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COMMODITY FUTURES TRADING COMMISSION

ENERGY AND ENVIRONMENTAL MARKETS
ADVISORY COMMITTEE MEETING

Washington, D.C.

Wednesday, May 13, 2009

ANDERSON COURT REPORTING
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4 JILL SOMMERS, Commissioner
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6 DOMINICK CHIRICHELLA, CFTC
7 LAURA CAMPBELL, APGA
8 DONALD CASTURO
9 Goldman Sachs
10 EILEEN CLAUSSEN
11 Pew Center on Global Climate Change
12 JACK COGEN
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17 CME Group
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20 BENJAMIN FELDMAN
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1 P R O C E E D I N G S

2 (8:06 a.m.)

3 CHAIRMAN CHILTON: If everybody will
4 have a seat we'll get started. The Energy and
5 Environmental Markets Advisory Committee will come
6 to order. My name is Bart Chilton and I am Chair
7 of the EEMAC, and I am very thankful to my
8 colleagues both Commissioner Lukken who is not
9 with us today, and Commissioner Dunn, the Acting
10 Chairman of the Commission, and Commissioner
11 Sommers for allowing me to work on this really
12 exciting and energetic committee on some really
13 very important issues not just for markets, but
14 for our economy and for consumers.

15 Just a couple of housekeeping things.
16 If you could turn your BlackBerrys off, those tend
17 to mess around with the electronics and we want to
18 avoid that. When you want to be recognized, if
19 you would hold your name tents up sort of like
20 this or if you're around the room later if you'd
21 let me know when we get to that part where other
22 folks want to participate. This is a bit of an

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1 unusual FACA, which is the Federal Advisory
2 Committee Act, this is a FACA committee and it's a
3 bit unusual in that we're trying to do this as
4 much as possible paperless, so there is not a lot
5 of materials that you will see in front of you.
6 There are not any big piles of paper off to the
7 side like you'll see in a congressional hearing.
8 The members of the EEMAC should have received bios
9 and an agenda and potentially a few PowerPoints.
10 We're not going to have a big, long PowerPoint
11 presentation. I want to get your views on a lot
12 of things and talk with you and have more of a
13 dialogue than have it be a structured
14 presentation. I'm proud of the fact that it's
15 paperless and I hope that's a government trend.
16 There was an article in the "Post" today on page
17 A-17 which talked about just the millions of
18 pieces of paper that government employees waste by
19 printing up copies of testimony, et cetera, and
20 throwing them out. So I hope this will be a
21 little bit of a new way of doing things, and we've
22 done some other ecologically friendly things

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1 around the room and around this meet as you'll
2 see.

3 I did want to also note for your
4 calendars that tentatively the next official
5 meeting I'd like to do on September 16, and in
6 that I'd like to be even more eco friendly in that
7 I want it to be a virtual meeting. You can
8 participate at one of our offices either D.C., New
9 York, Chicago, or in Kansas City, or you can just
10 dial into an audio line where you will be able to
11 participate. That is still TBD and we'll let you
12 know soon. I know you're all very busy and
13 important people and it's one of the reasons that
14 you're here, that you're enlightened folks who can
15 help us on these issues and I want to make sure I
16 mark that potential date out as early as possible.

17 Other housekeeping things, on these
18 microphones, they're pretty easy to operate.
19 There's just a button there. If one of your
20 colleagues next to you is going to use the mike,
21 turn it off before you pass it over and then do
22 speak into it so the court reporter can hear you.

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1 What I'd like to do now before I ask my
2 colleagues if they have any opening comments is
3 just go around the room and just say who you are
4 and who you represent. I'm not looking for a
5 summary of what you're doing or what your
6 interests are. We'll get to that later.

7 MR. PROKOP: Mike Prokop with Amerex
8 Brokers LLC outside of Houston, Texas.

9 MS. DOW: Good morning. I'm De'Ana Dow.
10 I'm Managing Director with the CME Group
11 Washington office.

12 MR. SANDOR: Richard Sandor, Chicago
13 Climate Futures Exchange.

14 MS. CLAUSSEN: Eileen Claussen, Pew
15 Center on Global Climate Change.

16 MR. SCHLEMER: Good morning, Steve
17 Schlemer, from Barclays Capital.

18 MR. CASTURO: Don Casturo, Goldman
19 Sachs.

20 MR. SLOCUM: Tyson Slocum, Director of
21 the Energy and Climate Program at Public Citizen.

22 MS. CAMPBELL: Laura Campbell, Memphis

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1 Light, Gas and Water representing APGA.

