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FUTURES MARKETS

Approach for Examining Oversight of Energy Futures

Statement of Orice M. Williams, Director
Financial Markets and Community Investment

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the design of our ongoing study of the Commodity Futures Trading Commission's (CFTC) oversight of futures trading in energy commodities. As you are aware, record high crude oil and natural gas prices have generated significant concerns by the public and members of Congress that the high and relatively volatile prices may be the result of factors other than market forces. Several members of the House and the Senate have expressed concerns over the upward trending prices and factors that may be causing the perceived increases in volatility of several energy commodities, including crude oil, gasoline, natural gas, and heating oil. As a result, we initiated this study under the authority of the Comptroller General. My remarks today focus on our ongoing study of (1) changes in energy futures markets and volatility since 2000 and (2) CFTC surveillance and enforcement activities in the oversight of energy futures trading.

This ongoing work will leverage results of our previous reviews of the financial and physical energy markets, and trading data from the CFTC and the New York Mercantile Exchange (NYMEX).[1] It will also be based on discussions and reviews of available information from officials and staff from several federal agencies, refiners, vertically integrated oil companies, associations representing end users of natural gas, investment banks, and hedge funds, as well as market analysts and academics. We will also be reviewing relevant CFTC enforcement cases and CFTC Inspector General reports and incorporating their results in our work.

In summary:

Our ongoing study explores how energy futures markets and market participants with different investment objectives affect futures and commodity prices in a complex and rapidly evolving marketplace. Some of these participants include producers and refiners, who use futures

[1]See U.S. GAO, *Energy Markets: Factors Contributing to Higher Gasoline Prices*, GAO-06-412T (Washington, D.C.: February 1, 2006); U.S. GAO, *Motor Fuels: Understanding the Factors That Influence the Retail Price of Gasoline*, GAO-05-525SP (Washington, D.C.: May 2005).

contracts[2] as a key tool to manage risk they face due to changes in prices. Since 2000, there has also been an increase in the number of new participants, such as hedge funds and investment banks. Our ongoing study will evaluate what market studies and other market data indicate as to whether energy futures prices have become more volatile. Specifically, we are looking at different ways of measuring volatility and reviewing recent studies on volatility by NYMEX, CFTC, Consumer Federation of America, and others. We are also using NYMEX trading data to document trends in volatility.

Our ongoing study also explores how CFTC's market surveillance program is used to monitor and detect market abuses in the trading of energy futures. We are also determining what fraudulent, manipulative, and abusive practices have been identified by CFTC and others in the trading of energy futures and how CFTC is positioned to protect market users from these practices. CFTC's surveillance program is one tool used to oversee the integrity of the futures market. CFTC uses its large trader reporting system and other sources such as relevant self-regulatory organizations (SRO) and other federal agencies to monitor for attempted manipulation in the futures markets. In cases of suspected fraud, manipulation or abuse, CFTC will undertake enforcement actions. As part of this study, we are looking at CFTC's authority and its resources to protect market users.

Background

Futures contracts are traded on regulated exchanges and are settled daily based on their current value in the marketplace. The key players in futures markets are hedgers, speculators, and brokers. Hedgers use futures to shift the risk of a price change onto other market participants such as speculators. Speculators may assume the price risk that hedgers try to avoid in the hope of making a profit. Although speculators usually have no commercial interest in the commodities they trade, the desire to make a profit motivates them to collect market information regarding the supply

[2]Futures are one type of derivatives contract. The market value of a derivatives contract is derived from a reference rate, index, or the value of an underlying asset, including stocks, bonds, commodities, interest rates, foreign currency exchange rates, and indexes that reflect the collective value of underlying financial products. The regulation of derivatives generally varies depending on whether they are traded on exchanges (exchange-traded) or traded over-the-counter (OTC) and on the nature of the underlying asset, reference rate, or index. Futures obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified future date and are often traded on exchanges.

and demand of commodities to anticipate the potential impact of this information on prices. Finally, there are brokers, who make the trade.

