

**Testimony of James A. Overdahl, Chief Economist
U. S. Commodity Futures Trading Commission
Before the Senate Committee on Energy and Natural Resources
September 6, 2005**

Mr. Chairman, Senator Bingaman, and Members of the Committee, I appear before you today in my capacity as Chief Economist of the Commodity Futures Trading Commission, the federal government regulator of futures and futures options markets in the United States. Energy contracts falling under the CFTC's jurisdiction include futures and related contracts on crude oil, natural gas, heating oil, propane, electricity, and unleaded gasoline. Trading in these contracts takes place predominately at the New York Mercantile Exchange (NYMEX).

In U.S energy markets, recent experience has shown that even small disruptions in production, refining capacity, or transportation networks can significantly affect prices in the face of high demand for energy products. Therefore, given the scale of disruptions caused by Hurricane Katrina, it is not surprising that current prices for energy products have risen significantly. Consumers of energy products, who are paying these higher prices, deserve to know that energy prices are being set fairly in an open and competitive environment.

Futures markets serve energy producers and consumers in two important ways. First, these markets provide a means for market participants to manage risks arising from their normal day-to-day commercial activity. This risk-management activity is commonly referred to as "hedging." A significant majority of futures positions held over time are established by commercial users of energy products who hedge their exposure to price risks occurring in the underlying "cash" energy markets. Second, futures markets are a venue for price discovery. The prices discovered through the interaction of thousands of traders provide valuable information even to those who are not direct participants in futures markets. These prices are widely distributed through newspapers and over the internet and television so that anyone, not just professional traders, can observe futures market prices and can use these prices as a reliable benchmark upon which to guide forward-looking decisions. The prices discovered in futures markets are also used as a benchmark in many types of privately-negotiated, over-the-counter contracts.

My purpose here today is to do two things. First, I will briefly describe the methods the CFTC uses to ensure market integrity. Second, I will address the role played by non-commercial traders, commonly referred to as "speculators," in energy markets under the CFTC's jurisdiction.

Methods used by the CFTC to ensure that energy futures prices are determined in an open and competitive environment. The CFTC's mission is to administer the Commodity Exchange Act (CEA), the statute governing futures trading in the United States. Under the CEA, the CFTC is the exclusive regulator of futures and futures options markets in the United States. At its core, the CEA is an anti-manipulation statute, meaning that the CFTC's primary mission is to detect and deter market manipulation and other trading abuses. The CFTC relies on a program of market surveillance to ensure that markets under CFTC jurisdiction are operating in an open and competitive manner, free of manipulative influences or other sources of price distortions.

The heart of the CFTC's market surveillance program is its Large Trader Reporting System. This system captures end-of-day position-level data for market participants meeting certain criteria. Positions captured in the Large Trader Reporting System make up 70 to 90 percent of all positions in a particular market. The Large Trader Reporting System is a powerful tool for detecting the types of concentrated and coordinated positions required by a trader or group of traders attempting to manipulate the market.

In addition to regular market surveillance, the CFTC conducts an aggressive enforcement program that prosecutes and punishes those who break the rules. Nearly one-third of the CFTC's resources are devoted to its enforcement program. The punishment meted out as the result of enforcement proceedings deters would-be violators by sending a certain and clear message that improper conduct will be detected and will not be tolerated.

In addition to the efforts of the CFTC, futures exchanges, such as the NYMEX, also conduct regular surveillance of their markets under their self-regulatory obligations as defined in the Commodity Exchange Act. Under the CEA, futures exchanges are guided by a set of eighteen core principles to ensure that futures trading takes place in an open and competitive environment. Core principles 3, 4, and 5 speak directly to the duty of futures exchanges to adopt internal rules and policies and to design futures contracts that reduce the threat of market manipulation and other sources of price distortions. In addition, Core principle 9 addresses the duty of futures exchanges to provide a competitive, open, and efficient market for executing futures transactions. The CFTC oversees compliance with the core principles by conducting periodic rule enforcement reviews to ensure that the exchanges are enforcing the rules on their books. Aside from their assigned self-regulatory obligations to the public, futures exchanges also have private business reasons to make sure that the markets they host operate in an environment free of manipulation. Even the perception of manipulation is one of the worst fates that can befall a futures market.

