues, but has also failed to solve the structural imbalances brought to light by Amaranth's trading. In addition, this policy could create new problems by diminishing the vitality of the natural gas industry's pricing benchmark. Consequently, NYMEX believes that legislative change may be necessary and appropriate.

Conclusion

A series of profound changes have occurred in energy-related derivatives markets since the passage of the CFMA, including technological advances in trading, such that the regulated DCM, NYMEX, and the IntercontinentalExchange, an unregulated ECM, have become highly linked trading venues. As a result of this phenomenon, the regulatory disparity between NYMEX and ICE, which are functionally equivalent to each other, has created serious challenges for the CFTC as well as for NYMEX in its capacity as an SRO.

We do not support any new regulation of derivatives transactions that are individually negotiated and executed off-exchange between eligible participants in the traditional bilateral OTC market. On the other hand, we do believe that ECMs such as ICE that function more like a traditional exchange and that are linked to an established exchange should be subject to the full regulation of the CFTC. In addition, the aggregation and mutualization of risk at the clearinghouse level from trading on active ECMs such as ICE, where large positions are not monitored, raise concerns about spill-over or ripple implications for other clearing members and for various clearing organizations that share common clearing members. Consequently, legislative change may be necessary to address the real public interest concerns created by the current structure of the natural gas market and the potential for systemic financial risk from a market crisis involving significant activity occurring on the unregulated trading venue.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions Members of the Subcommittee may have.

The CHAIRMAN. Thank you, sir. Mr. Sprecher.

STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. SPRECHER. Thank you, Mr. Chairman, Subcommittee Members and staff members. My name is Jeff Sprecher and I am the Chairman/Chief Executive Officer of IntercontinentalExchange, which is also called ICE. We very much appreciate the opportunity to appear before you today to discuss the operations of ICE, and

to share with you our views on the regulation of the energy derivatives markets. ICE operates a leading global commodity marketplace comprising of both futures and over-the-counter markets across a wide variety of product classes, including agriculture and energy commodities, foreign exchange and equity indices.

ICE owns and operates two regulated futures exchanges. ICE Futures, which is a London-based energy futures exchange, and it is overseen by the UK Financial Services Authority, and we own the Board of Trade of the City of New York, which is an agricultural commodity and financial futures exchange regulated by the CFTC. ICE's electronic marketplace for OTC energy contracts is now serving customers in Asia, Europe and the U.S. and it is operated under the Commodity Exchange Act as a category of marketplace known as the ECM. As an ECM, these markets are subject to the jurisdiction of the CFTC and to regulations of the CFTC which impose record keeping, reporting and other requirements on us.

In addition, ICE has established an automated, daily position reporting system to the CFTC in our cleared natural gas markets, which we continue to work with them to enhance and support. ICE has always been, and we continue to be, a strong proponent of open and competitive markets in energy commodities and their related derivatives, and of regulatory oversight of these markets. As an operator of global futures and over-the-counter markets and as a publicly traded company, we strive to ensure the utmost confidence in the integrity of the markets and the soundness of our business mode. So to that end, we have consistently worked with the CFTC and regulatory agencies in the U.S. and abroad to make sure that they have access to all relevant information that is available to ICE regarding the trading activity in our markets. And we are going to continue to work with all relevant agencies in the future.

We strongly support legislative and regulatory changes that will enhance the quality of oversight and available information with respect to natural gas in the United States. For example, we are in favor of increases to the CFTC's budget and the enhancement of its access to trading information. However, we do not believe that a complete overhaul of the current regulatory structure is either warranted, or is it advisable. Moreover, any regulatory changes that are made need to reflect the nature of ICE and its markets and the significant differences that exist between the many venues for over-the-counter trading of swaps and derivatives that exist today.

We also believe that any consideration of possible changes to the current regulatory structure must be based on an understanding of the operations of an ECM market such as ICE and the balance that was struck by Congress and the CFTC between overseeing these markets, while still allowing them to function in the context of OTC trading by commercial and institutional participants. We welcome the opportunity to work with the Subcommittee and its staff on these important issues and thank you.

[The prepared statement of Mr. Sprecher follows:]

PREPARED STATEMENT OF JEFFREY C. SPRECHER, FOUNDER, CHAIRMAN, AND CEO, INTERCONTINENTALEXCHANGE, INC., ATLANTA, GA

Mr. Chairman, Subcommittee Members and Staff Members, my name is Jeff Sprecher and I am the Chairman and Chief Executive Officer of

IntercontinentalExchange, Inc., or "ICE." We very much appreciate the opportunity to appear before you today to discuss the operations of ICE and to share with you our views on the regulation of the energy derivatives markets.

ICE operates a leading global commodity marketplace, comprising both futures and over-the-counter ("OTC") markets, across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. ICE owns and operates two regulated futures exchanges—ICE Futures, a London-based energy futures exchange overseen by the U.K. Financial Services Authority, and the Board of Trade of the City of New York, or "NYBOT," an agricultural commodity and financial futures exchange regulated by the Commodity Futures Trading Commission ("CFTC"). ICE's electronic marketplace for OTC energy contracts serves customers in Asia, Europe and the U.S. and is operated under the Commodity Exchange Act ("CEA") as a category of marketplace known as an "exempt commercial market," or ECM. As an ECM, these markets are subject to the jurisdiction of the CFTC and to regulations of the CFTC imposing record keeping, reporting and other requirements. In addition, and as I will discuss later, ICE has established a daily position reporting program to the CFTC in its cleared natural gas markets that we continue to enhance and support.

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and related derivatives, and of regulatory oversight of those markets. As an operator of global futures and OTC markets and as a publicly-held company, we strive to ensure the utmost confidence in the integrity of our markets and in the soundness of our business model. To that end, we have continuously worked with the CFTC and other regulatory agencies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets and we will continue to work with all relevant agencies in the future. ICE strongly supports legislative and regulatory changes that will enhance the quality of oversight and available information with respect to the natural gas markets. For example, we are in favor of increases to the CFTC's budget and the enhancement of its access to trading information.

However, we do not believe that a complete overhaul of the current regulatory structure is either warranted or advisable. Moreover, any legislative or regulatory changes that are made need to reflect the nature of ICE and its markets and the significant differences between ICE and the many other venues for OTC trading that exist today. In particular, as I will discuss, while the New York Mercantile Exchange ("NYMEX") natural gas futures contract is subject to position limits in the last 3 days of trading, such limits are neither appropriate nor necessary in connection with ICE's OTC natural gas swap. Indeed, the NYMEX natural gas swap, like ICE's contract, is not subject to position limits. We also believe that any consideration of possible changes to the current regulatory structure must be based upon an understanding of the operations of "exempt commercial markets," such as ICE, and of the balance struck by Congress and the CFTC between overseeing these markets while still allowing them to function in the context of OTC trading by commercial and institutional participants. We welcome the opportunity to work with the Subcommittee and its staff on these important issues.

ICE Operates Its Over-the-Counter Platform as an ECM and Is Not "Unregulated"

Broadly, because OTC markets tend to be global in nature, most OTC markets are now conducted electronically across asset classes, including OTC markets for U.S. interest rate instruments, foreign exchange and debt securities. ICE responded to the transparency and speed enjoyed in other OTC markets by establishing its many-to-many electronic marketplace for trading physical energy commodities and financially-settled over-the-counter derivatives, primarily swaps, on energy commodities. ICE in effect performs the same function as a "voice broker" in the OTC market, but does so through an electronic platform that provides full market transparency to market participants, timely market information, greater speed of trade execution, record keeping efficiency and a more reliable and complete audit trail with respect to orders entered, and transactions executed, on our platform than exists with respect to traditional, non-electronic OTC venues. The introduction and development of ICE's platform have promoted competition and innovation in the energy derivatives market, to the benefit of all market participants and consumers generally. The reliability of ICE's markets has also resulted in an increasing preference for electronic trading in these markets. NYMEX itself, in its recent testimony before the Senate Permanent Subcommittee on Investigations (the "Senate PSI"), noted that 80–85% of its volume is now traded electronically, a development driven largely by competition from ICE. The CFTC also pointed out, in its Senate PSI testimony, that "the ability to manipulate prices on either [NYMEX or ICE] has likely

been reduced, given that ICE has broadened participation in contracts for natural gas."

Participants on ICE enter bids and offers electronically and are matched in accordance with an algorithm that executes transactions on the basis of time and price priority. Participants executing a transaction on our platform may settle the transaction in one of two ways—on a bilateral basis, settling the transaction directly between the two parties, or on a cleared basis through LCH.Clearnet using the services of a futures commission merchant that is a member of LCH.Clearnet. In addition to providing the clearing house with daily settlement prices, ICE is also responsible for maintaining data connectivity to the clearing house.

It is important to note that there are substantial differences between ICE's OTC market, other portions of the OTC market, and the NYMEX futures market, and that these differences necessarily inform and guide the appropriate level of oversight and regulation of our markets. First, ICE is only one of many global venues on which market participants can execute OTC trades. A significant portion of OTC trading in natural gas is executed through voice brokers or direct bilateral negotiation between market counterparties. Of the available fora, only ICE (and any other similarly-situated ECMs) is subject to CFTC jurisdiction and the CFTC's regulations, or to limitations on the nature of its participants. ICE also provides far greater transparency, efficiency and data reliability for the benefit of market participants and regulators alike than voice brokers or other OTC market mechanisms. Second, participants in the futures markets must either become members of the relevant exchange or trade through a futures commission merchant that is a member. In contrast, ICE's OTC market, by law, is a "principals only" market in which participants must have trades executed in their own names on the system, providing greater transparency with respect to trader-level transaction data due to the absence of a "middle man." Third, the OTC market offers a substantially wider range of products than the futures markets, including, for example, hundreds of derivatives contracts on natural gas and pricing against a large number of delivery points, of which there are approximately 100 in North America.

Fourth, the financially-settled swaps traded on ICE's OTC market require one party to pay to the other a cash amount determined by reference to settlement prices in the corresponding futures contracts but do not, and cannot, result in the physical delivery or transfer of energy commodities. Our natural gas contract, for example, constitutes an important commercial hedging vehicle and has served as an important complement to and a hedge for the NYMEX natural gas futures contract. However, our contract cannot affect physical delivery in the market and it therefore ultimately has limited ability to drive the pricing of natural gas, particularly as the relevant futures contract approaches delivery. An understanding of the differences between the NYMEX and ICE markets and contracts is critical to any determination of the appropriate regulation of these markets, as I will explain more fully later.

ICE operates its OTC platform as an "exempt commercial market," or "ECM," under the CEA. The ECM category was adopted as part of the Commodity Futures Modernization Act of 2000 ("CFMA"). The creation of the ECM category reflected Congress's recognition that "electronic voice brokers," such as ICE, occupy a middle ground between completely unregulated OTC brokers and market participants and fully regulated exchanges. Congress therefore sought to strike a balance between providing for oversight and regulation of these electronic markets, due to the more extensive participation in their markets by commercial and institutional entities, while still allowing them to function as OTC markets, which hold a vital place in commodity market structure, rather than as futures markets, which would alter their role as a hedging mechanism. The ECM category accomplished this objective. Pursuant to the CFMA, an electronic market can operate as an ECM if it limits its participants to "eligible commercial entities," or "ECEs." Transactions and participants on ECMs are fully subject to the anti-fraud and anti-manipulation provisions of the CEA and the CFTC has jurisdiction over such transactions and participants.

As an ECM, ICE is itself subject to a certain level of regulation by the CFTC. In particular, ICE is required, pursuant to the CEA and CFTC regulations specifically addressed to ECMs, to:

- prepare and maintain for 5 years records of all transactions executed on its markets;
- report to the CFTC certain information regarding transactions in products that are subject to the CFTC's jurisdiction and that meet specified trading volume levels;

- report to the CFTC certain trader information on the execution of transactions in ICE's cleared natural gas market, pursuant to a special call for information from the CFTC;
- record and report to the CFTC complaints of alleged fraud or manipulative trading activity related to certain of ICE's products; and
- if it is determined by the CFTC that any of ICE's markets for products that are subject to CFTC jurisdiction serve a significant price discovery function (that is, they are a source for determining the best price available in the market for a particular contract at any given moment), publicly disseminate certain market and pricing information free of charge on a daily basis.

The information that ICE reports to the CFTC on a daily basis regarding natural gas contract positions for transactions executed on our platform is particularly instructive. This information is being provided pursuant to a special call from the CFTC for this data, which illustrates the CFTC's statutory and regulatory authority to obtain available information regarding transactions executed on ICE. It also illustrates ICE's commitment to ensuring that the CFTC has access to the information it needs, to the extent available to ICE, to conduct appropriate market surveillance or to take appropriate actions. ICE has worked extensively with the CFTC, and has expended substantial resources, to develop and provide position reporting information to the CFTC notwithstanding the fact that ICE does not have this information readily available due to the fact that, unlike NYMEX, it is not the party that actually clears such transactions (this is done by LCH.Clearnet). This information can be used by the CFTC alongside the information that NYMEX provides for a more comprehensive, but not complete, view of the market. The fact that ICE does not itself clear transactions executed on its platform, and does not control the clearing house through which transactions are cleared, means that there are certain limitations on the position information that ICE can provide in that positions can be moved within a clearing house. In addition, the fact that ICE represents only a small portion of the much larger OTC marketplace means that the CFTC's view will necessarily be incomplete. However, we will continue to work with the CFTC to enhance the nature and quality of the information that we provide and we are committed to furnishing any information needed by the CFTC that is available to ICE.

The CFTC and NYMEX Have Access to Information Regarding Trading on ICE

As noted above, the CFTC has the authority to make special calls to ICE for any information that it requires, and the CFTC has in fact exercised this authority to require additional information from ICE both before and since the events related to Amaranth in 2006. In addition, the CFTC recently proposed amendments to its regulations clarifying its existing requirement that large traders on DCMs maintain books and records of their transactions and to make such books and records available to the CFTC. In proposing these amendments, the CFTC noted that "The Act [the CEA] provides ample authority to require keeping books and records and providing pertinent information with respect to non-reporting transactions [i.e., those not executed on a futures exchange]." 72 *Fed. Reg.* 34413 (June 22, 2007). It also pointed out that the CFTC previously interpreted its rules "to include position and transaction data for non-reporting transactions" and that it "has received such information in response to requests made pursuant to the Regulation." While the CFTC believed it appropriate to clarify the obligations of participants in the futures markets, therefore, it also made it clear that the CFTC currently has the power to obtain the information.

