



Commodity Futures Trading Commission

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Testimony

**Testimony of Walter L. Lukken
Commissioner
U. S. Commodity Futures Trading Commission
before the
Committee on Agriculture
United States House of Representatives
April 27, 2006**

Chairman Goodlatte, Ranking Member Peterson and Members of the Committee, I appreciate the opportunity to testify on behalf of the Commodity Futures Trading Commission (CFTC) concerning the CFTC's oversight of energy futures and options markets.

The CFTC has been paying particularly close attention to futures trading in energy commodities because of the importance of energy prices and supplies to the U.S. economy and to every U.S. citizen. Both the level and the volatility of prices will react to new information. If such reactions are based on accurately reported information about market fundamentals, such as short- or long-term changes in supply or demand, then the futures markets are performing their proper price discovery function. Based on our surveillance so far, we believe that crude oil and gasoline futures markets have been accurately reflecting the underlying fundamentals of these markets.

In my testimony today, I will describe the CFTC's oversight of the energy futures markets. I will also share my observations on the current state of the futures markets for crude oil and gasoline.

A. The Commodity Futures Trading Commission's Core Mission

Futures markets play a critically important role in the U.S. economy. They provide risk management tools that producers, distributors, and commercial users of commodities (such as crude oil and unleaded gasoline) utilize to protect themselves from unpredictable price changes. The futures markets also play a price discovery role as participants in related cash and over-the-counter (OTC) 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.

The CFTC's primary mission under the Commodity Exchange Act (CEA) is to ensure that the commodity futures and options markets operate in an open and competitive manner, free of price distortions. The CFTC fulfills this obligation through a comprehensive, multi-faceted program that is designed to identify and mitigate the potential for manipulation and other market abuses, and to ferret out and punish illegal behavior.

B. The CFTC's Market Oversight Program

To the full extent of our congressionally conferred legal authority, the CFTC attempts to proactively identify and mitigate the potential for price manipulation. When any new futures or options contract is listed for trading on a futures exchange, the CFTC staff reviews the terms and conditions of the contract to determine if it is readily susceptible to manipulation. For example, although most futures contracts are ultimately financially-settled (meaning participants offset their positions through the exchange by paying or receiving money rather than by making or

taking delivery of the actual commodity), the CFTC carefully examines those contracts that permit physical delivery (as do key energy contracts on the New York Mercantile Exchange, or NYMEX) to ensure that the deliverable supply of the commodity is sufficient to facilitate orderly deliveries and liquidations at contract expiration dates, and to prevent any would-be manipulator from cornering or squeezing the market.

Every trading day, CFTC staff closely monitors trading activities on the exchanges to detect unusual activity or price aberrations that may indicate actual or attempted manipulation. The cornerstone of the CFTC's market surveillance program is the Large Trader Reporting System. The Large Trader Reporting System requires clearing members, futures commission merchants, and foreign brokers to file daily reports with the CFTC concerning their own and their customers' positions in a particular contract. This reporting requirement is triggered when a trader holds a position at an exchange that is at or above specific reporting levels set by CFTC's regulations. Through Large Trader Reports, the CFTC becomes aware of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation.

In addition to the daily Large Trader Reports, the CFTC may issue a "special call" to a reportable trader or firm. Through these special calls, the CFTC can obtain more detailed information on a participant's trading and delivery activity, and on the trader's positions and transactions in the underlying commodity.

Market surveillance is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively supervise trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the Commission, and are publicly posted on the CFTC Web

site (www.cftc.gov). Furthermore, exchanges must impose position limits, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy futures contracts.

When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications to work to resolve the situation. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. CFTC staff contacts the largest long- and short-side traders to obtain information on, among other things, their delivery intentions and capability, and their price objectives in liquidating trades. The traders are advised of the CFTC's concern regarding the orderly expiration of the futures contract, and reminded that they are expected to trade in a responsible manner. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. When, however, staff is not satisfied that it has been successful, a more formal written warning will be issued to notify the trader of the CFTC's concern about the possibility of manipulation.

Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action, which, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Such actions could include limiting trading to liquidating transactions, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or in extraordinary circumstances, closing a market. Fortunately, most issues are resolved without the need for the

CFTC's emergency powers. The fact that the CFTC has had to take emergency action only four times in its history demonstrates its commitment not to intervene directly in markets unless all other efforts have been unsuccessful.

C. The CFTC's Enforcement Program

The CFTC aggressively pursues any individual or entity that intentionally seeks to disrupt or undermine the integrity of markets for trading commodity futures and options contracts. The CFTC's Division of Enforcement investigates and, as appropriate, prosecutes individuals and entities for violations of the CEA or CFTC regulations, including manipulation and false reporting, as well as trade practice abuses (*e.g.*, wash sales and accommodation trading) involving trading on markets subject to CFTC oversight. The proposed sanctions sought in the CFTC's enforcement actions serve the dual purposes of obtaining redress for the charged violations and acting as a deterrent for would-be violators by sending a clear message that improper conduct will not be tolerated.

The CFTC's Division of Enforcement may receive referrals from several sources: the CFTC's own market surveillance staff; the Division's interaction with compliance staff at the relevant exchange; market participants and complaints from members of the public; and other State, Federal, and international regulatory authorities. Upon determining that further inquiry concerning the referral is warranted, Enforcement staff immediately gathers information internally available within the CFTC and from the exchanges, and conducts relevant interviews. The CFTC may grant formal administrative subpoena authority, which enables its Division of Enforcement to obtain documents (*e.g.*, audio recordings, e-mail and trade data), and testimony from third parties.

The investigation may be conducted in cooperation with the applicable exchange and other regulators such as the Federal Energy Regulatory Commission (FERC). On October 12, 2005, the CFTC and FERC executed a Memorandum of Understanding, pursuant to provisions of the Energy Policy Act of 2005, to ensure that information requests to markets within the respective jurisdiction of each agency are properly coordinated to minimize duplicative information requests, and to address the confidential treatment of proprietary energy trading data. It will enable both the CFTC and FERC to work actively to assure the price integrity of the energy markets.

If warranted at the conclusion of its investigation, the Division of Enforcement will recommend that the CFTC initiate a civil injunctive action in Federal district court or an administrative proceeding. The CFTC may seek temporary statutory restraining orders and preliminary and permanent injunctions in federal courts to halt ongoing violations, as well as civil monetary penalties, appointment of a receiver, the freezing of assets, restitution to customers, and disgorgement of unlawfully acquired benefits. 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 is a member of the President's Corporate Fraud Task Force, which is chaired by the Department of Justice. The CFTC may refer an enforcement matter to the Department of Justice and 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.

In recent years, the CFTC's Enforcement program has conducted an extensive investigation of alleged abuses in energy-related markets. This investigation has focused on

energy trading firms that allegedly have engaged in: 1) reporting false, misleading or knowingly inaccurate market information (including price and volume information) to natural gas reporting firms which affects or tends to affect the market price of energy commodities, including futures prices as traded on NYMEX; and 2) manipulation or attempted manipulation which could affect prices of NYMEX energy futures contracts. The CFTC's enforcement actions in the energy sector reflect an approach to market oversight that emphasizes tough enforcement actions against proven wrongdoers. As a result of its efforts in investigating wrongdoing in the energy markets, the CFTC has filed 32 enforcement actions charging 27 companies and 23 individuals in cases involving natural gas since December 2002. These enforcement actions have thus far resulted in civil monetary penalties totaling nearly \$300 million, among other sanctions.

D. Current State of Futures Markets for Crude Oil & Unleaded Gasoline

Having described the process the CFTC uses to ensure that futures markets are operating in an open and competitive manner, I will now describe what CFTC staff has recently observed in the futures markets for crude oil and unleaded gasoline. These observations are directed at the following: 1) participation rates of non-commercial traders, the so-called "speculators"; 2) current futures market prices for contracts with delivery dates during the upcoming summer season; 3) recent delivery experience; and 4) the relationship between crude oil futures prices and unleaded gasoline futures prices.