The role of non-commercial traders in energy markets under the CFTC's jurisdiction.

Data from the CFTC's Large Trader Reporting System can help answer questions about the role of non-commercial traders in U.S. energy futures markets. For the unleaded gasoline futures markets, approximately 80 percent of all open futures positions meet the size threshold for inclusion in the CFTC's Large Trader Reporting System. A current snapshot of these reportable positions shows that non-commercial traders, those who are commonly labeled as speculators because they do not have an underlying commercial purpose for holding a futures position, hold about 25 percent of the "long" positions, that is, positions that will appreciate if gasoline futures prices rise. This current percentage is slightly lower than the average percentage for similar positions over the past two years. The remainder of open positions, which represent a significant majority of positions, are held by commercial traders, that is, producers, refiners, and retailers, who are commonly viewed as hedgers. The CFTC provides on its web site (www.cftc.gov) a weekly report, called the Commitments of Traders Report, showing the aggregate positions of commercial and non-commercial traders based on the CFTC's Large Trader Reporting System.

The role of non-commercial traders in futures markets has been studied extensively, both by CFTC economists and others. One can find a long list of academic studies on the role played by

non-commercial traders in affecting a variety of market characteristics across many different markets. One lesson from these studies is that non-commercial traders are necessary in order for futures markets to facilitate the needs of hedgers. In order for hedgers to reduce the risk they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Non-commercial traders take on this risk for a price. Non-commercial traders also add to overall trading volume which contributes to the formation of liquid and well-functioning markets. Futures exchanges know from experience that the markets they host cannot exist with hedgers alone. Both hedgers and speculators are necessary for a futures market to perform its socially beneficial role of transferring risk from those who do not want it to those who are willing to accept it for a price.

Non-commercial traders are a diverse group with diverse trading objectives. Managed money traders, including those called hedge funds, fall into the category of non-commercial traders because they do not have a commercial interest in the product upon which the futures contract is written. In the futures market for unleaded gasoline, managed money traders represent a sizable portion of the category of large non-commercial traders captured in the CFTC's Large Trader Reporting System. Like other non-commercials, the trading strategies of managed money traders can vary greatly from one trader to another. On average, managed money traders make up approximately 75 percent of the non-commercial positions on the "long" side of the market, that is, the side of the market that would benefit from increases in unleaded gasoline futures prices.

The attached chart provides a snapshot of participation by managed money traders in the October 2005 unleaded gasoline contract traded at the NYMEX. I call your attention to the last three vertical columns representing the positions of managed money traders in the days immediately following Hurricane Katrina. As a group, managed money traders reduced their positions, that is, they were selling, as market prices, represented by the continuous line, were soaring. A conclusion that can be drawn from this chart is that managed money traders, and speculators in general, do not have perfect foresight.

Managed money traders also represent a significant share of traders speculating on prices across related markets. A common trading strategy is to simultaneously establish offsetting positions between crude oil and the products that are refined from crude oil, that is, gasoline and heating oil. This trading strategy is referred to by traders as the "crack spread." In the past week, prices for refined products have moved much higher, on a percentage basis, than prices for crude oil. A conclusion that can be drawn from the behavior of the crack spread is that the increase in gasoline prices following Hurricane Katrina are being driven primarily by disruptions to the refining process, and not as much from increases in the level of crude oil prices.

As I mentioned earlier, an important benefit to society provided by futures markets is price discovery. Looking at NYMEX futures prices for wholesale unleaded gasoline over the next year, one can see that the market expects prices in the future to fall back to levels close to where they were before Hurricane Katrina. Overall however, the futures market reflects expectations that gasoline prices a year from now will be significantly higher than prices a year ago. Of course, such expectations depend on many variables, including how quickly refinery facilities and transportation networks return to normal operations. I look forward to your questions.

Unleaded Gasoline: AFOC Delta Adjusted Net Long Managed Money Positions and October 2005 Future Settlement Prices