2 MR. SCHRAG: Jonathan Schrag, Executive
3 Director of Regional Greenhouse Gas Initiative
4 Inc.

5 MR. MCCOY: Bill McCoy of Morgan
6 Stanley.

7 MR. PICKEL: Bob Pickel, Chief Executive
8 Officer of the International Swaps and Derivatives
9 Association.

10 MR. MANSFIELD: Good morning, Tony
11 Mansfield from McDermott Will & Emery,
12 representing Shell Trading U.S. Company.

13 MR. SHELK: Good morning. I'm John
14 Shelk and I'm President of the Electric Power
15 Supply Association.

16 MR. MARTINEZ: Rafael Martinez, an
17 economist in market surveillance at the CFTC.

18 MR. CHIRICHELLA: Dominick Chirichella
19 of the Energy Management Institute.

20 MR. COTA: Sean Cota, Cota & Cota
21 Heating Fuels in Vermont and representing the New
22 England Fuel Institute and Petroleum Marketers of

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1 America for Heating Oil and Gasoline.

2 MR. HORVATH: Skip Horvath, President of
3 the Natural Gas Supply Association.

4 MR. FELDMAN: Ben Feldman, JP Morgan.

5 MR. OPPENHEIMER: Ron Oppenheimer, Bank
6 of America/Merrill Lynch Commodities.

7 MR. COGEN: Jack Cogen. I'm CEO of
8 Natsource, and I'm Chairman of the International
9 Emissions Trading Association.

10 MR. VICE: Chuck Vice, Intercontinental
11 Exchange.

12 MS. ECKERT: Heike Eckert, Eurex in
13 Chicago.

14 MR. GERO: Gary Gero, President of
15 Climate Action Reserve.

16 MR. KELLY: Brian Kelly, Colonial
17 Energy.

18 MS. MOLER: Betsy Moler, Exelon
19 Corporation.

20 MS. KOEPPPEL: Holly Koepfel, American
21 Electric Power.

22 MR. GOLDMAN: Good morning. I'm Seth

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1 Goldman, co-founder and TEO of Honest Tea.

2 MR. POTRATZ: Good morning. I'm Dan
3 Potratz, Industrial Electrical Consumers of
4 America.

5 MR. FOX: Kevin Fox representing D.E.
6 Shaw & Company.

7 MR. STROSCHEIN: I'm Ryan Stroschein,
8 Air Transport Association.

9 CHAIRMAN CHILTON: With that I'll go
10 ahead I'll yield to my colleague, the Acting
11 Chairman, Commissioner Dunn, and again thank you
12 for asking me to help out on this, sir.

13 COMMISSIONER DUNN: Bart, you won't be
14 surprised next time you're bumped on an airline
15 flight.

16 Let me first of all welcome everybody to
17 the second meeting of the committee. We've
18 renamed it, and I want to thank my friend and
19 colleague, the Chairman of this committee, Bart
20 Chilton, for the interest and the exuberance that
21 he's put in in putting together and expanding this
22 committee to talk about other subjects and what

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1 the original Energy Marketing Advisory Committee
2 had been discussing. I think it is very
3 appropriate. It certainly is a topic that's being
4 discussed right now in Washington. There are a
5 number of legislations that are being developed
6 and hopefully with input from this advisory group
7 it'll give us some give us some directions on
8 where we ought to be on some of these particular
9 pieces of legislation that are going.

10 Let me just talk about a couple of
11 things since the last meeting of the Energy
12 Advisory Committee. There was a great deal of
13 concern expressed about the effects of speculators
14 in the energy markets including swap dealers and
15 index funds. Also at least year's meeting we
16 announced that the agency would undertake a
17 special call, a collection of data on swap dealers
18 and index traders and analyze that data for their
19 effects on the market. In September we issued a
20 staff report on the data and we continue to
21 collect and analyze the data and evaluate
22 regulatory reforms to assure that excessive

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1 speculation does not disrupt our marketplace.