1. Participation Rates of Non-Commercial Traders

Data from the CFTC's Large Trader Reporting System help answer questions about the role of non-commercial traders in futures markets for crude oil and unleaded gasoline. A weekly summary, called the Commitments of Traders (COT) Report, is based on information gathered

through the Large Trader Reporting System. The CFTC publicly releases the COT Report every Friday afternoon via its Web site (www.cftc.gov).

A snapshot of positions in the futures markets for crude oil and unleaded gasoline, current as of April 18, 2006, shows that as a group, non-commercial traders – that is, those who are commonly labeled as speculators – have most recently held net long positions in both markets. In other words, non-commercial traders have held positions that will gain in value if prices for crude oil and unleaded gasoline rise. In the crude oil futures market, non-commercial traders hold approximately 18.3 percent of the open long positions and 11.6 percent of the open short positions. In unleaded gasoline, non-commercial traders hold approximately 21.8 percent of the open long positions and 7.0 percent of the open short positions.

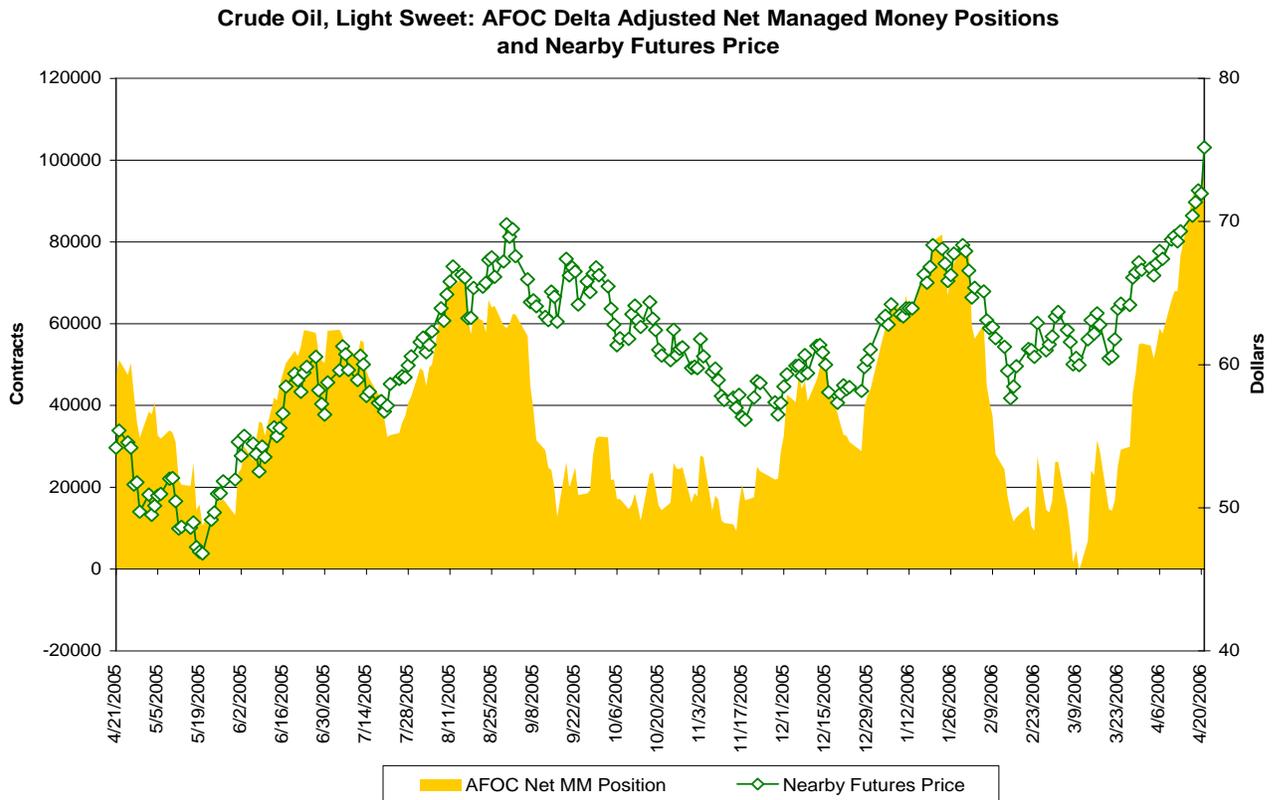
Positions in both crude oil and unleaded gasoline futures markets are held predominately by commercial traders – that is, producers, refiners, and retailers, who are commonly known as hedgers. In the crude oil futures market, approximately 55.6 percent of outright long positions (*i.e.*, positions that will gain value if prices rise) are held by commercial traders compared to 18.3 percent for non-commercial traders. In the unleaded gasoline futures market, approximately 56.6 percent of outright long positions are held by commercial traders compared to 21.8 percent for non-commercial traders.¹