In a recent speech, CFTC Commissioner Walter Lukken noted that:

> ICE is prominent in the trading of natural gas swaps that are pegged to regulated NYMEX futures contracts. This competition has led to significant innovation over the last several years both in the OTC and regulated marketplaces. From a risk perspective, this competition raises the possibility that traders could take positions on one market in order to profit off positions on the other. To address this concern, the CFTC has recently utilized its authorit[y] to request information from ICE regarding trader position data for these pegged contracts on an ongoing basis similar to what we receive from large traders on regulated exchanges. This has allowed our surveillance staff a more comprehensive view of this marketplace. These tailored actions developed from risk considerations—primarily protecting the financial integrity of the *regulated* marketplace and the price discovery process for energy products.
>
> Speech by Commissioner Walter Lukken, May 3, 2007.

As a self-regulatory organization, or "SRO," NYMEX similarly has the power under its rules to request information from its members regarding their trading on other markets, including ICE, and to compel its members to produce such information, in connection with assessing positions held in its portfolio. Specifically, even prior to the events related to Amaranth, NYMEX rules required its members to disclose to NYMEX, upon its request, their trading strategies, including those on other markets, in connection with positions exceeding NYMEX accountability levels. Moreover, if NYMEX believes that its current rules are inadequate to permit it to view members' positions on other markets, including ICE, it clearly has the power to amend its rules or adopt new rules to compel members to provide this information. NYMEX, in its testimony before the Senate PSI, noted that it now requires its members to provide information about their trading on other markets under certain circumstances. The CFTC noted in its testimony that it has been receiving daily position reports from the CFTC "on an ongoing basis." These statements reflect the authority of NYMEX and the CFTC under current law to obtain the relevant information. To the extent that they require additional information about trading on ICE, it is clear that they are able similarly to obtain that information as well.

Position Limits or Accountability Requirements on ICE's Markets Are Not Necessary and Are Inappropriate

Because of the fundamental and important differences between ICE's OTC market and NYMEX's futures market, we do not believe that the type of position limits applied to NYMEX's futures contract are necessary or appropriate in the context of trading on ICE. ICE's natural gas swap, as noted, is a cash-settled contract, with settlement priced *against* the physical NYMEX natural gas futures contract. The CFTC itself has acknowledged that there is less of a need for market surveillance in connection with cash settled contracts. Specifically, the CFTC has stated that "[t]he size of a trader's position at the expiration of a *cash-settled* futures contract cannot affect the price of that contract because the trader cannot demand or make delivery of the underlying commodity. The surveillance emphasis in cash-settled contracts, therefore, focuses on the integrity of the cash price series used to settle the futures contract." (CFTC website, *www.cftc.gov/opa/backgrounder/opasurveill.htm*; emphasis added.) For this reason, the ICE cash-settled swap—*like the NYMEX cash-settled swap*—is not subject to position limits.

As previously stated, NYMEX offers a cash-settled natural gas swap, through its "Clearport" facility. Because the NYMEX swap is cash-settled, there are no position limits on this contract, which is subject only to position accountability. As an article in "The Desk" recently reported, "NYMEX puts limits on NG [the natural gas futures contract] but not NN [the cash-settled natural gas swap]. NN has no limits. The [June 25 Senate PSI] Report never mentions this. Yet for some reason, financial contracts on ICE should be limited. Where is the logic there? NYMEX lifted the NN limits earlier in the year and clamped down on NG, which is the true pricing mechanism. NN reporting is still there but not the limits. It was a brilliant and appropriate maneuver." The Desk, June 29, 2007. We believe that there are compelling reasons for different treatment of the NYMEX natural gas futures contract and ICE's cash-settled swap; there is no clear reason whatsoever to treat the ICE contract differently from NYMEX's identical cash-settled swap. If Congress seeks to implement a "level playing field," it should be between substantively similar contracts and, if ICE's natural gas swap is to be compared to any other product, it should be the NYMEX natural gas swap and all other OTC swaps offered by voice brokers, not the NYMEX futures contract. Otherwise, the impact would be commercially-oriented rulemaking that codifies preference for one venue despite identical products and reporting structures.

Moreover, we note that NYMEX (not the CFTC) imposes *position limits* on its physical natural gas futures contract **only during the final 3 days of trading** in its natural gas futures contract and, at all other times, requires only accountability reports from certain participants. In addition, during the events related to Amaranth's trading, NYMEX took no action over the course of several months as Amaranth consistently exceeded its accountability levels; in fact, NYMEX increased the limits applicable to Amaranth, apparently based solely on Amaranth's unsubstantiated requests and without seeking information about Amaranth's trading on ICE or other markets, despite its ability to request and obtain such information from market participants.

As noted previously, ICE currently provides the CFTC with reports of all transactions executed by participants in its Henry Hub cleared natural gas swaps, pursuant to a special call from the CFTC issued after the trading losses experienced by Amaranth. Because ICE is a principals-only market, this information is provided at the trader level and therefore gives the CFTC information on the activity of partici-

pants in our markets and facilitates the ability of the CFTC to take appropriate action in connection with potentially problematic or illegal conduct. Further, the CFTC has ample authority under current law to require ICE to obtain or provide to the CFTC additional information regarding its participants' trading activities if the CFTC believes such action to be necessary or appropriate.

The balance created under the CFMA was designed to allow ECMs to function effectively in the OTC market while providing the CFTC with ample authority to oversee their activities and trading by their participants. ECMs like ICE operate in an environment that is qualitatively distinct in a number of fundamental respects from that of the futures markets, despite the surface similarities. Congress and the CFTC recognized these distinctions and have sought to create a regulatory environment that allows OTC markets to perform their important role in the markets while still ensuring market integrity and the protection of participants, as well as using technology, transparency and innovation to promote the advancement of these goals. The judgments made by Congress and the CFTC are fair, appropriate and effective and have promoted competition and transparency in the OTC markets and in the broader derivative markets as well. Indeed, the development of markets, such as ICE, has benefited users of the energy markets by tightening market spreads centralizing liquidity and attracting participants by bringing more transparency to the markets. This evolution has also forced member-dominated exchanges, such as NYMEX, to overcome their traditional hostility to electronic trading and preference for floor-based markets to provide a more efficient, accessible and transparent means of trading to end-users of the markets. As Senator Coleman noted in his statement in the Hearings on the Senate Permanent Subcommittee Report, "If we extend CFTC oversight and regulation to electronic, over-the-counter exchanges, we must avoid unintended consequences. These exchanges have brought vital liquidity and increased transparency to our energy markets. Therefore, we cannot create incentives for traders to shift their business from over-the-counter electronic exchanges like ICE, to far less transparent and unregulated markets."

ICE Supports Legislative and Regulatory Changes

Notwithstanding the issues raised above, we believe that there are a number of steps that Congress and the CFTC can take that will result in further enhancements to the current regulatory structure. First, we believe that the funding of the CFTC should be increased and its staffing and resources significantly expanded. The CFTC is obviously a critical component in the system of market controls and oversight and its role is critical in ensuring the continued integrity of all markets within its jurisdiction. With the growth of these markets and the introduction of new types of market participants, it is essential that the CFTC have the tools it needs to oversee the markets and to perform its vital functions. In addition, we fully endorse enhancements to the quality and quantity of information currently available to the CFTC and, in particular, its ability to integrate data from ICE and NYMEX.

We understand the surface appeal of the so-called "level playing field" argument for treating and regulating ICE and NYMEX's futures market similarly. However, these markets are fundamentally different in significant respects, and any regulatory approach must take those differences into account. Also, this argument ignores the much larger OTC market outside of both ICE and NYMEX. Indeed, as we have noted, if there is a comparison between ICE and NYMEX products to be made, it is the comparison between ICE's OTC market and NYMEX's cash-settled swap, not its futures market. While we support the maintenance of a "level playing field," we do not believe that this can or should result in regulating cash-settled OTC contracts in the same manner as physically-settled futures contracts because they are fundamentally different products.

Thank you for the opportunity to share our views with you on these important issues. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you, sir. Mr. Pickel.

STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, NEW YORK, NY

Mr. PICKEL. Thank you, Mr. Chairman and Members of the Committee. I very much appreciate the opportunity to have ISDA testify this morning. The work which this Committee has done in the past and which it continues to do today plays a critical role in creating active markets for risk management. ISDA represents par-

ticipants in the privately negotiated derivatives industry. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

Energy derivatives are used by a wide range of market participants, including energy companies, financial institutions such as banks and hedge funds, and traditional end-users of energy. The motivations of these market participants differ and can include those looking to hedge price risk, as well as those looking to take a view on, or speculate on, the movement of energy prices. The growth of these markets has coincided with volatility in energy prices, leading some to question whether the growth in derivatives markets and the influx of new market participants has led to this volatility. Even more sinister, some have alleged that volatility is the result of attempts to manipulate the prices of energy commodities.

Fortunately, there is little evidence that markets of energy commodities are subject to widespread manipulation. As noted by the Bank for International Settlements, in a recent quarterly update, several recent studies which explore the relationship between investor activity and commodity prices indicate that price changes have led to change in investor interest rather than the other way around. The BIS cites studies conducted by the CFTC and the International Monetary Fund. In addition to these studies, the Government Accountability Office, the Federal Trade Commission, the Department of Energy and numerous academics likewise have examined the question of whether manipulation of energy prices exists and is having an adverse effect on consumers.

All have reached the same conclusion. Energy prices are caused by the external forces of supply and demand influenced by factors such as refinery capacity and hurricane activity, and not by the derivatives markets. Both exchange traded and privately negotiated derivatives contribute to more stable and more efficient commodity markets.

The CFMA greatly increased American competitiveness in both the exchange traded and OTC derivatives industries. For futures exchanges, the law created a principles-based regulatory regime that greatly increased the flexibility and efficiency of those markets. For OTC derivatives, the law removed legal uncertainty, protected the right of sophisticated counterparties to engage in individually negotiated swap transactions, and retained anti-fraud and anti-manipulation authority over the OTC commodity markets.

OTC derivatives remain subject to a broad range of regulation. OTC market participants, themselves, such as commercial banks and broker/dealers are subject to regulation by their respective regulators. In addition to the regulations of the counterparties, themselves, certain OTC energy derivative transactions are subject to CFTC oversight.

Oversight of the energy markets in the United States is thorough and effective. Enforcement efforts by Federal regulators have been very successful in detecting, deterring and punishing misbehavior. The CFTC has brought numerous actions against defendants accused of wrongdoing in the energy markets. Among ISDA member firms, there is no doubt that there is strong oversight of these markets. They report regular visits and requests for information from

Federal regulatory officials as part of the routine operation of their businesses.

Almost immediately after Congress passed the CFMA, there were calls in some quarters to repeal parts of that law. Fortunately, Congress has time and again rejected efforts to repeal the balance between legal certainty for sophisticated institutional market participants and the need for Federal oversight provided by the CFMA. For the most part, calls to revisit the CFMA rest upon claims of a lack of transparency in the markets, as well as suggestions of impropriety. However, as I described before, there are no studies which demonstrate a cause and effect relationship between activities in the derivatives markets and consumer energy prices.

More to the point, as the members of the President's working group have repeatedly noted, there is no change in Federal law as applied to derivatives that could alleviate the volatility in energy prices which have existed over the last several years. Energy prices respond to a variety of supply and demand factors which have in recent years been aggravated by events such as: active hurricane seasons; lack of refinery capacity; unusual weather patterns; and military and political crises in major oil producing regions.

Changing the CFMA will not address those factors nor will it do anything to alleviate consumer concerns about high energy prices. You can't amend the law of supply and demand. Instead, amending the legal certainty for OTC energy derivatives provisions of the CEA will serve only to make business less attractive in the United States. As acting Chairman Lukken noted, American competitiveness in the financial service arena is under assault from foreign markets which are eager to attract lucrative U.S. financial services activity. There is simply no reason that energy transactions which do not call for the actual physical delivery of a commodity need be done in the United States. Therefore Congress should tread carefully if considering legislation in this area.

Mr. Chairman and Members of the Committee, thank you very much for your time today. This is an important issue and leadership which this Committee has shown on this topic over the last several years has greatly improved the legal and regulatory environment in the United States. Going forward, we are confident that you will continue to play a leading role in promoting the healthy growth of these markets. Thank you again and I would be privileged to answer any questions that you may have.

[The prepared statement of Mr. Pickel follows:]

PREPARED STATEMENT OF ROBERT G. PICKEL, EXECUTIVE DIRECTOR AND CEO, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, NEW YORK, NY

Mr. Chairman and Members of the Committee:

Thank you very much for inviting ISDA to testify this morning. The work which this Committee has done in the past, and which it continues to do today, plays a critical role in creating healthy, active markets for risk management. Thank you very much for your leadership in this important area.

About ISDA

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the busi-

nesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

Overview of Derivatives

Derivatives are critical risk management tools which allow producers and end-users of commodities to hedge the risk of adverse price movements. In the most basic type of derivative, an option, the option writer will sell to the buyer the right (but not the obligation) to purchase or sell a fixed quantity of a good, at a fixed price, in some future period. Options provide the basic building block of derivatives, and other types of derivatives can be seen as a combination of options. For instance, a long futures contract can be seen as the purchase of an option to purchase a commodity combined with the simultaneous sale of an option to sell that same commodity. Futures contracts are traded on organized exchanges regulated in the United States by the Commodity Futures Trading Commission. Privately negotiated derivatives, such as swap agreements, are a type of derivative subject to negotiation between the parties as to the fundamental material economic terms of the transaction. Privately negotiated derivatives differ from exchange traded futures contracts in that they are not fungible nor by their terms subject to offset through the purchase of a contract with the opposite characteristics (e.g., a counterparty cannot cancel out its contractual obligations under a swap agreement to sell a fixed interest rate by simply purchasing a swap agreement to buy the same fixed rate). Another important differentiation is that OTC derivatives are typically transacted between counterparties that meet certain standards for wealth and sophistication.