2 To that end, the Commission currently
3 has a concept release in the Federal Register
4 seeking comments on whether the Commission should
5 eliminate the bona fide hedge exemptions for
6 certain swap dealers and create a new limited risk
7 management exemption for speculative position
8 limits. This comment period will remain open
9 until May 26, 2009, and I encourage you to provide
10 comments as you may deem appropriate. What we
11 usually do an advisory committees if there are
12 appropriate comments made on this concept release,
13 we will include that in there.

14 Again I want to thank Chairman Chilton
15 of this committee for bringing this up. I look
16 forward to it. I have to apologize that I've got
17 some other things that are cooking today so I may
18 be in and out quite a bit, but it does not reflect
19 a lack of interest and I'm sure my colleague will
20 keep me up to speed on things. Thank you, Bart.

21 CHAIRMAN CHILTON: Thank you, sir.
22 Commissioner Sommers?

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1 COMMISSIONER SOMMERS: Thank you so
2 much, Bart. I think that I want to echo Mike's
3 comments in thanking you for all of your hard work
4 in putting this meeting together. It's not hard
5 to look around the room to the attention to detail
6 to know that Bart is passionate about these
7 issues, environmental and energy issues. So we're
8 happy to have him chairing this important advisory
9 committee.

10 He's pulled together a very
11 distinguished group of industry professionals
12 today who have a wide range of experience and
13 knowledge about the energy and environmental
14 markets in our country, and I'm really looking
15 forward to the discussion today.

16 I am specifically interested in what the
17 CFTC's role will be potentially regulating these
18 new markets and what you around the table may
19 identify the challenges for us at the CFTC in
20 regulating a carbon futures market under a new
21 framework of cap and trade. Do you see
22 significant differences between the markets that

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1 we currently regulate, the emissions markets we
2 currently regulate and those under this new
3 framework? And how you would see these markets
4 evolving globally.

5 I'm also very interested to hear from
6 the EEMAC participants who were here with us last
7 June. A lot of changes have changed in the energy
8 market since then. I think the day that we met
9 last June, crude was above \$130 a barrel and
10 probably none of us anticipated what would have
11 happened in the last two quarters of 2008. So a
12 lot has changed, and I'm interested in hearing
13 from all of you in what has changed positively and
14 negatively for the businesses and associations
15 that you represent here today.

16 Again I just want to thank all of you.
17 This is a busy time of year for being here with us
18 today taking time out of your schedules to be with
19 us, and I'm really looking forward to the
20 discussion. Thanks.

21 CHAIRMAN CHILTON: Thank you. I did
22 also want to mention that this is being webcast

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1 and there's an audiocast also, and I'm pleased
2 that people are able to join us that way. And I
3 also want to welcome our staff from Kansas City,
4 New York, and Chicago, many of whom are looking
5 and some who are or in the overflow room.

6 I want to just make a brief comment
7 before we start. All of us speak for ourselves.
8 I don't speak for the Commission and we don't
9 always agree, although we get along famously, and
10 I know everybody in this room won't agree with
11 what I'm going to say now, but I was looking at
12 the webcast last night of this event from a year
13 ago that Commissioner Dunn spoke about and it was
14 at that time that we started seeing commodity
15 prices both in the ag and the energy complex
16 shooting up. Secretary Paulson had just declared
17 that speculators had no role in this and I said it
18 was too early to tell, that we didn't have all the
19 data. As we started to look and started to
20 undertake the swaps report that Commissioner Dunn
21 spoke about, it became clear that some of this
22 data just doesn't exist and that we need more. So

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1 I've supported the Durbin Bill and the Reid Bill
2 and the House bill that failed and the House bill
3 that passed with 283 bipartisan votes last
4 Congress and the Peterson bill from this year that
5 passed at the House Ag Committee.