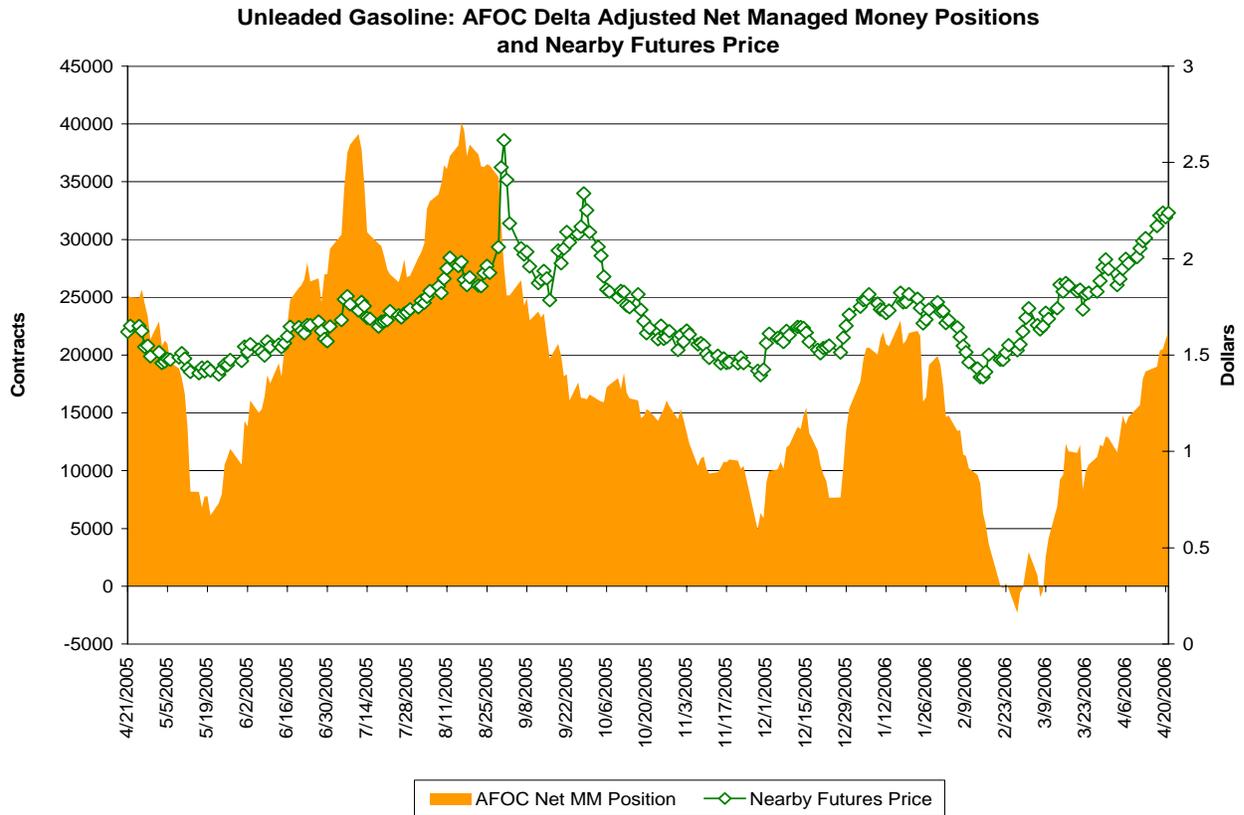
¹ A large percentage of the remaining long positions are held by traders whose positions are too small to meet the reporting size threshold for inclusion in the Commission's Large Trader Report. The remaining long positions are held as part of so-called "spread" positions across contract months. A spread position is established by simultaneously taking a long position in one futures contract and a short position in a related contract. Although spread positions are generally regarded as speculative, the speculation is based on relative price differences between contracts. Spread strategies do not depend on, and are therefore unrelated to, the overall level or direction of the market.