Derivatives play an important role in allowing businesses to manage risks unrelated to their core business. No doubt you are familiar with how a family farm might sell December corn futures to hedge its risk of a glut in the corn market, thus locking in today a corn price which will allow it to remain in business in the future. Likewise, America's largest corporations use this same strategy to manage the risk of adverse movements in foreign exchange rates, interest rates, credit prices, property values and virtually any other threat one can imagine.

> *Southwest, the only major U.S. airline to remain profitable since the Sept. 11, 2001, terrorist attacks, attracts customers with low fares. That profit allows the company to buy hedges locking in prices on a portion of its fuel needs four years in advance, saving it $155 million in the quarter. Southwest paid 38 percent less than the market price for jet fuel in the quarter Mary Schlangenstein Washington Post,* Friday, April 15, 2005; Page E05

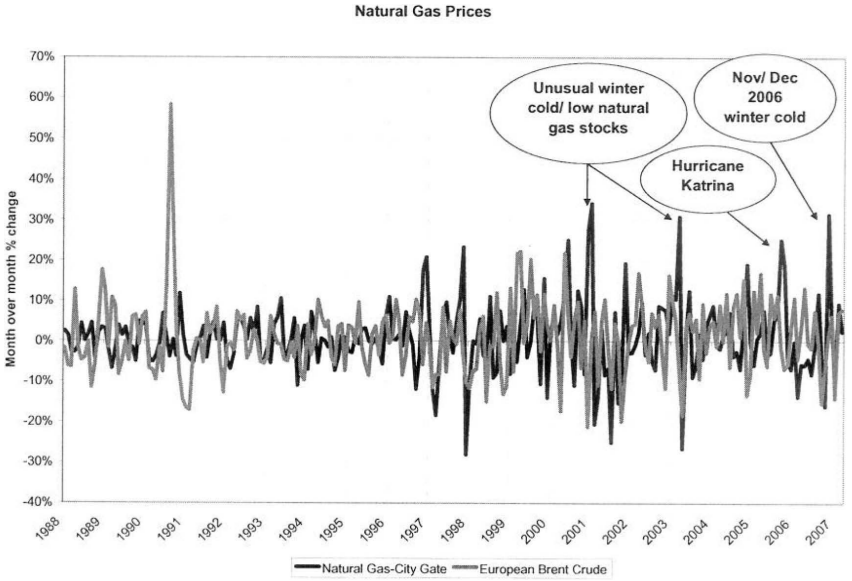
Overview of the Energy Markets

Energy derivatives are used by a wide range of market participants including energy companies, financial institutions such as banks and hedge funds, and traditional end-users of energy. The motivations of these market participants differ, and can include those looking to hedge price risk as well as those looking to take a view on, or speculate, on the movement of energy prices. Indeed, in some cases an entity will play both roles, having positions designed to hedge the price risk associated with its use of the physical commodity while at the same time holding positions speculating on the movement of future prices. Hedging and speculation play a symbiotic role in the functioning of a market, hedging because it enables risks to be distributed optimally among market participants, and speculation because it increases liquidity and increases the alternatives available to those seeking to hedge their risks.

Allegations of Market Manipulation

The growth of these markets has coincided with volatility in energy prices, leading some to question whether the growth in derivatives markets and the influx of

new market participants has led to this volatility. Even more sinister, some have alleged that volatility is the result of attempts to manipulate the prices of energy commodities. For instance, on June 25, 2007 the Senate Permanent Subcommittee on Investigations claimed that "excessive speculation distorts prices, increases volatility, and increases costs and risks for natural gas consumers, such as utilities, who ultimately pass on inflated costs to their customers." These very serious charges are of concern to everyone involved in these markets, as no one, be they consumers, end-users or market participants themselves, would benefit from the intentional manipulation of prices.



Fortunately, there is very little evidence that markets in energy commodities are subject to widespread manipulation. As noted by the Bank for International Settlements (BIS) in its March 2007 Quarterly Update:

> Intuitively, one might expect large inflows of funds into commodity markets to cause prices to rise sharply, possibly to higher levels than are justified by economic fundamentals. The prima facie evidence seems to support this view, as financial activity has broadly increased in parallel with prices during the past 4 years. However, the results of empirical work on the impact of the growing presence of financial investors on commodity prices are less clear-cut. Several recent studies, which explore the relationship between investor activity and commodity prices, indicate that price changes have led to changes in investor interest rather than the other way around.

The BIS cites in support of this thesis studies conducted by James Overdahl, Chief Economist of the Commodity Futures Trading Commission, as well as a report by the International Monetary Fund. In addition to these studies the Government Accountability Office, the Federal Trade Commission, the Department of Energy and numerous academics likewise have examined the question of whether manipulation of energy prices exists and is having an adverse effect on consumers. All have reached the same conclusion: energy prices are caused by the external forces of supply and demand, influenced by factors such as refinery capacity and hurricane activity, and not by the derivatives markets. As succinctly stated in testimony before the House Energy and Commerce Committee by W. David Montgomery, Vice President for CRA International, regarding gasoline prices: "There has never been a finding that . . . price increases were caused by any manipulation of the markets."

Given the overwhelming evidence that derivatives do not lead to manipulation of energy markets, it makes sense to ask what role these instruments do play. In addition to serving as risk management tools, the experience of market participants and academic research alike confirms that on a macro level energy derivatives increase market liquidity and depth and stabilize commodity markets. Both exchange traded

and privately negotiated derivatives contribute to more stable, more efficient commodity markets.

The Evolution of the Commodity Exchange Act

Given the tremendous growth of the energy derivatives industry and the role these products play in helping manage risk and stabilize markets, it is worth considering how government policy in the United States helped promote such a beneficial result. Even before the passage of the Commodity Futures Modernization Act of 2000 the CFTC realized the inappropriateness of applying a "one-size-fits-all" standard to derivatives. Beginning in 1990 the Commission began creating protections for energy transactions, such as the "Statutory Interpretation Concerning Forward Transactions" and the 1993 Exemptive Order. These administrative decisions provided some comfort to market participants that their individually negotiated contracts would be protected from unwarranted regulatory intervention, while at the same time ensuring that market participants would be subject to the anti-manipulation provisions of the Commodity Exchange Act (CEA).

Nevertheless, market participants were still exposed to the risk that their contracts would be held legally unenforceable because of the inappropriate application of the CEA to their private contracts. Because the CEA was originally written to address exchange traded agricultural commodities the law contained a provision making any off-exchange future-like contract illegal (and thus unenforceable). This "legal uncertainty," which threatened to undermine an important and growing market, caused this Committee and its Senate counterpart, the House and Senate Banking Committees, the House Commerce Committee and the President's Working Group on Financial Markets to jointly undertake an historic effort to improve and reform the CEA.

The Commodity Futures Modernization Act of 2000 greatly increased American competitiveness in both the exchange traded and OTC derivatives industries. For futures exchanges, the law created a principles-based regulatory regime that greatly increased the flexibility and efficiency of those markets. For OTC derivatives the law removed legal uncertainty, protected the right of sophisticated counterparties to engage in individually negotiated swap transactions and retained anti-fraud and anti-manipulation authority over the OTC commodity markets.

Regulation of OTC Derivatives

It is important to recognize that OTC derivatives are subject to a broad range of regulation. OTC market participants themselves, such as commercial banks and broker dealers, are subject to plenary regulation by their respective front line regulatory agencies (for example, the Federal Reserve and the SEC; the CFTC likewise retains regulatory authority over the operations of registered commodity trading advisors and commodity pool operators.) This is important, since these OTC dealers are the counterparty on the overwhelming majority of transactions conducted in the over-the-counter markets. In addition to the regulation of the counterparties themselves OTC energy derivative transactions are subject to CFTC oversight under section 2(h)[1] of the Commodity Exchange Act.

Section 2(h) deals with exempt commodities. These are commodities which are neither financial nor agricultural, and include oil, natural gas, coal and precious metals. Under 2(h) contracts between eligible contract participants which are not traded on a trading facility are exempt from most provisions of the CEA except for the Act's anti-fraud and anti-manipulation provisions. Section 2(h) also exempts trades between eligible commercial entities[2] done on a principal-to-principal basis when transacted on an electronic trading facility. In addition to being subject to the anti-fraud and anti-manipulation provisions of the CEA, exempt electronic trading facilities are subject to record keeping requirements and must provide price, trading volume and such other trading information as the CFTC determines is appropriate

[1] Section 2(h) is sometimes derogatorily called the "Enron Loophole," because of allegations that the provision was "snuck in at the last minute" in H.R. 5660, the legislation which contained the CFMA. In fact, numerous hearings were held on H.R. 4541, the original version of the CFMA. H.R. 4541 contained a similar provision to current 2(h) entitled "Exempt Commodities"; the bill was the subject of numerous hearings in the House, including four hearings in the House Agriculture Committee. In addition to H.R. 4541 the companion Senate legislation, S. 2697, likewise contained a provision regarding energy commodities; S. 2697 was also the subject of legislative hearings.

[2] Eligible commercial entities are a narrower subset of eligible contract participants that, in general, are in the business of dealing in the underlying exempt commodity as a routine part of their operations.

if the Commission determines the entity serves as a price discovery market for the underlying exempt commodity.

In addition to the Commodity Exchange Act, Federal oversight of energy products is also provided by the Federal Energy Regulatory Commission (FERC). Amendments passed by Congress as part of the Energy Policy Act of 2005 provided FERC with anti-fraud and anti-manipulation authority over transactions in electricity and natural gas. These amendments to the Federal Power Act and the Natural Gas Act are modeled after the Securities and Exchange Commission's authority under section 10(b) of the 1934 Securities and Exchange Act. The FERC's authority applies to physical transactions in a commodity, as opposed to derivative transactions which are under the exclusive jurisdiction of the CFTC. Nevertheless, the two agencies' authorities in this area provide an overarching web of regulation of both the physical and derivative energy markets, giving a holistic view of these interlinked areas. CFTC and FERC likewise have a Memorandum of Understanding allowing for information sharing between the two agencies.

Oversight of the energy markets in the United States is thorough and effective. Enforcement efforts by Federal regulators have been very successful in detecting, deterring and punishing misbehavior. Between December 2002 and May 2007 the CFTC has collected over $307 million in civil penalties from defendants accused of wrongdoing in the energy markets. Among ISDA member firms there is no doubt that these agencies are providing strong oversight of these markets; they report regular visits and requests for information from Federal regulatory officials, as part of the routine operations of their businesses.

Calls for Greater Regulation Are Unwarranted

Almost immediately after Congress passed the CFMA there have been calls in some quarters to repeal parts of that law. Nowhere have these calls come more loudly than with regard to energy commodities. Fortunately Congress has time and again rejected efforts to repeal the balance between legal certainty for sophisticated institutional market participants and the need for Federal oversight provided by the CFMA.

For the most part, calls to revisit the CFMA rest upon claims of a lack of transparency in the markets as well as insinuations of impropriety. However, as discussed earlier in this testimony, there are no credible studies which demonstrate a cause and effect relationship between activities in the derivatives markets and consumer energy prices. More to the point, as the Members of the President's Working Group have repeatedly noted, there is no change in Federal law as applied to derivatives which could alleviate the volatility in energy prices which have existed over the last several years. As Federal Reserve Chairman Ben Bernanke noted in response to questioning in the Senate last Congress: "I am unaware of any evidence that supports the view that additional reporting requirements or other new regulations would reduce energy prices or energy price volatility."

Energy prices respond to a variety of supply and demand related factors, which have in recent years been aggravated by events such as an active hurricane season, lack of refinery capacity, unusual weather patterns and military and political crises in major oil producing regions. Changing the CFMA will not address those factors, nor will it do anything to alleviate consumer concerns about high energy prices.

Consequences of Rewriting the CFMA

Instead, amending the legal certainty for OTC energy derivatives provisions of the Commodity Exchange Act will serve only to make business less attractive in the United States. Already, American competitiveness in the financial services arena is under assault from foreign markets which are eager to attract lucrative U.S. financial services activity. As recently noted in the paper "Sustaining New York's and the U.S.'s Global Financial Services Leadership," sponsored by New York Mayor Bloomberg and U.S. Senator Charles Schumer:

> "Europe's also the center for derivatives innovation. 'People feel less encumbered overseas by the threat of regulation and so are more likely to think outside of the box,' notes one U.S.-based business leader."

OTC energy trades are done in the U.S. by the choice of the market participants, who favor the current regulatory environment and prefer the strength of U.S. courts and their respect for privately negotiated agreements. But there is simply no reason that energy transactions which do not call for the actual physical delivery of a commodity need be done in the United States. Indeed, because these transactions can be done electronically their execution can be readily relocated to more favorable regulatory environments should they feel that the costs and burdens of regulation have become too onerous.

Therefore Congress should tread carefully if considering legislating in this area. To date the OTC derivatives markets have been robust, stable and liquid, and provided the means for end-users of energy products to manage the risks of recent price volatility in a cost-efficient manner. Making the use of these products too costly, through the application of an inappropriate regulatory regime, would serve only to hurt American businesses and ultimately consumers, while doing nothing to alleviate energy prices.

Conclusion

Mr. Chairman and Members of the Committee, thank you very much for your time today. This is an important issue, and the leadership which this Committee has shown on this topic over the years has greatly improved the legal and regulatory environment in the United States. Going forward we are confident that you will continue to play a leading role in promoting the health and growth of these markets. Thank you again and I would be privileged to answer any questions you might have.

The CHAIRMAN. Thank you, sir. Mr. Corbin.

