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Remarks

Oil Market Transparency: A Preventative Measure for Extreme Volatility

Remarks by Commissioner Scott D. O'Malia before IEA/IEEJ Forum on Global Oil Market Challenges, Tokyo, Japan

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It was 26 years ago that I first visited Japan as a student. When I landed in Osaka, I had a walkman and a skateboard. I was an 18-year-old kid from an automotive town in Michigan. I would be lying if I told you that I had visions of becoming a CFTC Commissioner with a goal of improved transparency in the derivatives markets.

This trip, I've returned -- armed with an iPod and a laptop, and I'm focused on market volatility and transparency. This is a far cry from my priorities when I first arrived as an 18-year-old student and the price of a barrel of oil was near its historic low of $10.42. Things have certainly changed since then.

One thing that hasn't changed since my first visit is the extraordinary hospitality of my Japanese hosts. I sincerely appreciate the invitation from Executive Director Nobuo Tanaka to return to Japan to represent the U.S. Commodity Futures Trading Commission.

My remarks today will focus on two areas. First, the regulatory changes and financial reforms that are underway in the United States and, second, the opportunities that exist for the global community to bring greater transparency to the oil markets.

A Defining Moment for International Cooperation

Today, we find ourselves at a defining moment where the financial reform decisions we make will impact both the financial markets and the energy industry. The decisions we make at this moment must be a product of careful thought and international cooperation.

The regulatory decisions we make will need to foster greater transparency and minimize the threat of systemic risk. Accomplishing these goals will result in highly liquid markets

with transparent prices, reduced volatility, and increased confidence among market participants. All told, there will be greater certainty for investors in alternative energy and critical oil and gas projects.

Recent events have eroded confidence in the markets and regulators. We've experienced extraordinary price volatility and record prices in agriculture, energy, and metals contracts. And, we have lived through the worst financial disaster since the Great Depression. U.S. policy makers are responding to the crisis and considering a range of policy options to create a more transparent and stable financial system. Similar reforms are also underway in the European Union, Great Britain, and Japan.

In response to the financial crisis and the commodity price volatility, aggressive steps are being taken to improve the oversight of the financial and energy-related markets. Specifically, the CFTC and Congress are taking steps to increase transparency, to enact legislative reform, and to decide on establishing position limits. Let me take a moment to touch upon each of these three actions.

Market Transparency Promoted by the CFTC

The first action is increased transparency; transparency to better understand market participant positions and the relationship between the financial and the physical markets.

As the price of oil spiked to $147 per barrel in July 2008, the CFTC took steps to understand the forces at work. Both the Interagency Task Force on Commodity Markets, chaired by the CFTC, and the International Energy Agency studied the market with an aim to understand the role of speculation. These studies concluded that supply and demand factors were the foundation for the price moves. *See* Interim Report on Crude Oil (July 2008) and Medium-Term Oil Market Report (June 2009).

Despite such reports, skeptics remain and believe that energy prices are no longer anchored by the fundamentals of supply and demand. Naysayers identified large index traders as being responsible for the price increases because they invested billions of new capital into the commodity markets.

In response, the CFTC began collecting and publishing new data specifically related to positions held by index traders and swap dealers. The CFTC also began to publish disaggregated trade data of the positions held by Producers and Users, Swap Dealers, Managed Money and Others. The CFTC now releases this information on a weekly basis.

In addition, the CFTC will collaborate with the Department of Energy's Energy Information Administration to better understand the relationships between the physical and financial energy markets.

The International Organization for Securities Commission ("IOSCO") established the Commodity Futures Markets Task Force, co-chaired by the U.S. CFTC and UK FSA to assess whether regulatory practices have kept pace with evolving market developments. The Task Force published a report in March 2009 that made a variety of recommendations to enhance the transparency of commodity markets, including

ensuring that regulators have access to information in the OTC derivatives and underlying physical commodity markets.

The CFTC is also working with other international regulatory agencies to provide training on the development and utilization of the Commitment of Trader Reports. There is no doubt in my mind that the U.S. is leading the world in making markets more transparent.

Financial Reform Legislation

Transparency is the first element of reform; the second is tied to the comprehensive financial reforms being considered by the U.S. Congress. These reforms expand the CFTC's authority to oversee the $300 trillion U.S. Over-the-Counter (OTC) derivatives markets. The legislation will apply new rules to banks and major swap dealers including mandatory clearing of all standard derivative contracts and will require all other trades to be reported to a trade repository. The bill requires the CFTC to set minimum capital and margin requirements for swap dealers and major swap participants. Enhanced clearing and improved risk management rules will greatly minimize systemic risk among counterparties and the financial system as a whole.