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. As a group, managed money traders represent a significant – but minority – portion of the relatively small percentage of non-commercial positions in both crude oil and unleaded gasoline futures markets. On average, managed money traders make up approximately 47 percent of the non-commercial long positions and 26 percent of the non-commercial short positions in the unleaded gasoline futures markets. In the crude oil futures market, managed money traders make up 44 percent of the non-commercial long positions and 36 percent of the non-commercial short positions.

Figures 1 and 2 below provide a snapshot of participation by managed money traders in the crude oil and unleaded gasoline futures contracts traded at NYMEX. The net positions of managed money traders as a group are displayed by the vertical columns. These positions are reported, in thousands of contracts, for all futures and options combined (defined as “AFOC” in Figures 1 and 2 below). Each crude oil contract is written on 1,000 barrels (equivalent to 42,000 gallons) of crude oil. Each unleaded gasoline contract is written on 42,000 U.S. gallons (1,000 barrels). The continuous line on each chart shows the end-of-day price for the nearby futures contract. Both charts show that managed money traders have held mainly long positions in both markets but do offset long positions (or “go short”) frequently, and so they would benefit from falling – not rising – futures prices in these instances. The charts also show that while the positions of managed money traders and prices generally move together, there are several instances where prices move independently from the positions of managed money traders. A conclusion that can be drawn from this chart is that managed money traders, and speculators in general, do not have perfect foresight. And as noted above, while these managed money traders

are currently long, and comprise a sizeable proportion of the non-commercial category, the commercial traders in these markets are more numerous and hold larger, long positions.





The role of non-commercial traders in futures markets has been studied extensively, both by the CFTC’s economists and others. One lesson from these studies is that non-commercial traders are necessary in order for futures markets to fulfill the needs of hedgers. An “all hedgers” market simply can not work. In order for hedgers to reduce the risk that 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. Therefore, both hedgers and speculators are necessary for the futures markets to perform their vital role of transferring risk to those who are willing to accept it for a price.

A recent study by the CFTC’s economists demonstrates the relationship between speculators and hedgers. The study shows that when a commercial trader sells, it will often be a managed money trader who takes the other side of the transaction; when a commercial trader

buys, it will often be a managed money trader who is the seller. This observation is consistent with the notion that managed money traders provide liquidity in our energy markets.

2. *A Snapshot of Current Futures Market Prices*

As I mentioned earlier, the futures markets serve an important price discovery function. As a general policy, the CFTC refrains from predicting prices. However, futures market prices can be viewed as reflecting the markets' aggregate expectation of future spot market prices. Each table below displays current (as of April 25, 2006) futures prices for contracts expiring during the upcoming months. These futures prices show, based on current information, that the futures markets expect spot market prices to remain close to current levels. These prices and expectations are revised continuously by the market as new information becomes available.