STATEMENT OF ARTHUR CORBIN, PRESIDENT AND CEO, MUNICIPAL GAS AUTHORITY OF GEORGIA, KENESAW, GA; ON BEHALF OF AMERICAN PUBLIC GAS ASSOCIATION

Mr. CORBIN. Mr. Chairman and Members of the Committee, I appreciate this opportunity to testify before you today on the important issue of energy based derivatives trading and in particular, natural gas market transparency. Again, my name is Arthur Corbin and I am President and CEO of the Municipal Gas Authority of Georgia. The Municipal Gas Authority of Georgia is a nonprofit natural gas joint action agency that supplies all the natural gas requirements of its 76 member cities. I am testifying today on behalf of the American Public Gas Association.

APGA is the national association for publicly owned not-for-profit natural gas distribution systems. These retail distribution systems are owned by public agencies and accountable to the citizens they serve. There are approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. APGA's top priority is the safe and reliable delivery of affordable natural gas. To bring gas prices back to an affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in natural gas pricing. This requires the natural gas market be fair, orderly and transparent so that the price consumers pay reflects fundamental supply and demand forces, and not the result of manipulation or other abusive conduct.

An appropriate level of transparency does not exist and this has led to a growing lack of confidence by our members in the natural gas market. Without question, natural gas futures contracts traded on NYMEX and those financial contracts of natural gas traded in the over-the-counter markets are economically linked. A participant's trading conducted in one venue can affect and has affected the price of natural gas contracts in the other. A recent report released by the Senate Permanent Subcommittee on Investigation affirmed these economic links. The impact of last year's activities of the Amaranth Advisors hedge fund is a perfect example of these economic links between markets.

When the excessively large positions accumulated by Amaranth began to unwind, gas prices decreased. Unfortunately, many distributors, including the Municipal Gas Authority of Georgia, had

already locked in prices prior to that period at levels that did not reflect fundamental supply and demand conditions, but rather were elevated during this period when Amaranth held these exceedingly large positions. As a result of the elevated prices, the Gas Authority's members were forced to pay an $18 million premium and pass it through to their customers on their gas bills.

Today the Commodity Futures Trading Commission has effective oversight of NYMEX and the CFTC and NYMEX provide a significant level of transparency. Despite the economic links between prices on NYMEX and the OTC markets, the OTC markets lack such transparency. The simple fact that the CFTC's large trader reporting system, its chief tool in detecting and deterring manipulative market conduct, generally does not apply to transactions in the over-the-counter market.

This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies, or simply to accumulate excessively large positions with little risk of early detection by the CFTC until after the damage has been done to the market. It simply makes no sense to have transparency in one small segment of the market and none in a much larger and growing segment.

Accordingly, APGA believes that transparency in all segments of the market, including those transactions that take place off-exchange and platforms are critical to ensure that the CFTC has a complete picture of the market. The CFTC has stated that it is nearing the outer limits of its authority. We believe that the CFTC does not currently have the tools necessary to police its beat. Today Congressman Barrow and Graves introduced legislation entitled the Market TRUST Act that would provide the CFTC with the tools to police their beat.

The level of transparency created by this legislation will significantly reduce opportunities for market manipulation and restore public confidence in natural gas markets. APGA strongly supports this legislation and commends Congressmen Barrow and Graves for their efforts on behalf of consumers. The CFTC has done a good job in catching market abuses after the fact. However, by the time these cases are discovered, using the tools available to government regulators, our members and their customers have already suffered the consequences of those abuses in terms of higher natural gas prices.

Whether or not Amaranth's trading meets the legal definition of the manipulation, it is beyond dispute that the CFTC did not have a complete picture of the full extent of Amaranth's trading position until after Amaranth's collapse. Greater transparency with respect to large trader positions, whether entered into on a regulated exchange or in the over-the-counter market in natural gas will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

The current situation is not irreversible. Congress can provide American consumers with the production they deserve by passing the Market TRUST Act, which would turn the lights on in these currently dark markets. APGA looks forward to working with you

to accomplish this goal and I will be happy to answer any questions you have.

[The prepared statement of Mr. Corbin follows:]

PREPARED STATEMENT OF ARTHUR CORBIN, PRESIDENT AND CEO, MUNICIPAL GAS AUTHORITY OF GEORGIA, KENESAW, GA; ON BEHALF OF AMERICAN PUBLIC GAS ASSOCIATION

Chairman Etheridge, Ranking Member Moran and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on the important subject of energy derivatives. My name is Arthur Corbin and I am the President and CEO of the Municipal Gas Authority of Georgia. The Municipal Gas Authority of Georgia is the largest nonprofit natural gas joint action agency in the United States. Our agency is made up of 76 publicly-owned natural gas distribution system members in five states: Georgia; Alabama; Florida; Pennsylvania; and Tennessee. Our principal role is to supply all the natural gas requirements of these systems. Together, our members meet the gas needs of approximately 243,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and almost 700 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. To bring natural gas prices back to a long-term affordable level, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other abusive market conduct. APGA strongly believes that this level of transparency currently does not exist, and this has directly led to a lack of confidence in the natural gas marketplace.

The economic links between the natural gas futures contracts traded on the New York Mercantile Exchange ("NYMEX") and those contracts, agreements and transactions in natural gas traded in the over-the-counter ("OTC") markets are beyond dispute. Without question, a participant's trading conduct in one venue can affect, and has affected, the price of natural gas contracts in the other.[1] Today, the Commodity Futures Trading Commission ("CFTC") has effective oversight of NYMEX, and the CFTC and NYMEX provide a significant level of transparency with respect to NYMEX's price discovery function. But, the OTC markets lack such price transparency.

This lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for a participant to engage in manipulative or other abusive trading strategies with little risk of early detection; and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market. It simply makes no sense to have transparency over one segment of the market and none over a much larger segment, especially when the OTC markets are the fastest growing sectors of the natural gas marketplace. APGA strongly believes that it is in the best interest of consumers for Congress to rectify this situation by passing legislation that would ensure an adequate level of transparency with respect to OTC contracts, agreements and transactions in natural gas.

The Market in Natural Gas Contracts

The market for natural gas financial contracts is composed of a number of segments. Contracts for the future delivery of natural gas are traded on NYMEX, a designated contract market regulated by the CFTC. Contracts for natural gas are also traded in the OTC markets. OTC contracts may be traded on multi-lateral electronic trading facilities which are exempt from regulation as exchanges. They may

[1] *See* "Excessive Speculation in the Natural Gas Market," Report of the U.S. Senate Permanent Subcommittee on Investigations (June 25, 2007) ("PSI Report"). The PSI Report on page 3 concluded that "Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap. . . . The data show that prices on one exchange affect the prices on the other."

also be traded in direct, bilateral transactions between counterparties, through voice brokers or on electronic platforms. OTC contracts may be settled financially or through physical delivery. Financially-settled OTC contracts often are settled based upon NYMEX settlement prices and physically delivered OTC contracts may draw upon the same deliverable supplies as NYMEX contracts, thus linking the various financial natural gas market segments economically.

Increasingly, the price of natural gas in many supply contracts between suppliers and local distribution companies ("LDC"), including APGA members, is determined based upon monthly price indexes closely tied to the monthly settlement of the NYMEX futures contract. Accordingly, the futures market serves as the centralized price discovery mechanism used in pricing these natural gas supply contracts.

Generally, futures markets are recognized as providing an efficient and transparent means for discovering commodity prices.[2] However, any failure of the futures price to reflect fundamental supply and demand conditions results in prices for natural gas that are distorted and which do not reflect its true value. This has a direct affect on consumers all over the U.S., who as a result of such price distortions, will not pay a price for the natural gas that reflects bona fide demand and supply conditions. If the futures price is manipulated or distorted, then the price a consumer pays for the fuel needed to heat their home and cook their meals will be similarly manipulated or distorted.

Regulatory Oversight

NYMEX, as a designated contract market, is subject to oversight by the CFTC. The primary tool used by the CFTC to detect and deter possible manipulative activity in the regulated futures markets is its large trader reporting system. Using that regulatory framework, the CFTC collects information regarding the positions of large traders who buy, sell or clear natural gas contracts on NYMEX. The CFTC in turn makes available to the public aggregate information concerning the size of the market, the number of reportable positions, the composition of traders (commercial/non-commercial) and their concentration in the market, including the percentage of the total positions held by each category of trader (commercial/non-commercial).

The CFTC also relies on the information from its large trader reporting system in its surveillance of the NYMEX market. In conducting surveillance of the NYMEX natural gas market, the CFTC considers whether the size of positions held by the largest contract purchasers are greater than deliverable supplies not already owned by the trader, the likelihood of long traders demanding delivery, the extent to which contract sellers are able to make delivery, whether the futures price is reflective of the cash market value of the commodity and whether the relationship between the expiring future and the next delivery month is reflective of the underlying supply and demand conditions in the cash market.[3]

Although the CFTC has issued "special calls" to one electronic trading platform, and that platform has determined to voluntarily provide the CFTC with information on traders' large positions,[4] the CFTC's large trader reporting surveillance system does not routinely reach traders' large OTC positions.[5] Despite the links between prices for the NYMEX futures contract and the OTC markets in natural gas contracts, this lack of transparency in a very large and rapidly growing segment of the natural gas market leaves open the potential for participants to engage in manipulative or other abusive trading strategies with little risk of early detection and for problems of potential market congestion to go undetected by the CFTC until after the damage has been done to the market, ultimately costing the consumers or producers of natural gas.

Amaranth Advisors LLC

Last year's blow-up of the Amaranth Advisors LLC and the impact it had upon prices exemplifies these linkages and the impact they can have on natural gas sup-

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[2] *See* the Congressional findings in Section 3 of the Commodity Exchange Act, 7 U.S.C. § 1 et seq. ("Act"). Section 3 of the Act provides that, "The transactions that are subject to this Act are entered into regularly in interstate and international commerce and are affected with a national public interest by providing a means for . . . discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

[3] *See* letter to the Honorable Jeff Bingaman from the Honorable Reuben Jeffery III, dated February 22, 2007.

[4] *Id,* at 7. The CFTC presumably issued this call for information under Section 2(h)(5) of the Act.

[5] As explained in greater detail below, special calls are generally considered to be extraordinary, rather than routine, requirements. Although special calls may be an important complement to routine reporting requirements in conducting market surveillance, they are not a substitute for a comprehensive large trader reporting system.

ply contracts for LDCs. Amaranth Advisors LLC was a hedge fund based in Greenwich, Connecticut, with over $9.2 billion under management. Although Amaranth classified itself as a diversified multi-strategy fund, the majority of its market exposure and risk was held by a single Amaranth trader in the OTC derivatives market for natural gas.

Amaranth reportedly accumulated excessively large long positions and complex spread strategies far into the future. Amaranth's speculative trading wagered that the relative relationship in the price of natural gas between summer and winter months would change as a result of shortages which might develop in the future and a limited amount of storage capacity. Because natural gas cannot be readily transported about the globe to offset local shortages, the way for example oil can be, the market for natural gas is particularly susceptible to localized supply and demand imbalances. Amaranth's strategy was reportedly based upon a presumption that hurricanes during the summer of 2006 would make natural gas more expensive in 2007, similar to the impact that Hurricanes Katrina and Rita had had on prices the previous year. As reported in the press, Amaranth held open positions to buy or sell tens of billions of dollars of natural gas.

As the hurricane season proceeded with very little activity, the price of natural gas declined, and Amaranth lost approximately $6 billion, most of it during a single week in September 2006. The unwinding of these excessively large positions and that of another previously failed $430 million hedge fund—MotherRock—further contributed to the extreme volatility in the price of natural gas. The Report by the Senate Permanent Subcommittee on Investigations affirmed that "Amaranth's massive trading distorted natural gas prices and increased price volatility."[6]

Many natural gas distributors locked-in prices prior to the period Amaranth collapsed at prices that were elevated due to the accumulation of Amaranth's positions. In the case of the Municipal Gas Authority of Georgia, Amaranth's activities had a significant impact on the price we, and ultimately our members' customers, paid for natural gas. To reduce volatility and mitigate additional price spikes on supplies of natural gas, the Gas Authority's hedging procedures required that we hedge part of our 2006–2007 winter natural gas in the spring and summer of 2006. In the spring of 2006 we knew natural gas prices were still extremely high, but it would have been irresponsible if we were to gamble and not hedge a portion of our winter gas in the hope that prices would eventually drop. As a result, we hedged half of our winter gas prior to September 2006. By hedging earlier in 2006 when natural gas prices were high as a result of Amaranth's market activities, our members incurred hedging losses of $18 million over the actual market prices during the winter of 2006–2007. The Gas Authority's members were forced to pay an $18 million premium and pass it through to their customers on their gas bills as a result of the excess speculation in the market by Amaranth and others.

The lack of OTC transparency and extreme price swings surrounding the collapse of Amaranth have caused bona fide hedgers to become reluctant to participate in the markets for fear of locking-in prices that may be artificial.

Greater Transparency Needed

Our members, and the customers served by them, do not believe there is an adequate level of market transparency under the current system. This lack of transparency leads to a growing lack of confidence in the natural gas marketplace. Although the CFTC operates a large trader reporting system to enable it to conduct surveillance of the futures markets, it cannot effectively monitor trading if it receives information concerning positions taken in only one segment of the total market. Without comprehensive large trader position reporting, the government is currently handicapped in its ability to detect and deter market misconduct. If a large trader acting alone, or in concert with others, amasses a position in excess of deliverable supplies and demands delivery on its position and/or is in a position to control a high percentage of the deliverable supplies, the potential for market congestion and price manipulation exists. Unless Congress moves forward to enable the CFTC to increase transparency with respect to OTC financial contracts, agreements or transactions in natural gas, the government will continue to be woefully unprepared to: (1) detect a problem until it is too late; (2) protect the public interest; and (3) ensure the price integrity of the markets, thus impairing our ability as a nation to maintain the flow and deliverability of a fundamental fuel.

Over the last several years, APGA has pushed for a level of market transparency in financial contracts in natural gas that would routinely, and prospectively, permit the CFTC to assemble a complete picture of the overall size and potential impact of a trader's position irrespective of whether the positions are entered into on

[6] *See* PSI Report at p. 119.