It is critical that this legislation doesn't open new opportunities for regulatory arbitrage. It's essential that the new regulatory authority creates a consistent and seamless regulatory structure over the $600 trillion global OTC market.

It's likely that a legislative reform package will pass the Congress this year. The House has passed its legislation and Senate staffs are meeting daily with a goal to develop a bipartisan proposal.

Positions Limits

Now that I've touched on transparency, and legislative reform, the third effort underway in the U.S. is the draft position limit proposal. The CFTC has recently unveiled a proposal to impose position limits on four energy exchange-traded contacts including oil, natural gas, heating oil and gasoline. These limits are consistent with the agriculture limits and are based on open interest. The goal of this proposal is to prevent any single trader from becoming too concentrated in a single market or contract. These limits are not intended to control prices. In fact, despite strict federal position limits, wheat, corn, soybean, and cotton contracts were not spared from record price spikes in 2007 and 2008.

These limits would not apply to trades conducted on the OTC markets, unless Congress changes the law, as is proposed in the House bill. I supported the release of the position limit proposal to receive input from effected market participants. I invite you to submit comments, which will assist in the final decision on whether to implement position limits.

The Shift in the Oil Paradigm

The aforementioned reforms are a key part of the solution. But before we talk about other needed action, we have to acknowledge that we've witnessed a paradigm shift in

the global oil market over the past decade. The paradigm has shifted in two significant ways, which we can all agree have impacted the oil markets.

First, oil is now a financial asset and its price movements are correlated to economic growth. Second, the growth in oil demand is being led by developing nations. According to Daniel Yergin, developing nations accounted for 85% of global oil demand over the past decade. According to EIA, these same nations are expected to make up 73% of future demand. EIA predicts that oil demand will grow by 44% between now and 2030. Future demand can readily be anticipated since China is the now the largest automobile market in the world.

The oil demand shift, however, has resulted in less transparency in oil usage and reserve capacity in these nations. This is a very troubling trend.

One very important factor to watch is the spare capacity in oil markets. The price of oil peaked in 2008 at $147 per barrel, in part, because the global demand had virtually eliminated any spare capacity in the global oil markets. In fact, during the price spike, there was less than 2 million barrels per day of spare capacity.

While the oil demand has fallen off dramatically, as a result of the recession, it has created some spare capacity. This is a temporary situation. By 2015, we will see spare capacity depleted and will return to the tight market conditions of 2008.

It's imperative that oil markets have accurate and timely data regarding tightening in market conditions if we hope to avoid the future price spikes that will undermine our economic growth.

Oil Market Transparency

Recognizing the paradigm shift in the oil markets, it's clear that the time has come to improve the transparency. Since its establishment in the 1970's the International Energy Agency has coordinated energy policy among its Member Countries and collected and published data on energy utilization, refinery, and reserve capacity for the largest oil markets in the world. However, with the growth in oil demand anchored in developing nations, more must be done to make these developing markets as transparent and open as IEA Member Countries.

Also, publishing data regarding oil in-transit will reduce the uncertainty of what is being stored at sea – or withheld from the market. In addition, we must call into question the practices of certain oil traders that buy oil and put that oil into storage, if such practices are designed to extract money from consumers and producers.

With the shift in oil demand, nations must be committed to expand IEA membership or create another data collection entity that has the confidence of developing nations. As a consensus on this entity develops, the G20 member nations, as set forth in the G20 Pittsburg Communiqué, must lead by example in collecting and reporting all oil market data to make sure that the markets are completely transparent. The G20 nations now represent the largest oil users and the top producing nations. The IEA can facilitate the data collection in order to prepare this data for the G20 meeting to be held in Toronto, Canada in June.

The End Result of Market Transparency: Alternative Energy

Prior to my appointment as a CFTC Commissioner, I spent a considerable amount of time focused on energy policy in the U.S. Senate. Our goal was to incentivize domestic oil and gas production, as well as, the deployment of zero emission energy technologies such as nuclear, wind, and solar technology. Due to the massive scope and scale of transforming the U.S. energy infrastructure, developing financing mechanisms that price against volatile commodities presents an enormous challenge.

Both the regulatory reforms and oil market transparency initiatives that I outlined will create an environment where alternative energy investors will have more predictable and transparent markets. Under these conditions, markets will thrive.

As I noted earlier, a lot has changed since my first visit to Japan in 1984. We've gone from walkmen to iPods and I believe there are significant changes in the works for both energy and futures markets yet to come. While we are unlikely to ever see $10 oil again, I hope we can create the right environment where markets will serve the roles for which they were created: price discovery and commercial hedging.

I would like to thank Executive Director Nobuo Tanaka for the opportunity to speak here today.

Thank you.