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Highlights

Highlights of GAO-08-174T, a testimony before the Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, House of Representatives

October 24, 2007

COMMODITY FUTURES TRADING COMMISSION

Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight

Why GAO Did This Study

Energy prices for crude oil, heating oil, unleaded gasoline, and natural gas have risen substantially since 2002, generating questions about the role derivatives markets have played and the scope of the Commodity Futures Trading Commission's (CFTC) authority. This testimony focuses on (1) trends and patterns in the futures and physical energy markets and their effects on energy prices, (2) the scope of CFTC's regulatory authority, and (3) the effectiveness of CFTC's monitoring and detection of abuses in energy markets. The testimony is based on the GAO report, *Commodity Futures Trading Commission: Trends in Energy Derivatives Markets Raise Questions about CFTC's Oversight* (GAO-08-25, October 19, 2007). For this work, GAO analyzed futures and large trader data and interviewed market participants, experts, and officials at six federal agencies.

What GAO Recommends

As part of CFTC's reauthorization process, GAO recommended that Congress consider exploring the scope of the agency's authority over energy derivatives trading, in particular for trading in exempt commercial markets. In addition, GAO recommends that CFTC improve the usefulness of the information provided to the public, better document its monitoring activities, and develop more outcome-oriented performance measures for its enforcement program. CFTC generally agreed with GAO's recommendations.

To view the full product, including the scope and methodology, click on GAO-08-174T. For more information, contact Orice Williams at (202) 512-8678 or williamso@gao.gov.

What GAO Found

Various trends in both the physical and futures markets have affected energy prices. Specifically, tight supply and rising demand in the physical markets contributed to higher prices as global demand for oil has risen rapidly while spare production capacity has fallen since 2002. Moreover, increased political instability in some of the major oil-producing countries has threatened the supply of oil. During this period, increasing numbers of noncommercial participants became active in the futures markets (including hedge funds) and the volume of energy futures contracts traded also increased. Simultaneously, the volume of energy derivatives traded outside of traditional futures exchanges increased significantly. Because these developments took place concurrently, the effect of any individual trend or factor on energy prices is unclear.

Under the authority granted by the Commodity Exchange Act (CEA), CFTC focuses its oversight primarily on the operations of traditional futures exchanges, such as the New York Mercantile Exchange, Inc. (NYMEX), where energy futures are traded. Increasing amounts of energy derivatives trading also occur on markets that are largely exempt from CFTC oversight. For example, exempt commercial markets conduct trading on electronic facilities between large, sophisticated participants. In addition, considerable trading occurs in over-the-counter (OTC) markets in which eligible parties enter into contracts directly, without using an exchange. While CFTC can act to enforce the CEA's antimanipulation and antifraud provisions for activities that occur in exempt commercial and OTC markets, some market observers question whether CFTC needs broader authority to more routinely oversee these markets. CFTC is currently examining the effects of trading in the regulated and exempt energy markets on price discovery and the scope of its authority over these markets—an issue that will warrant further examination as part of the CFTC reauthorization process.

CFTC conducts daily surveillance of trading on NYMEX that is designed to detect and deter fraudulent or abusive trading practices involving energy futures contracts. To detect abusive practices, such as potential manipulation, CFTC uses various information sources and relies heavily on trading activity data for large market participants. Using this information, CFTC staff may pursue alleged abuse or manipulation. However, because the agency does not maintain complete records of all such allegations, determining the usefulness and extent of these activities is difficult. In addition, CFTC's performance measures for its enforcement program do not fully reflect the program's goals and purposes, which could be addressed by developing additional outcome-based performance measures that more fully reflect progress in meeting the program's overall goals. Because of changes and innovations in the market, the reports that CFTC receives on market activities may no longer be accurate because they use categories that do not adequately separate trading being done for different reasons by various market participants.