NYMEX, on an OTC multi-lateral electronic trading facility which is exempt from regulation or through bilateral OTC transactions, which can be conducted over the telephone, through voice-brokers or via electronic platforms.

Bilateral Trading

Because Amaranth's trading was largely conducted on both a regulated futures exchange and on an unregulated electronic trading facility, the immediate focus has been confined to the relative inequality of transparency between those two multi-lateral trading venues. Moreover, because the volume of transactions in bilateral markets may not be as apparent as the volume of transactions on exchanges or electronic trading facilities there may be a tendency to discount the impact that the bilateral markets have upon the price discovery process. APGA believes that, to be comprehensive, a large trader reporting system must include large positions amassed through the OTC bilateral markets in addition to those accumulated on futures exchanges or on OTC electronic trading facilities.

Bilateral trading can also take place on an electronic trading venue that may be as attractive to traders as multi-lateral trading facilities. Enron On-line, for example, was an all-electronic, bilateral trading platform. Using this platform, Enron offered to buy or sell contracts as the universal counterparty to all other traders. On the Enron On-line trading platform, only one participant—Enron—had the ability to accept bids and offers of the multiple participants—its customers—on the trading platform. This one-to-many model constitutes a dealer's market and is a form of bilateral trading.[7]

Section1a(33) of the Act further defines bilateral trading by providing that, "the term 'trading facility' does not include (i) a person or group of persons solely because the person or group of persons constitutes, maintains, or provides an electronic facility or system that enables participants to negotiate the terms of and enter into bilateral transactions as a result of communications exchanged by the parties and not from interaction of multiple bids and multiple offers within a predetermined, non-discretionary automated trade matching and execution algorithm. . . . ." This means that it is also possible to design an electronic platform for bilateral trading whereby multiple parties display their bids and offers which are open to acceptance by multiple parties, so long as the consummation of the transaction is not made automatically by a matching engine.

Both of these examples of bilateral electronic trading platforms might very well qualify for exemption under the current language of sections 2(g) and 2(h)(1) of the Commodity Exchange Act. It is entirely foreseeable that if a CFTC large-trader reporting regime were expanded to require the reporting of positions entered into only on multi-lateral electronic trading facilities and does not include bilateral electronic trading platforms too, traders who wish to evade the new reporting requirement would simply be able to move their trading activities from an electronic trading facility to a bilateral electronic trading platform, just as Amaranth moved its trading from NYMEX to ICE.

Moreover, even in the absence of electronic trading, the ability of traders to affect prices in the natural gas markets through direct or voice-brokered bilateral trading should not be underestimated. For example, a large hedge fund may trade bilaterally with a number of counterparty/dealers using standard ISDA documentation. By using multiple counterparties over an extended period of time, it would be possible for the hedge fund to establish very large positions with each of the dealer/counterparties. Each dealer in turn would enter into transactions on NYMEX to offset the risk arising from the bilateral transactions into which it has entered with the hedge fund. In this way, the hedge fund's total position would come to be reflected in the futures market.

Thus, a prolonged wave of buying by a hedge fund, even through bilateral direct or voice-brokered OTC transactions, can be translated into upward price pressure on the futures exchange. As futures settlement approaches, the hedge fund's bilateral purchases with multiple dealer/counterparties would maintain or increase upward pressure on prices. By spreading its trading through multiple counterparties, the hedge fund's purchases would attract little attention and escape detection by either NYMEX or the CFTC. In the absence of routine large-trader reporting of bilat-

[7] This stands in contrast to a many-to-many model which is recognized as a multi-lateral trading venue. This understanding is reflected in section 1a(33) of the Act, which defines "Trading Facility" as a "group of persons that . . . provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system."

eral transactions, the CFTC will only see the various dealers' exchange positions and have no way of tying them back to purchases by a single hedge fund.

Legislation is needed to remedy this critical lack of transparency. The CFTC recently proposed an amendment to its Rule 18.05 "special call" provision to make explicit that its special call authority to traders applies to OTC positions, including bilateral transactions and transactions executed on the unregulated electronic trading facilities where the trader has a reportable position on a designated contract market in the same commodity.[8] This amendment, however, merely makes explicit authority that the CFTC has previously exercised under Rule 18.05.[9] Moreover, special calls are extraordinary in nature and will not be used until a problem has been detected by some other means. Thus, this special call requirement is not an effective tool for conducting routine market surveillance. Moreover, the provision, even as it is proposed to be amended, only applies when a trader has a reportable position on a regulated futures market. Thus, by maintaining positions in the regulated futures market below the reporting level, a trader can avoid being required to report, even on a special call basis. This is exactly the path that Amaranth took when ordered to reduce its NYMEX position.

Only a comprehensive large trader reporting system that includes all segments of the market would have enabled the CFTC to spot the relative size of Amaranth's OTC position prior to its collapse. A comprehensive large trader reporting system would enable the CFTC, while a scheme is unfolding, to determine whether a trader is using the OTC natural gas markets to corner deliverable supplies and manipulate the price in the futures market.[10] A comprehensive large trader reporting system would also enable the CFTC to better detect and deter other types of market abuses, including for example, a company making misleading statements to the public or providing false price reporting information designed to advantage its natural gas trading positions, or a company engaging in wash trading by taking large offsetting positions with the intent to send misleading signals of supply or demand to the market. Such activities are more likely to be detected or deterred when the government is receiving information with respect to a large trader's overall positions, and not just those taken in the regulated futures market.

The need to provide the CFTC with additional surveillance tools is not meant to imply that the CFTC has not been vigilant in pursuing wrongdoers. Experience tells us that there is never a shortage of individuals or interests who believe they can, and will attempt to, affect the market or manipulate price movements to favor their market position. The fact that the CFTC has assessed over $300 million in penalties, and has assessed over $2 billion overall in government settlements relating to abuse of these markets affirms this. These efforts to punish those that manipulate or otherwise abuse markets are important. But it must be borne in mind that catching and punishing those that manipulate markets after a manipulation has occurred is not an indication that the system is working. To the contrary, by the time these cases are discovered using the tools currently available to government regulators, our members, and their customers, have already suffered the consequences of those abuses in terms of higher natural gas prices. Greater transparency with respect to traders' large positions, whether entered into on a regulated exchange or in the OTC markets in natural gas will provide the CFTC with the tools to detect and deter potential manipulative activity before our members and their customers suffer harm.

Accordingly, APGA has petitioned Congress to pass legislation that would expand the large trader reporting system to mandate the reporting of positions held in financial contracts for natural gas in all segments of the market. Specifically, we believe that large traders should report their positions regardless of whether they are entered into on designated contract markets, on electronic trading facilities, on OTC bilateral electronic trading platforms, in the voice-brokered OTC markets or in direct bilateral OTC markets. This would treat all trading positions in financial natural gas contracts equally in terms of reporting requirements. Extending large trader reporting to OTC natural gas positions and to positions entered into on electronic trading facilities will provide the CFTC with a complete picture of the natural gas

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[8] "Maintenance of Books, Records and Reports by Traders," 72 *Fed. Reg.* 34413 (June 22, 2007).

[9] The CFTC stated in its *Federal Register* release that, "Commission staff has interpreted Regulation 18.05 to include position and transaction data for non-reporting transactions [transactions executed over-the-counter and or pursuant to Sections 2(d), 2(g) or 2(h)(1)–(2) of the Act] and has received such information in response to requests made pursuant to the Regulation." *Id.* at 34415.

[10] *See e.g., U.S. Commodity Futures Trading Commission* v. *BP Products North America, Inc.,* Civil Action No. 06C 3503 (N.D. Ill.) filed June 28, 2006.

marketplace and ensure that the cop on the beat has the tools necessary to be effective.

Greater Transparency Is a Reasonable Response to Conditions in the Natural Gas Market

It is important to note that APGA's proposal is narrow in scope. First, APGA is requesting a comprehensive large trader reporting system only with respect to financial contracts, agreements and transactions in natural gas. The legislation that APGA is seeking is not intended to, and would in no way effect financial swaps. Natural gas contracts are more susceptible to manipulation than other commodities or instruments because the deliverable supply of natural gas is often small relative to the size of the derivatives positions held by large traders and, as mentioned previously, natural gas is constrained by the manner in which it can be delivered. These conditions do not necessarily pertain to other commodities or instruments which are "exempt commodities" under the Act[11] and they most certainly do not pertain to contracts, agreements or transactions in the "excluded commodities" under the Act.[12] Accordingly, it must be emphasized that APGA's proposal is limited to contracts in natural gas. It would have no effect with respect to the OTC markets in financial swaps or in any other contracts, agreements or transactions on an "excluded commodity" or in any "exempt commodity" other than natural gas. Moreover, APGA's proposal with respect to financial contracts, agreements or transactions in natural gas is merely a reporting requirement and would not impose any regulatory requirements with respect to such transactions.

Second, the CFTC's large trader reporting system would not in any way result in the public release of information relating to an individual entity's trading positions. Information collected through the CFTC's large trader reporting system is used for the government's market surveillance purposes only and is kept confidential by the CFTC in accordance with Section 8 of the Act. Any information which is made publicly available by the CFTC, as described above, is on an aggregated basis and does not disclose individual trading positions. APGA is not advocating a change in this practice.

Finally, although some have raised concerns about the costs of expanding the large trader reporting system, we believe the costs would be reasonable. Insofar as the CFTC's large trader reporting system is already operational, the CFTC will not be creating an entirely new program to collect this information. In addition, large traders, such as those which would be required to report to the CFTC, will likely have automated record keeping systems for their own internal risk management purposes that could be adapted for the purpose of reporting positions to the CFTC. Finally, as discussed above, certain trading facilities have already taken steps to make information available to the CFTC. Accordingly, APGA believes that the costs of a comprehensive large trader reporting system for natural gas would be reasonable and are far outweighed by the benefits in terms of helping assure consumers that the market price is a reflection of appropriate market forces.

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Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. Without giving the government the tools to detect and deter manipulation, market users and consumers of natural gas who depend on the integrity of the natural gas market cannot have the confidence in those markets that the public deserves. The current situation is not irreversible. Congress can provide American consumers with the protection they deserve by passing legislation that would expand the CFTC's large trader reporting requirements to include financial contracts for natural gas that are currently exempt from reporting. APGA and its approximately 700 public gas system members stand ready to work with you towards accomplishing that goal.

The CHAIRMAN. Thank you, sir. Mr. Cicio.

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[11] "Exempt commodities" are defined in Section 1a(14) of the Act as, "a commodity that is not an excluded commodity or an agricultural commodity." Thus, for example, exempt commodities include other energy commodities and base and precious metals.

[12] "Excluded commodities" are defined in Section 1a(13) of the Act and include interest rates, currency, indexes and various other types of financial instruments or interests.

STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

Mr. CICIO. Thank you, Mr. Chairman. The Industrial Energy Consumers of America is a nonprofit trade association whose membership are significant consumers of natural gas and from every major energy intensive manufacturing sector. At the heart of the matter is that every consumer in the county assumes that the government is protecting their interests and that energy markets are working fairly, without manipulation, and operating with a level playing field. Nothing could be further from the truth.

The subject of excessive financial speculation, and market power, manipulation first came to our attention starting in 2001 with the implementation of the Commodity Futures Modernization Act and concerns have continued to grow. The signs were obvious, but the lack of data, we could never prove it. This all changed with the implosion of the Amaranth Advisors hedge fund. The June 2007 Senate Permanent Subcommittee on Investigations report entitled, *Excessive Speculation in the Natural Gas Market* provides a clear and troubling picture of how easy it is for a large hedge fund or funds and Wall Street trading companies to potentially manipulate the market to the benefit of their investors, to the detriment of every consumer in the country. Amaranth completely dispels the Wall Street myth that the market is too large for one company to manipulate.

All market inefficiencies are paid for by us, the consumer. And even a relatively small increase in the price of natural gas of just 25¢ over the course of a year would cost consumers $5.5 billion. Unlike other major commodities like currencies or gold, excessive speculation of natural gas has a direct impact on real people, homeowners, farmers and our manufacturing competitiveness. And because natural gas supply is fragile, it is particularly vulnerable to manipulation. We can't assume that had Amaranth not continued to increase their control of price by continuing to add to their positions, market conditions would have driven the price lower because national inventories of natural gas were above a 5 year average and production was stable.

In fact, after Amaranth collapsed, so did the price of natural gas. In September 2006 the price was $6.81; after the collapse, it fell to $4.20. If we simply assume that $1 of that $2.61 was due to Amaranth's activities, consumers would have paid some $9 billion over the period of April to August of 2006. The Amaranth event raises several important questions for Congress to address. The CFTC has known for a long time that a significant market oversight gap existed. Why didn't the Chairmen of the CFTC step forward to say there is a problem? Why wasn't the CFTC responsive and accountable to the public interest? Did the Commodity Futures Modernization Act of 2000 go too far? Did it weaken CFTC's market oversight accountability? Is the relationship between CFTC and the exchanges and Wall Street too cozy? Why aren't there time limits to prevent CFTC officials from taking top positions in the exchanges?

It is not without notice that last year Wall Street trading companies weighed in on Congress to oppose the same reporting and transparency provisions that we are asking for that would have

prevented Amaranth activities. Interestingly, these same companies do mark to market position accounting at the end of each trading day and they do it for their internal financial management. It is also safe to say that companies currently reporting to NYMEX and to CFTC are the same companies that are not being required to report their positions through ICE.

IECA recommends that Congress take immediate action to give CFTC regulatory oversight over ICE, and the OTC markets, in general; require large traders to report their positions daily to CFTC; give CFTC the ability to aggregate positions taken on these exchanges and OTC markets; establish responsible daily volume trading limits; increase monitoring in future months; and increase the funding to allow for better enforcement. Thank you.

[The prepared statement of Mr. Cicio follows:]

PREPARED STATEMENT OF PAUL N. CICIO, PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA, WASHINGTON, D.C.