Crude Oil Futures Prices	
Delivery Date	Futures Price as of 04/25/2006 U.S. dollars and cents per barrel
June 2006	72.88
July 2006	74.35
Dec 2006	76.33
Jan 2007	76.34

Unleaded Gasoline Futures Prices	
	Futures Price as of 04/25/2006

Delivery Date	U.S. dollars and cents per gallon
June 2006	2.1270
July 2006	2.1140
Dec 2006	1.9305
Jan 2007	1.9350

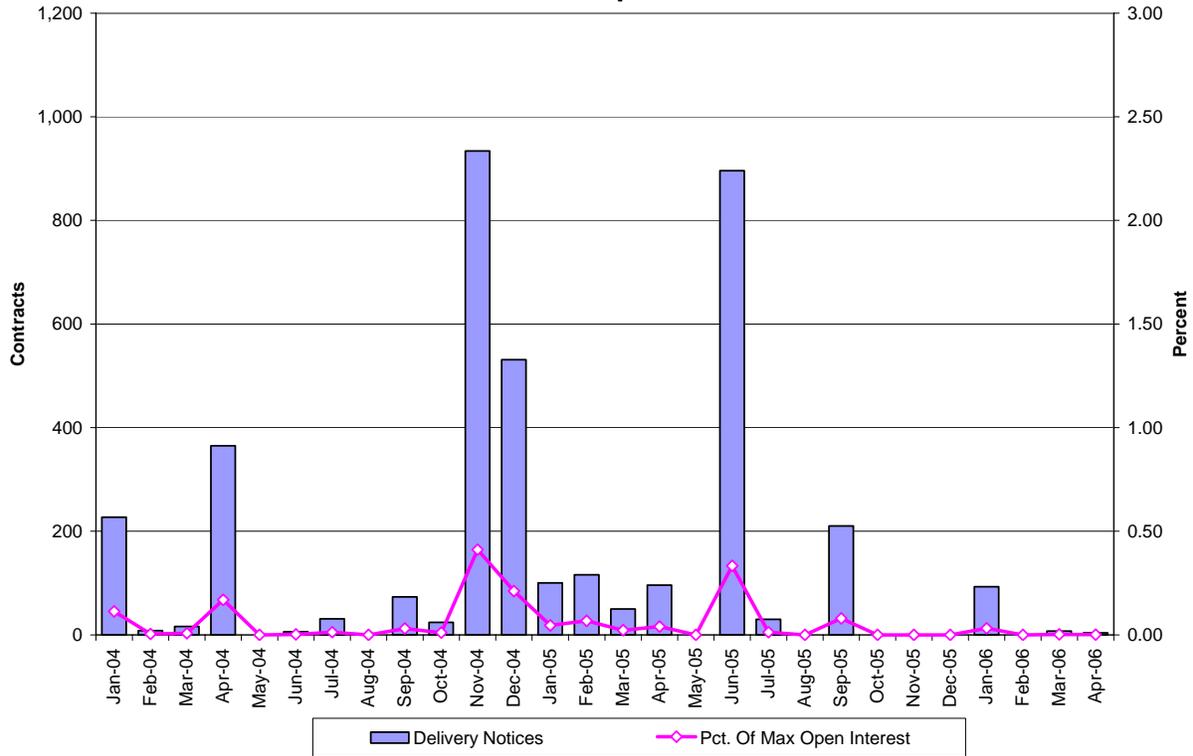
In recent years, with increased economic growth in China and elsewhere, demand for petroleum products has risen faster than have supplies of these commodities. This has created very tight demand/supply balances in these markets. In economists' jargon, both supply and demand for crude oil and unleaded gasoline are price inelastic in the short run. Therefore, changes in supply or demand can, in the short run, have disproportionately large effects on price. In addition, futures markets are by their nature anticipatory; they incorporate into prices a probabilistic estimate of possible future changes in supply and demand.

