G A O
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-07-1095T, testimony before Subcommittee on General Farm Commodities and Risk Management, Committee on Agriculture, House of Representatives

July 12, 2007

ENERGY DERIVATIVES

Preliminary Views on Energy Derivatives Trading and CFTC 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 reasons for the increase. Some observers believe that the higher energy prices were solely due to supply and demand fundamentals while others believe that increased futures trading activity may also have contributed to higher prices. This testimony highlights GAO's preliminary findings related to (1) trends and patterns in the futures and physical energy markets and the effect of these trends on energy prices and (2) the Commodity Futures Trading Commission's (CFTC) regulatory and enforcement authority over derivatives markets.

GAO analyzed futures and large trader reporting data; trading data obtained from the New York Mercantile Exchange (NYMEX) for crude oil, heating oil, unleaded gasoline, and natural gas; and various other sources of energy-related data. GAO also analyzed relevant academic and other studies on the subject and interviewed market participants, experts, and officials at relevant federal agencies.

What GAO Recommends

This testimony is based on an ongoing engagement, and therefore GAO is making no recommendations at this time.

www.gao.gov/cgi-bin/getrpt?GAO-07-1095T.

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

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 antimanipulation and antifraud 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.