Chairman Etheridge and Ranking Member Moran, thank you for the opportunity to testify before this Subcommittee on the important issue of trading of energy-based derivatives.

The Industrial Energy Consumers of America (IECA) is a nonprofit trade association whose membership are significant consumers of natural gas and from every major energy intensive manufacturing sector. Corporate Board Members are top energy procurement managers who are leaders in their industry, technical experts, strongly committed to energy efficiency and environmental progress. IECA membership represents a diverse set of industries including: plastics, cement, paper, food processing, aluminum, chemicals, fertilizer, brick, insulation, steel, glass, industrial gases, pharmaceutical, construction products, automotive products, and brewing.

At the heart of the matter is that every consumer in the country assumes that the government is protecting their interests and that energy markets are working fairly, without manipulation and operating with a level playing field. Nothing could be further from the truth.

The subject of excessive speculation, market power and market manipulation first came to our attention in 2001 and has continued to grow in concern. The signs were obvious but because of the lack of transparency, we could never prove it. This all changed with the implosion of the Amaranth Advisors hedge fund. The fund reportedly lost $6.0 billion on natural gas trades.

The June 2007 U.S. Senate Permanent Subcommittee on Investigations report entitled "Excessive Speculation in the Natural Gas Market" confirms that Amaranth controlled 100,000 natural gas contracts which mean they controlled the equivalent of 1 trillion cubic feet of natural gas—the equivalent of 54 percent of our country's monthly demand. Clearly, this looks like market power and market manipulation to a consumer. We strongly encourage each Member of Congress to read the Senate report that provides a startling reality check on how markets are being manipulated.

Amaranth provides a clear and troubling picture of how easy it is for large hedge fund and Wall Street trading companies to manipulate the market to the benefit of their investors and to the detriment of every consumer in this country. Amaranth completely dispels the Wall Street myth that the market is too large for any one company to manipulate.

The Commodity Futures Trading Commission (CFTC) knows there are significant market oversight gaps and have failed to act in the public interest. There is excessive speculation but we can deal with it 'if' we have transparency for the regulators to monitor the size of the natural gas volumes that any one player is controlling on NYMEX, the IntercontinentalExchange (ICE) and other over-the-counter (OTC) markets. Today, under existing law, regulators can only monitor trading volumes on NYMEX.

We believe that markets work better when market participants know there is strong government oversight that has the ability to catch and severely penalize market manipulation. Unfortunately there is neither sufficient government oversight nor sufficient penalties to deter manipulation.

All market inefficiencies are paid for by us, the consumer. And, even a relatively small increase in the price of natural gas such as $0.25, amount to significant cost

impact of $5.5 billion over the course of a year. And, unlike, many other commodities such as currencies or gold, excessive speculation of natural gas has a direct impact on all sectors of the economy including homeowners, farmers and the manufacturing sector.

IECA member companies are some of the world's largest consumers of natural gas. Natural gas is used as a feedstock and fuel. Member company competitiveness is impacted directly and indirectly from the price of natural gas and the functioning of natural gas markets. Indirectly, the higher price of natural gas is increasing the price of electricity across the country.

For example, natural gas represents 85% of the cost of making anhydrous ammonia which is used to make fertilizer for our farmers. Much of our plastics today are made from either ethylene or propylene and a substantial portion of U.S. capacity is produced using natural gas as the feedstock. In this case 93% of the cost of ethylene and propylene is attributable to the cost of natural gas. Most manufacturers use natural gas as a fuel for their boilers and to co-generate electricity and steam to operate their facilities. There is virtually no substitute.

Member companies historically use hedging practices to protect themselves from volatility and to increase predictability of the purchase price of natural gas. Since 2001, volatility has significantly increased in large part due to excessive speculation which has also increased the cost to hedge. For example, using a ATR (Average True Range 15 week moving average) and comparing May 2000 to June 2007, the volatility is up greater than 100%. If we compare May 2000 to the September 2006 (the time period after the Amaranth implosion) the volatility increased by 475%. Volatility is a manufacturer's nightmare and a trader's dream. Volatility makes it extremely difficult for manufacturers to plan product pricing, capital expenditures and plant operations.

It is now a well known fact that Amaranth continued to increase the volume of natural gas they controlled on the NYMEX and IntercontinentalExchange (ICE) during the spring and summer of 2006. Doing so resulted in higher prices than what would have otherwise been the case. National natural gas inventories at the time were above the 5 year average and domestic production was stable. It is impossible for anyone to accurately determine the premium consumers paid because of Amaranth. However, we can provide perspective.

We can assume that had Amaranth not continued to increase their control of the price by continuing to add to their positions, market conditions would have driven the price lower. In fact, after Amaranth collapsed, so did the price of natural gas. In September 2006, the price was $6.81 per mm Btu and after the Amaranth collapse the price fell in October 2006 to $4.20 per mm Btu, a $2.61 difference. If we assume that only $1 of the $2.61 price was due to Amaranth, it would have cost consumers an estimated $9 billion over the time period of April thru August of 2006!

The clear responsibility of the CFTC is to ensure that the natural gas market is functioning efficiently, fairly and that the derived market price is trustworthy. That is, without manipulation. They cannot succeed in doing so without greater jurisdiction to provide oversight of the over-the-counter markets (OTC) including ICE. It is well known to all market participants that because CFTC has oversight of NYMEX and requires large players to report their positions to the "Commitment of Trader Report", that traders have moved much of their trading volumes to ICE where there is no reporting. Without jurisdiction over ICE, it is impossible for the CFTC to reduce excessive speculation and make sure that market power and market manipulation does not occur.

The Amaranth event raises several important questions for Congress to address. The CFTC has known for a long time that a significant market oversight gap exists. Why hasn't the Chairman of the CFTC stepped forward to say there is a problem? Why isn't the CFTC responsive and accountable to the public interest? Did the Commodity Futures Modernization Act (CFMA) of 2000 go too far and did it weaken CFTC's market oversight accountability? Is the relationship between the CFTC and the exchanges to cozy? Why are there not time limits that prevent CFTC officials from taking top positions with the exchanges?

At least one CFTC Commissioner has said there is a problem. Below are the remarks of CFTC Commissioner Michael V. Dunn before the National Grain Trade Council on September 8, 2006.

> *"However, a large portion of energy trading occurs in the over-the-counter market, mostly beyond the scrutiny of any Federal agency. The Commission's enforcement actions continue to uncover repeated examples of people and companies trying to game the energy markets, often in the belief that no one is watching, or that if someone is, there is nothing that can be done to them."*

"Because the CFTC is barred from regulating the OTC energy markets, it cannot collect large trader data from unregulated energy markets, or conducting regular surveillance of them. It is virtually impossible to know, therefore, the extent of fraud and manipulation that may be occurring in the over-the-counter markets."

CFTC opines it has subpoena power. It does. But that is not the type of government oversight that is needed. Subpoena power is used after the damage to markets has already been done. We want a preemptive approach that effectively monitors markets and prevents manipulation.

IECA recommends that Congress take immediate action to give CFTC regulatory oversight of ICE and other over-the-counter markets; require large traders to report their positions daily to CFTC; give CFTC the ability to aggregate positions regardless of where they are held; establish daily volume trading limits; increase monitoring in all months, not just near term months; increase CFTC funding for monitoring and enforcement; and lastly, increase the supply of natural gas.

Asking OTC 'large traders' to report their position to the CFTC just like the NYMEX does today, is not asking too much of these companies. These same companies do 'mark-to-market' position accounting at the end of each trading day for internal financial management reasons anyway. Plus, it is safe to say that the same companies who are reporting to CFTC thru NYMEX are the same companies who are not reporting thru ICE. Reporting large positions to the CFTC is not asking much when the public trust is at stake.

Thank you.

The CHAIRMAN. Thank you, sir. Mr. Eerkes.

STATEMENT OF CRAIG EERKES, PRESIDENT, SUN PACIFIC ENERGY; CHAIRMAN, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, KENNEWICK, WA; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE

Mr. EERKES. Chairman Etheridge and Ranking Member Moran and the distinguished Members of the Committee, thank you for the opportunity to testify before you today. My name is Craig Eerkes and I appreciate the opportunity to provide some insight on the way that the energy-based futures markets affect independent petroleum marketers. I am here today offering testimony on behalf of the Petroleum Marketers Association of America and the New England Fuel Institute. Both PMAA and NEFI have worked together to advocate increased CFTC oversight of the energy futures markets.

PMAA is a national federation of 45 state and regional associations representing some 8,000 independent petroleum marketing companies from coast to coast. NEFI is a regional trade association representing over 1,000 fuel marketers in the New England region. Combined, our members own or supply gasoline and diesel to 100,000 convenience stores and sell 90 percent of the heating oil and farm fuel sold in the United States.

My petroleum marketing company, Sun Pacific Energy, owns and operates 32 gas stations and convenience stores in Washington State and we also supply Shell and ExxonMobil gasoline to 75 independent dealers. Independent marketers began to pay closer attention to futures markets in the aftermath of September 11, 2001. Many petroleum marketers were stunned by the immediate price volatility that spiked from coast to coast. Many marketers in the Pacific Northwest were hit with dramatic wholesale price increases on 9/11 and we did not think it correlated to supply and demand. Our area refineries were not affected, our terminals had plenty of supply, yet wholesale prices quickly increased up to 40¢ per gallon.

First of all, I want to stress that we are not alleging any wrongdoing by any person or any company. Our point of view is really

quite simple: Because the futures markets have become the basis for the daily wholesale price of gasoline, diesel and heating oil, it is imperative that Federal regulators monitor all significant trading activity. Several weeks ago the House of Representatives passed a gas price gouging bill that will severely restrict my ability to operate my company during a national emergency. I can say with firm conviction that my marketer colleagues did everything possible to hold down gas prices following 9/11 and Hurricane Katrina.

By contrast, one oil trader bragged that his profits following Hurricane Katrina, in an industry newsletter, this particular futures marketer bragged that he made enough money in the week following Katrina that he would not have to work the rest of the year. Can you imagine what would happen if a gas station owner made a similar comment? If you want to do something meaningful about retail petroleum prices, make sure the energy futures markets are effectively monitored by the CFTC. Because of the "Enron Loophole," 75 percent of futures trading which occurs on the over-the-counter exchanges, including offshore exchanges such as ICE, are completely opaque and are not accountable to U.S. law.

This is unacceptable. There needs to be transparency, accountability and the rule of law on all energy commodity markets. We urge you to close the "Enron Loophole" and give the CFTC the authority and the tools to do the job. Please ensure that energy futures trades are made subject to the same oversight as wheat, corn and pork bellies. Energy consumers are affected by excessive speculation and price volatility in the energy commodity markets in profound ways. When excessive speculation and volatility results in high prices for gasoline and diesel, few Americans have transportation alternatives.

When heating oil, natural gas and other fuels skyrocket, it places at risk the health and welfare of American families who need heat for their homes. The commodity markets are the price discovery points for all energy commodities. Excessive speculation and questionable trading practices have an instant and tremendous impact on the consumer. American families and small businesses are at the financial whim of the energy trader and the hedge fund manager. It is time that Congress stepped in and said, "Enough is enough."

Please make sure that these markets are completely driven by supply and demand for the benefit of all U.S. citizens. I thank you for permitting me to participate in today's hearing and I look forward to answering any questions you may have. Thank you.

[The prepared statement of Mr. Eerkes follows:]

PREPARED STATEMENT OF CRAIG EERKES, PRESIDENT, SUN PACIFIC ENERGY; CHAIRMAN, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, KENNEWICK, WA; ON BEHALF OF NEW ENGLAND FUEL INSTITUTE

Chairman Etheridge and Ranking Member Moran 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 way that the energy based futures markets affect independent petroleum marketers. I hope that my many years of experience in the industry will help shed light on this issue and assist you in your policy-making and oversight endeavors.

I am here today offering testimony on behalf of the Petroleum Marketers Association of America (PMAA) and the New England Fuel Institute (NEFI). Both PMAA

and NEFI have worked together to advocate increased Commodity Futures Trading Commission (CFTC) oversight of the energy futures markets. PMAA is a national federation of 45 state and regional associations representing some 8,000 independent petroleum marketing companies from coast to coast. NEFI is a regional trade association representing over 1,000 fuel marketers in the New England region. Combined our members own or supply gasoline and diesel to 100,000 convenience stores and sell 90% of the heating oil sold in the U.S. Also, of particular interest to this Committee, PMAA and NEFI member companies supply an estimated 90% of the gasoline, diesel, kerosene and heating oil to our nation's farms.

My petroleum marketing company, Sun Pacific Energy, owns and operates 32 gas stations and convenience stores in Washington State. We also supply Shell and ExxonMobil gasoline to 75 independent dealers.

Independent petroleum marketers began to pay closer attention to futures markets in the aftermath of September 11, 2001. Many petroleum marketers were stunned by the immediate price volatility that spiked from coast to coast. Many marketers in the Pacific Northwest were hit with dramatic wholesale prices increases on 9/11 and we did not think it correlated to supply and demand fundamentals. Our area refineries were not affected; our terminals had an abundance of product yet wholesale prices increased up to 40¢ per gallon at some terminals.

From that day forward, PMAA and NEFI leaders began to take a hard look at the futures markets and their correlation to supply and demand.

First of all I want to stress that we are not alleging any wrong doing by any person or any company. Our point of view is really quite simple. Because the futures markets have become the basis for the daily wholesale prices for gasoline, diesel and heating oil, it is imperative that Federal regulators monitor all significant trading activity. It is unacceptable for Federal law to shield some energy trading activity from needed oversight.

Several weeks ago, the House of Representatives passed a "gas price gouging bill" that will severely restrict my ability to operate my company during national emergencies. I can say with firm conviction that my marketer colleagues did everything possible to hold down gas prices following 9/11 and Hurricane Katrina. By contrast, one oil trader bragged about his profits following Hurricane Katrina in an industry newsletter. This particular futures market trader bragged that he made enough money in the week following Katrina that he would not have to work the rest of the year. Can you imagine what would happen if a gas station owner made a similar comment?