3. Recent Delivery Experience

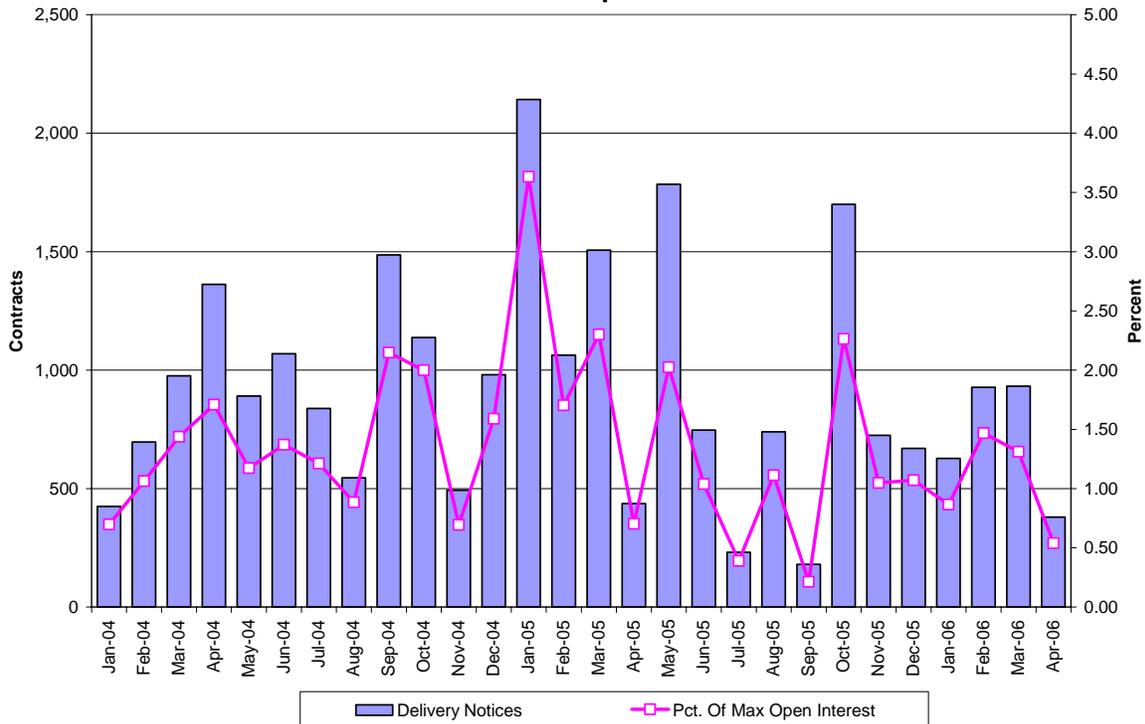
Figures 3 and 4 below show deliveries for crude oil and unleaded gasoline contracts since January 2004. The vertical columns depict the number of contracts delivered. The number of contracts corresponds with numbers displayed on the left-hand axis of the figures. The continuous line, corresponding to the right-hand axis, shows the size of the deliveries as a percentage of the maximum number of open positions established for each contract month. For example, if the maximum number of open positions over a contract's life was 100,000 contracts, and 4,000 positions were settled by delivery, the continuous line would represent 4 percent. The remaining open positions are settled by offset, that is, by taking an equal and opposite futures position that brings the trader's net position to zero.

Since futures contracts are primarily risk management contracts, positions are almost always settled by offset. Across all futures markets, less than one percent of open futures positions are settled by delivery. In physically settled futures contracts, such as crude oil and unleaded gasoline futures, close scrutiny of the delivery process is vitally important for preventing corners or squeezes. The CFTC and the exchanges surveil these commodities with special scrutiny. We focus particularly on a trader holding a large long position into the delivery process. The CFTC surveillance staff looks at many sources of information in addition to actual deliveries. The actual delivery experience in crude oil and unleaded gasoline does not yet display any unusual patterns consistent with a corner or squeeze during this period, but we will not tolerate any irregularity in these important areas and are being especially vigilant. (Note: Each crude oil contract is written on 1,000 barrels equivalent to 42,000 gallons, which is also equal to the size of the gasoline contract).