Oversight of the futures market is the responsibility of CFTC, which was created in 1974 as an independent agency responsible for encouraging competitiveness and efficiency in futures markets, ensuring their integrity, protecting market participants against manipulation, abusive trading practices, and fraud, and ensuring the financial integrity of the clearing process.[3] Through its oversight, especially its surveillance and enforcement programs, CFTC is responsible for enabling the futures markets to provide a means for determining the price of commodities—price discovery—and for offsetting price risk faced by market participants. Oversight is also provided by NYMEX, an SRO, that is itself regulated by the CFTC.

In the U.S. futures regulatory structure, SROs—the futures exchanges and the National Futures Association—provide industry oversight. Futures SROs, such as NYMEX, are responsible for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation, including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes. Their operations are funded by the futures industry through transaction fees and other charges. CFTC oversees the SROs to ensure that each has an effective self-regulatory program.

Changes in Energy Futures Markets and Volatility Since 2000

Since 2000, there has been an increase in the number of market participants in the energy futures markets, such as hedge funds and investment banks, raising questions about the impact they have had on the market overall and volatility in particular. Futures contracts are also seen as a key tool that producers and refiners use to manage the risks they face due to changes in prices. Our work is designed to describe how energy futures markets and market participants with different investment objectives influence energy prices. To address this, we will provide an overview of the energy futures markets and the role played by various market participants. Further, we will discuss how the markets function to

[3] According to CFTC, clearing is the procedure through which the clearing organization becomes the buyer to each seller of a futures contract or other derivative, and the seller to each buyer for clearing members.

provide price discovery, liquidity, and risk management. We will also address markets other than NYMEX, such as the over-the-counter (OTC) market, and how these markets differ from NYMEX. Finally, we will explore NYMEX's role in providing price discovery for energy commodities and futures prices and their link to spot or cash prices.

As part of our work, we are also reviewing what market studies by CFTC, NYMEX and others have found to affect volatility. Specifically, we are determining how volatility is defined and identifying factors that impact volatility. We will also address whether available evidence suggests that new market participants are a factor causing volatility. In answering this question we will analyze both CFTC and NYMEX trading data and studies that have addressed the causes of volatility in the futures markets.

CFTC Provides Oversight Through Surveillance and Enforcement Activities of Energy Futures Trading

CFTC provides oversight through surveillance and enforcement of energy futures trading and our ongoing work involves assessing how CFTC's market surveillance program is used to monitor and detect market abuses in the trading of energy futures. To address these issues we are evaluating both CFTC and NYMEX surveillance programs, with a focus on how CFTC uses its large trader reporting system data as part of its surveillance. This work will describe how CFTC commissioners are kept informed of surveillance and other market concerns. We will also describe how both CFTC and NYMEX surveillance programs provide oversight and how NYMEX monitors positions against specific limits to detect attempted abuses. This work will also document efforts of other agencies, including the Department of Justice, the Federal Trade Commission, and the Federal Energy Regulatory Commission in providing oversight to energy market activities.

We are also focusing on what fraudulent, manipulative, and abusive practices have been identified by CFTC and others in the trading of energy futures. We will provide information on the enforcement programs of CFTC and NYMEX, including the results of recent enforcement actions taken by CFTC and NYMEX and the settlements reached involving these enforcement actions. We are also addressing the extent to which CFTC uses internal and external sources in developing enforcement cases. This includes discussing NYMEX's enforcement activities and how NYMEX coordinates these activities with CFTC.

Finally, we are exploring how CFTC is positioned to protect market users and the public from actual and potential abuses in the trading of energy futures. Areas we are focusing on include changes in CFTC's regulatory approach since the Commodity Futures Modernization Act of 2000 and staff resources available to accomplish its mission including the allocation of staff. Our current timeframe from completing this work is September 2006.

Mr. Chairman, this completes my prepared statement. I would be pleased to answer any questions that you or Members of the Committee may have.

Contact and Acknowledgements

For further information about this testimony, please contact Orice Williams on (202) 512-8678 or williamso@gao.gov. 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 to this testimony include John Wanska (Assistant Director), Kevin Averyt, and John Forrester.

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