If you want to do something meaningful about gasoline, diesel and heating oil prices, make sure the energy futures markets are effectively monitored by the CFTC. Because of the "Enron Loophole," which Congress passed in 2000 at the behest of Enron lobbyists, the 75% of futures trading which occurs on the over-the-counter (OTC) exchanges, including off-shore exchanges such as the IntercontinentalExchange, are completely opaque and are not accountable to U.S. law. This is unacceptable—there needs to be transparency, accountability and the rule of law on all energy commodity markets. We urge you to close the "Enron Loophole" and give the CFTC the authority and the tools to do the job. Please insure that energy futures trades are made subject to the same oversight as wheat, corn and pork bellies.

Energy consumers are affected by excessive speculation and price volatility in the energy commodity markets in profound ways. When excessive speculation and volatility result in high prices for gasoline and diesel, few Americans have transportation alternatives. When heating oil, natural gas and other heating fuels skyrocket it places at risk the health and welfare of Americans families who need heat for their homes.

The commodity markets are the price discovery points for all energy commodities. Excessive speculation and questionable trading practices have an instant and tremendous impact on the consumer. American families and small businesses are at the financial whim of the energy trader and the hedge fund manager. It is time that Congress stepped in and said, "Enough is enough."

We and our customers need our public officials, including those in Congress and on the Commodity Futures Trading Commission (CFTC), to take a stand against a loophole that artificially inflates energy prices. We deserve to have confidence that the prices established in futures markets are in fact market based prices and not vulnerable to inappropriate trading practices.

Do not be mistaken. We very much support the free exchange of commodity futures on open, well regulated and transparent exchanges that are subject to the rule of law and accountability. Many PMAA and NEFI 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 and that is one

reason why I am here today. I think it is so important for Congress to improve the futures markets for the benefit of all U.S. citizens.

As I mentioned earlier, the futures markets have become the price point for wholesale refined product pricing in the U.S. Please make sure that these markets are competitively driven by supply and demand.

I thank you for permitting me to participate in today's hearing and I look forward to answering any questions you may have.

The CHAIRMAN. Thank you, sir. We have just gotten a call for voting on the floor. We will have three votes. They are probably going to take about 20 minutes at most, hopefully, and we will hustle right back. If you will just hang around, take a little break, we will try to get back as quickly as we can. I was hoping we would get through before they called the vote.

[Recess]

The CHAIRMAN. Let me thank you for your indulgence. It took longer than we thought. You know, they start the vote and they start dragging it out and it took a bit, but we appreciate you waiting around for us until we got back. We are going to move to our question area and we will allow each Member 5 minutes and I recognize myself for the first 5 minutes. And my first question will be to Dr. Newsome.

Dr. Newsome, during the Senate hearing on Monday, the New York Merc, ICE and the CFTC were all in agreement that the ICE and New York Merc trading venues are now pretty tightly linked and strongly interactive with each other. My question to you is what consequences does this have for the price discovery role of the two venues?

Dr. NEWSOME. Mr. Chairman, I think it links the price discovery role, as well. I mean, if you look at trading on both ICE and NYMEX, either exchange can lead the other exchange very quickly which follows within that price direction and even though NYMEX trades a physical contract, ICE trades a financial contract, the reality is that less than 1/10 of 1 percent of NYMEX contracts go to physical delivery. Now, they trade functionally as a financial contract, so I think the two are definitely linked. The two markets can move each other and while the price that is published is officially the NYMEX price, I don't think there is any question that the activity on ICE is a component of that price is discovered.

The CHAIRMAN. Okay. Mr. Sprecher, you said, at the Senate hearing, that ICE would support implementation of accountability levels to require traders to provide the exchange more information about their positions. Could ICE not implement this independently of any Commission authority or action?

Mr. SPRECHER. It is a very good question. We could. I think what the real issue is, is that ICE only has a limited view into the market. If you ask Dr. Newsome, he would tell you he only has a limited view into the market and increasingly, what we really need is for, in my mind, a central person, most likely the CFTC, to have an entire view of the market. If, in the context of that, the CFTC or Congress would like us to take some role in identifying large positions, that would be fine, but while I say we would be open to it, I don't necessarily think it is the best way of solving this. I actually think the CFTC, with an entire view of the market, is best positioned to decide who should be accountable and for what.

The CHAIRMAN. Dr. Newsome, let me put you on the hot seat again with that very same question, because I think that is part of what some of the issues are as it relates to large positions and concerning, I would hope, all others who are concerned.

Dr. NEWSOME. I think I definitely agree with Mr. Sprecher that the CFTC is the appropriate overseer. They are the ones that should have the global view of who is in these markets, how large they are in these markets, so Jeff and I are completely on the same page there, Congressman.

The CHAIRMAN. Mr. Pickel, along that same line, you heard some of your fellow panelists call for greater reporting to the CFTC, but only of positions of large traders, as we just talked about here. Can you break down for us the potential cost to a large trader in complying with such a provision?

Mr. PICKEL. If we look at it from the perspective of the sector that we represent, the privately negotiated business, those are all bilateral contracts. There is not the building up of a market position in the way you would do certainly on an exchange and perhaps, to some extent, through an ECM, such as ICE. So you don't have that building up of a market in the same sense. You have a series of bilateral trades between parties and both of those parties typically will be looking at the market prices, typically the NYMEX price, to determine whether the price of that individual trade, which they have negotiated, is an appropriate price to enter into a contract.

The CHAIRMAN. So give me a for instance, say on a $100,000 position or a half million dollar position.

Mr. PICKEL. In terms of the cost of——

The CHAIRMAN. Yes. If you know.

Mr. PICKEL. I don't have those numbers, specifically. It is fair to say that the members that we represent, and I think most people who are active in these markets, will be, as a risk management issue, collecting information and keeping records just for either accounting purposes, regulatory purposes or just good business sense.

The CHAIRMAN. Okay, thank you. I yield back. Mr. Moran.

Mr. MORAN. Mr. Chairman, thank you. Let me talk to Mr. Sprecher and Dr. Newsome about Amaranth. What I am interested in knowing is who knew what when? And as I understand, there were positions taken on both of your exchanges. What I don't know yet is whether each of you knew about the positions taken on the other's exchange, and second, what the CFTC knew about both of those positions or both of those exchanges and its dealings with Amaranth.

Dr. NEWSOME. Who do you want to go first?

Mr. MORAN. Well, you two are getting along so well, I will let you decide.

Mr. SPRECHER. We actually do get along.

Dr. NEWSOME. I think both of us are in the position of saying, "You can only manage what you can see." We could see the positions on NYMEX, the CFTC could see the positions on NYMEX, that is not the case, wasn't the case at the time in the ECM marketplace.

Mr. MORAN. And so you, Mr. Sprecher, only knew about the positions of Amaranth on your exchange; Mr. Newsome only knew about the positions that they took on his exchange. Is that true?

Mr. SPRECHER. That is correct.

Mr. MORAN. And then CFTC?

Mr. SPRECHER. At the time, which is not the case today, ICE was not giving the so-called large trader report information to the CFTC, so they would not have had a real-time way of looking at Amaranth. They would have been able to see it and I do believe they did see it through its special call provision after the fact. Today, with the more near real-time reporting, in other words, we send the positions every day, at the end of every day, they would have a near real-time view of the positions both on ICE and NYMEX, which didn't exist at the time.

Mr. MORAN. And what precipitated that change in that reporting?

Mr. SPRECHER. A special call from the CFTC, and as I said in our testimony, we believe that the CFTC has the authority to make that special call and indeed, we complied with it.

Mr. MORAN. And what would CFTC, they would be able to do something with that information, share it between the two exchanges, investigate positions taken in both places?

Mr. SPRECHER. Well, they have, with respect to ICE, they have tremendous authority over these over-the-counter markets as they affect Dr. Newsome's markets, to take broad action. But I should let you speak to——

Dr. NEWSOME. Congressman, I don't think the CFTC would share each other's exchanges with another exchange. They will take the higher level picture, deal directly with the customers and say, "We notice your positions on either exchange," start asking the questions, for instance, "What is your intent," the 'jawboning' that Chairman Lukken talked about earlier.

Mr. MORAN. Well, Doctor, the reason, that was at least an important question to me, is because of NYMEX's decision to allow an increase or change in their position eight times. My question is, if you had information related to what that hedge fund was doing in ICE, would you reach a different conclusion? And if the answer to that is yes, then that information is valuable to you.

Dr. NEWSOME. Well, I mean, we certainly could have reached a different conclusion. Again, you can only manage what you can see. In those circumstances, and it was brought up in the Senate hearing and again, earlier today, when we look at positions, position limits, position accountability, the eight cases, as you just mentioned, is accurate. But is very difficult to pull out a position in a particular month and say they were over or they were below, because when we look at it, we are looking at trying to prevent manipulation. We are looking at trying to stem undue risk. We look at the entire position.

So if you had a position in September that may be completely offset by a position in October, so from the exchange standpoint, we are looking at the aggregation of risk across all positions. That is typically the way the CFTC has done it. That is what our rules currently allow for. Now, that said, given the situation that happened with Amaranth, we have started paying much closer attention to

futures only position and back months, where in the past, we never felt that it was necessary to do so. We are doing that now and in fact, we are adopting rules that relate to that, as well, so that is something that we have learned through the situation with Amaranth.

Mr. MORAN. Are there other exchanges in which Amaranth or any hedge fund could have taken positions in addition to NYMEX and to ICE that it is important for CFTC or you, internally, to know about? So now that this information is being gathered, have we got every exchange that is important to know about a hedge fund's position going to the CFTC?

Dr. NEWSOME. Well, I think whether you are talking about exchanges or ECMs that function in an exchange-like manner, at least, in my opinion, and Mr. Sprecher can provide his comments. I think ICE and NYMEX provide the vast majority of the information that is necessary, given today's environment, because, to my knowledge, ICE and NYMEX are the only two that have the tight linkage in the natural gas market. They are the only two that function as equivalents and therefore the only two that it would have been necessary to look at the Amaranth positions as it occurred.

Mr. MORAN. My time is expired. In the past year, I would have been able to continue asking questions, but at the moment, I cannot. But in case the Chairman will allow me a second round of questions, I have a few things I would like to follow up on, Mr. Chairman. I may try to assume the time of any of my other Republican colleagues.

The CHAIRMAN. I thank the gentleman. Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman. Mr. Sprecher, this is a very complex issue and I think it might be helpful to us on the Committee if you could share with us just how ICE operates, and second, how ICE operates differently from NYMEX.

Mr. SPRECHER. Sure. As it has been testified to, we are this category of ECM, which is different than Enron On-line, which sought and received an exemption from any oversight. We applied for and received designation as an ECM, which has certain anti-fraud, anti-manipulation record keeping requirements, to the CFTC. NYMEX is, as a full so-called DCM, is the designated contract market. Its market is designated as the source of price discovery for natural gas and outside of NYMEX's market exist ICE and many other bilateral markets. In fact, there are global markets that trade swaps and derivatives that are related to NYMEX, but are not designated by the government as a source of price discovery.

And it is that distinction that I think was carefully crafted in the Commodity Futures Modernization Act and it is, in a large part, the underpinning of what we are discussing today, which is now that markets are increasingly linked globally, electronically, and investment dollars continue to come into this space as energy prices climb—what is the role of a marketplace that is not designated as a source of price discovery?

Mr. SCOTT. Let me ask you this, too. My time is limited and I got to get a question to Dr. Newsome. You recently came out for agreeing to increase regulation, in light of the differentiation that you mentioned between yourself and ICE, how would that relate? Were you talking about increased regulations for yourself or would

that apply to NYMEX, as well? And second, what would consist of your accountability stand and if you could be very brief with that, I would appreciate it.

Mr. SPRECHER. Yes. I think, as everybody has testified to today, giving the CFTC more information is a better thing, so while I don't believe we need a wholesale overhaul, I think the CFTC has, at least with respect to ICE, as an ECM, the authority it needs to gather that information. I think it is for you all to debate whether that should be broadened to non-ECMs and I won't take a position on that.

Mr. SCOTT. Thank you very much. Dr. Newsome, let me just add that I read in *The Wall Street Journal* recently, I think it was yesterday or the day before, that no less than eight times in 2006, NYMEX allowed Amaranth to trade far beyond its established accountability limits, seemingly at the request of Amaranth. In addition, the article states that although you issued warning letters to Amaranth, you rescinded the violations without explanation. So in light of that, I am having a little bit of trouble understanding why it is that you are pushing so hard for regulation of ICE when, in fact, according to this latest situation with Amaranth, you, yourself, refused to abide by already established accountability limits. Could you explain that, please?

Dr. NEWSOME. Absolutely, sir. I would love to. As I was trying to refer to Congressman Moran's question, when you look at positions, you can't just look at individual months. I mean, we are talking about trying to prevent manipulation and trying to manage systemic risk. You have to look at the positions in an aggregate manner. Now, we have far tougher rules with regard to hard position limits on the front months, more flexible rules with regard to position accountability in the back months.

But we do look at the positions across all contracts, not only futures contracts, but there are options contracts, as well, there are swaps contracts, and in many times these positions are offsetting to get to total futures position or risk position. In those instances, we looked at those positions, not necessarily by that exact month, but in aggregate. When we became concerned that in the aggregate position Amaranth had too much market power, that was the point in which we forced them to start liquidating those positions.

Mr. SCOTT. I want to give you an opportunity to respond to something there, because Michael Greenberger, who is a former CFTC official who oversaw exchange trading in the late 1990s, mentioned this. He said that NYMEX is making a lot of money off these trades and they are very conflicted about what to do. I think it is a very powerful statement that has been made against NYMEX and I would like to give you an opportunity to clear that up and respond to that.

Dr. NEWSOME. And I appreciate you giving me that opportunity, Congressman Scott. I cannot disagree with Mr. Greenberger more on this instance. In fact, if you look at our compliance department, you look at the firewall that we have between the compliance department and the business units of the exchange, at no point in time did the compliance department ever come to the business units or the Board to ask for permission to decrease the Amaranth positions, at no time.