**Figure 3. Delivery Notices - NYMEX Crude Oil, Light Sweet Futures
Jan. 04 - April 06**



**Figure 4. Delivery Notices - NYMEX Unleaded Gasoline Futures
Jan. 04 - April 06**

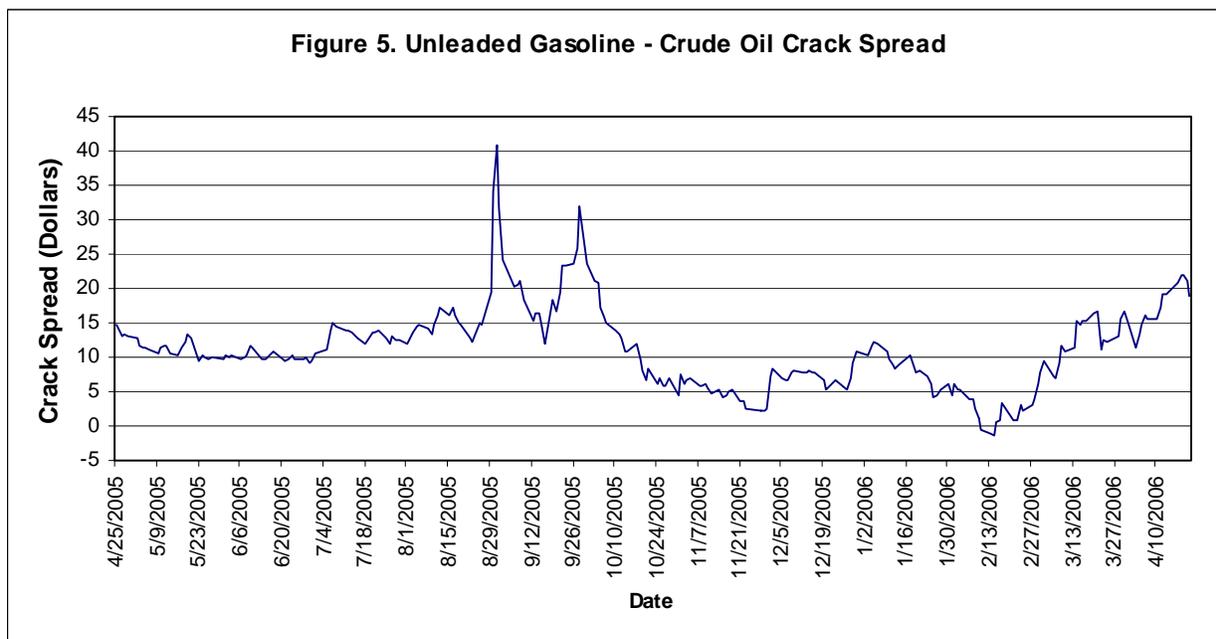


4. *The Relationship between Crude Oil Futures Prices and Unleaded Gasoline*

Futures Prices

A common trading strategy is to simultaneously establish offsetting positions between crude oil futures contracts and futures contracts for the products refined from crude oil, such as unleaded gasoline. Traders commonly call this trading strategy the “crack spread,” referring to the “cracking” process of turning crude oil into refined products. The chart below (Figure 5) displays the unleaded gasoline spread, using nearest-to-delivery futures contracts, over the past year. This chart shows that the value of the crack spread increased significantly following the switch in the unleaded gasoline contract specifications to reflect the phase-out of methyl tertiary butyl ether (MTBE) as an oxygenate in “reformulated” gasoline. In other words, even though prices for unleaded gasoline and crude oil have moved much higher (as one is an output of the other, there is a positive correlation between them), on a percentage basis, unleaded gasoline has risen more than prices for crude oil. We infer from the behavior of the unleaded gasoline crack spread that the increase in unleaded gasoline prices has been driven not only by increases in the level of crude oil prices, but also by complications associated with the transition of the futures contract from gasoline containing MTBE to so-called reformulated blendstock for oxygen

blending, or “RBOB,” to which ethanol will be added.



E. Conclusion

Although U.S. energy prices have been volatile in recent months, it is precisely during such volatile times that the risk-management and price-discovery features of futures markets are needed most by commercial users of energy products. The evidence we have seen indicates that futures markets for crude oil and unleaded gasoline and other energy products have been properly performing their risk management and price discovery roles. Nevertheless, we are on alert. The staff of the Commission will continue to conduct very close surveillance of these markets to ensure that they continue functioning properly. Any improper conduct will not be tolerated, and the CFTC will continue pursuing aggressive enforcement actions against those who break the rules.

This concludes my remarks. I look forward to your questions.