Mr. SCOTT. All right. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. The Chairman has a scheduling problem with going beyond 1 p.m. and consequently, you all have come a long way and offered testimony and not had much of an opportunity to have exchange with one another and with us. What I would like to propose is that once the hearing is adjourned, if you have time on your schedules and I trust that you do, that all six of you gentlemen join me.

We are trying to locate a room where we can have a more informal discussion which I will chair, but it will be pretty informal chairing, so that I can get—and those who wish to join me. I think Mr. Moran will join me and I expect Mr. Barrow will, if his schedule permits and perhaps Mr. Scott—so that I can get a better feel of the differences of opinion among you with regard to these different issues. What do you say? Anybody cannot do that? Great. That is very helpful.

Mr. Pickel, in the past we have talked about reporting and record keeping in your industry and I am sure all the reputable players in your industry are keeping appropriate records. Frankly, all of the reputable characters in your industry are reporting as well, not necessarily to the CFTC, but they are divulging, at the request of brokerage houses and others, their positions so that houses can appropriately gauge risk with regard to different transactions.

I know it is Mr. Corbin's view that an essential part of transparency in the market would be to have some kind of reporting and both NYMEX and ICE probably agree with that as long as they are going to have to be divulging things. What would be the problem with a simple reporting system as it affects the over-the-counter market?

Mr. PICKEL. I continue to go back to the fundamental nature of what I would call the pure OTC, or pure bilateral contract, that we represent and that is two parties getting together, individually negotiating a trade. Yes, they may do many trades, but it is an individual contract that ultimately they have entered into and there are protections under the CFMA for those types of contracts. You are certainly correct that the information is collected. It is just good business sense to collect that information and I know that our member firms, the reputable firms that you refer to are very cooperative with the CFTC and other agencies when they are investigating these situations.

Mr. MARSHALL. When it is a special call?

Mr. PICKEL. Yes.

Mr. MARSHALL. CFTC is not particularly anxious to have, to be flooded, frankly, with the details of all of the transactions that those you represent enter into. It doesn't have the capacity to actually analyze, wouldn't know what it received, would be worried that there is some sort of bombshell and consequently would have to devote resources. We might not provide adequate resources, devote resources to that and hence, take resources away from other oversight activities that it engages in; so there are real challenges here—but say, "Let's narrow it to a certain market."

Let us say natural gas, which has had some obvious problems recently, and reporting where that narrow market is concerned.

Make the reporting a very narrow question, just a few pieces of information about the trade; who the parties are, what the price was and try to take that, whatever the transaction is as between those bilateral entities and have those entities characterize that transaction so it fits into a simple reporting system; which then enables the CFTC, in advance, to anticipate problems with—and it is not just market manipulation here. Everybody is talking about the CFTC having authority where market manipulation is concerned or fraud, and that is the special call.

The argument by Mr. Corbin, and others, is that these markets are not properly finding the price. If you have somebody like Amaranth out there that has a trading strategy that proves to be erroneous, but is willing to back that strategy despite the wisdom of the market. The market prices change rather dramatically as a result of the influence of that entity, the CFTC, seeing that in advance, could conceivably avoid the problem for purchasers like Mr. Corbin and others. And so what would be the problem with doing that from the OTC perspective?

Mr. PICKEL. I think, from our perspective, these individual transactions, the parties will typically reference prices on the NYMEX, perhaps over time. If ICE develops a certain reference price or there is a price discovery function there, they might reference those prices. And they will need to take positions and hedge on those regulated markets and therefore the information regarding the underlying, even if not regarding the individual transaction, the information regarding the strategies will play out in the regulated markets.

Mr. MARSHALL. And assuming that is the case and I accept it is, what would be the harm with divulging the transaction in some simple way to the CFTC? Since you are the only market anyway.

Mr. PICKEL. Well, I think they would look at that information in the way that Dr. Newsome and Mr. Sprecher have described. They would have access to that information. I think that if they saw that that indicated some abnormalities in trading activities, they would certainly be in a position to ask for that information. I think that our member firms have been very good in turning over that information.

Mr. MARSHALL. Dr. Newsome, you keep waving your hand there.

Dr. NEWSOME. Yes, I wanted to make a comment on that, kind of as a non-OTC player. NYMEX, and I just want to get it clear for the record, NYMEX is in no way suggesting that the true, individually negotiated off-exchange bilateral markets should be subject to CFTC oversight and I think there are a couple of reasons. Just the fact that they are individually negotiated in terms of the size of the contract, the price of the contract and the fact that there is no aggregation of risk, like we have on our exchange, like Jeff has on his exchange. I think there is very little public good that can come out of that information.

Mr. MARSHALL. Can I interrupt? Was Amaranth doing, in addition to things on your exchanges, things in the over-the-counter market which were fairly similar to what it was doing in your exchanges?

Mr. PICKEL. I don't have the exact answer to that. My assumption would be that the bulk of their activity was on both NYMEX

and ICE. They may have had some, but again, even if they were, there was no——

Mr. MARSHALL. Well, hypothetically, let us assume Amaranth did, that a whole lot of what it was doing were bilateral trades, like you just described, on the OTC market. How does the CFTC adequately see the dangers, the risks, not just to Amaranth, but to the market and to market price discovery caused by a situation where a large player is just really going whole hog in a particular direction that the rest of the market thinks is crazy, but it is going to have to follow?

Mr. PICKEL. Well, I think the protections are self-built in. Again, since you have no aggregation of risk as you would on an exchange-type manner, I think the risk of a systemic problem is very, very small. Particularly, in natural gas, where somebody has to be able or the willingness to accept the counterparty credit risk, which in natural gas people are typically not willing to do so, that is why you see 90 percent of the natural gas market now cleared, either through ICE or NYMEX, because they don't want to accept that counterparty credit risk. So I totally understand the line of questioning, but I think, in terms of natural gas, it is not as big a risk as it could be and potentially other markets.

Mr. MARSHALL. If I could just finish this line?

The CHAIRMAN. Okay, quickly.

Mr. MARSHALL. I will. By the end of your statement just now, I take it that you think that this risk could exist in other markets, not necessarily in natural gas, and that am I also to assume that it could well be that a large trader who is doing not only trades on your exchanges that are visible, but in addition, trades OTC, same commodity that that large trader's risk to the market, to itself, to consumers, *et cetera*, wouldn't be seen by the CFTC unless there was reporting?

Mr. PICKEL. I am not aware of any risk in other marketplaces. Certainly, if that risk was there, the CFTC would not currently be able to see it.

Mr. MARSHALL. Thank you. Thank you, Mr. Chairman. I thank you for your generosity.

The CHAIRMAN. I thank the gentleman. Mr. Moran.

Mr. MORAN. Mr. Chairman, I will try to be brief. I, too, have a 1 p.m. appointment that I must keep. Let me just follow up with a couple of thoughts that I wanted to explore further. In this regulatory world that we are talking about, is there a transaction cost, a differential between a DCM and an ECM based upon the regulatory structure that CFTC provides?

Dr. NEWSOME. There is some cost, Congressman. I couldn't quantify that cost for you today. I think, looking at the cost of having to acquire and staff a compliance department, as we do, is certainly substantial cost for NYMEX. That is a more easily quantifiable cost. Position limits, there would be a cost there. Price reporting, that reporting is congregated at the clearinghouse level and submitted to the CFTC, so I don't think there would be any real cost on reporting.

Mr. MORAN. Thank you. And then, we heard, as we discussed CFTC reauthorization, about the unique nature of peculiarities of forex contracts, that at least allegedly make them more susceptible

to manipulation fraud. Is there anything inherent in natural gas, oil, and gasoline contracts that you could say the same thing about them? Is there any inherent opportunities for fraud or manipulation?

Dr. NEWSOME. I don't think there are more inherent opportunities other than we have seen more substantial volatility within the energy sector, so you have much more price movement and through that price movement, I guess there could, theoretically, be more opportunity.

Mr. MORAN. And finally, this is directed at Mr. Corbin. Mr. Corbin, there should be a gain that, in the cash market, that offsets losses if you are doing an appropriate hedge, so I assume that there were gains in the cash market that perhaps offset your losses?

Mr. CORBIN. No, there wasn't. What happened was, most of our members' consumption is in the wintertime and so what we are trying to do is hedge the risk of prices spiking in the winter, hitting levels that consumers literally have struggled to pay. And so here we are, earlier in the year, and we can't wait, hoping that prices are going to come down, so we saw them keep going up and up and up. You hope is not a risk management strategy, so we put on those hedges, in the summertime, prior to the Amaranth collapse. We locked in a price that may have been $9 or $10 a unit for wintertime gas. Following the collapse, those prices came down significantly. Yes, we bought gas. You are right. We physically bought gas cheaper, but you then have to add that loss that you incurred on your hedge that gets you right back up to $10 or $9. So the loss isn't offset in the physical market. It is a real loss.

Mr. MORAN. I assume that part of the losses are unrelated to Amaranth, they are related to the market, the volatility, the supply and demand.

Mr. CORBIN. Yes, we tried to simply look at that afterwards. We didn't go with where the market ultimately settled out, which I agree with you. Once it ultimately settles out, there are fundamental reasons, as well, for it to continue to move. We just tried to look at what was happening right at the time they were collapsing, how much did it decline right as they were exiting the market, and just use those numbers.

Mr. MORAN. Mr. Chairman, thank you for allowing me the opportunity to ask these questions. I would ask if anybody would like, not at this point, but in the future, in writing or in a conversation with me, I have heard about the "Enron Loophole" today and there is a suggestion that the "Enron Loophole" needs to be fixed. I would be happy to have the definition. Mr. Eerkes, you, in particular, used that in your testimony, but we heard it in the earlier panel. If there is an "Enron Loophole", I would like to know what it is and what the potential fix that any of you see is required or not required. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. Mr. Barrow, 5 minutes.

Mr. BARROW. I thank the Chairman. I have a few matters I want to follow up on, but out of consideration for the chair's conflict and in light of the informal meeting that Mr. Marshall is going to convene, I will pass on this opportunity, but once again, I want you

to accept my thanks for the opportunity to participate in this hearing. Thank you, sir.

The CHAIRMAN. I thank the gentleman. Dr. Newsome, I am just going to ask you a question and in the expediency of time and everyone's schedule that it would be in writing, if I may get it? According to the Senate Investigative Subcommittee, in a report on, this by and large is a natural gas market. It said from almost every day from mid-February through July of 2006, Amaranth held more than 50 percent of the open interest on New York Merc and in January of 2007, as well as in November of 2006, contracts.

My question is, is this common or normal for a trader to hold such a large position or contract? Second, does holding such a position trigger action at the exchange or the CFTC, for that matter? And finally, if so, what did New York Merc do with regard to Amaranth's position as it relates to this? And I would be happy to have that in writing so we can expedite this and allow you gentlemen to get on the road because you have been very kind with your time today and we do appreciate you staying with us through the votes we have had today. And with that, unless the Ranking Member has a further comment?

Mr. MORAN. No, sir. Thank you, Mr. Chairman.

The CHAIRMAN. Under the rules of the Committee, the record of today's hearing will remain open for 10 days to receive additional material and supplementary written requests and responses from witnesses to any question posed by a Member of this panel. This hearing of the Subcommittee on General Farm Commodities and Risk Management is adjourned. Thank you.

[Whereupon, at 12:56 p.m., the Subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

SUBMITTED QUESTION

Response from Orice M. Williams, Director, Financial Markets and Community Investment, U.S. Government Accountability Office, Washington, D.C.

Question Submitted By Hon. Hon. Jim Marshall, a Representative in Congress From Georgia

Question. Please review how the Municipal Gas Authority of Georgia (MGA) calculated the $18 million in losses for 2006 that were attributed in the futures market because of the trading practices of Amaranth Advisors, LLC; and analyze MGA's recommendations for changes to the Commodity Futures Trading Commission's (CFTC) oversight authority.

Answer. At the July 12, 2007, House Committee on Agriculture's Subcommittee on General Farm Commodities and Risk Management hearing on energy-based derivatives, you asked that we (1) review how the Municipal Gas Authority of Georgia (MGA) calculated the $18 million in losses for 2006 that were attributed in the futures market because of the trading practices of Amaranth Advisors, LLC; and (2) analyze MGA's recommendations for changes to the Commodity Futures Trading Commission's (CFTC) oversight authority. On July 20, 2007, we spoke with Arthur Corbin, President and Chief Executive Officer of MGA, and Jeff Billings, the head of risk management for MGA. We also reviewed data that MGA used to arrive at its $18 million loss estimate.

According to MGA officials, they estimated the $18 million loss by calculating the difference between the prices MGA members paid for futures contracts and what members would have actually paid for natural gas in the physical markets in 2006. This analysis assumed that Amaranth's trading was the only factor affecting natural gas prices in 2006, and did not include the possible effect of other factors such as changes in supply and demand or the trading activities of others. MGA officials acknowledged that other factors could have also played a role in futures prices during this period. As we testified, the factors affecting energy prices, including natural gas are complex and attributing a change in prices to any one fact is difficult. Therefore, we are unable to make any specific conclusions based on this analysis.

MGA recommended that CFTC have the same oversight authority over all markets that trade derivatives in energy. Specifically, they noted that even though off-exchange transactions lack the requirement for physical delivery of exchange-traded contracts, the absence of the requirement does not preclude a trader from manipulating commodity prices. Further, they said that without a complete picture of trading in all of the energy markets, particularly by large traders, CFTC can not adequately protect consumers from artificial prices. They also noted that CFTC's special call authority, while helpful, does not provide for routine monitoring and oversight of trading in natural gas derivatives; and that CFTC's authority to expose manipulative behavior after it occurs does little good because, as they said, contract prices already would have been affected. The issues raised are consistent with those raised by others who support greater CFTC authority over certain derivatives markets. Given the growth in energy trading in the exempt and over-the-counter markets, further debate and analysis is warranted including whether CFTC's current authority is sufficient in light of recent events.

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