6 But I have to say I'm fairly concerned
7 about the potential for progress because I think
8 the whole process has been contaminated by
9 circumstances. What I mean by that is that there
10 are so many myriad issues out there, political
11 issues, jurisdictional issues. There's the banks,
12 the economy. There are lots of things going on,
13 and I'm worried that regulatory reform, the things
14 that are included in the Peterson bill,
15 essentially increased transparency, the ability to
16 further regulate to put position limits when we
17 think we need to put position limits, clearing of
18 certain contacts, those things which I think are
19 really the strategic true north, the direction we
20 need to head in the future, are going to go by the
21 wayside because there are so many things and
22 competing proposals out there.

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1 I'll just say it's too important to
2 leave off to the side. These are really
3 necessary. And when you think about the first
4 issue we're going to talk about today, about
5 carbon markets and what they can be, our estimates
6 are that these could be \$2 trillion markets in 5
7 years of trading, the largest commodity markets
8 ever. So even if we get a cap and trade bill
9 passed, we need this regulatory reform component
10 to ensure that these markets are free from fraud,
11 abuse and manipulation. I'm just hopeful that
12 Congress and the administration who's been -- the
13 administration has been very good on these issues
14 and I hope they will say more in the future about
15 the importance of them, but I hope folks get the
16 message that this is stuff that can't be left on
17 the drafting floor and that we need to do
18 something on it. I know everybody doesn't agree
19 with me and we'll have a chance to talk about
20 that, and that's okay, but I just thought it
21 remarkable when I went back and looked at this
22 thing last night.

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1 With that we're going to start off with
2 Rafael Martinez. We traditionally do a preview, a
3 look back at markets with one of our market
4 surveillance specialists. Rafael is a senior
5 economist here at the Commission and he's one of
6 the folks who I really respect. He's not shy
7 about giving his opinions. So he's going to start
8 us off. Then we'll open up the dialogue to folks.
9 So with that, Rafael?

10 MR. MARTINEZ: Thank you very much.
11 Acting Chairman, Commissioners, committee members,
12 distinguished guests and colleagues, good morning.
13 Thank you for the opportunity to be with you this
14 morning, particularly to Commissioner Chilton,
15 Chairman of the Committee. Before I say anything
16 more, I want to affirm that the views expressed by
17 me here today are exclusively my own and do not
18 reflect the views of the Commission or Commission
19 staff.

20 Today's meeting has a particular
21 importance since we are in the middle of the
22 process to try to harness the power of markets to

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1 take under control emissions of carbon dioxide, so
2 I'm going to start to focus on that. I know most
3 of you probably know the markets much better than
4 I do and you've seen the last year unfold, so I'm
5 not going to really dwell on that at the moment.
6 But I'm going to give a staff view from the
7 surveillance staff of how we feel about what the
8 challenges are for regulating the markets for
9 carbon.

10 In the middle of what's proving to be a
11 very challenging time, the American public has
12 chosen to confront an issue which on its own would
13 seem gargantuan, and that's climate change. All
14 indications are that they will chose to do it
15 through markets. Federal oversight of such
16 markets will be a daunting challenge to anybody.
17 At the start of this decade, the energy sector was
18 in crisis. I joined the FERC back then, and the
19 head of my office, Bill Hederman, a friend and
20 mentor, would rally the troops using history to
21 explain the difference between being involved and
22 being committed. It went something like this.

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1 The hand comes to the pig all aflutter and tells
2 it that the farmer is planning to have ham and
3 eggs for breakfast and the pig says, stop your
4 cackling. You are merely involved. I am
5 committed. The Energy Markets Advisory Committee
6 has been to reflect the CFTC's commitment to
7 environmental markets. We are committed.

8 First I want to show why the task seems
9 to daunting. I have a visualization here that I
10 hope to show. I don't know if people through the
11 webcast will be able to see it, but I have some
12 screen prints on some slides that will be
13 available. I think I have to mention for the
14 viewers that this is not CFTC software, that this
15 is courtesy of the Google organization using the
16 Gapminder software which is sold now by Google.

17 What I have here is income per person on
18 the bottom axis. On the vertical axis I have the
19 CO2 emissions transfer per person. The size of
20 the bubbles, there are per country. They are
21 colored by the region of the world in which the
22 country is. And the size of the bubble is the

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1 total CO2 emissions. This is the view as of 2005.
2 I think the data for this comes from the United
3 Nations Development Program, but they probably
4 aggregated it from national organizations.
5 Anyway, it starts way back. It just starts with
6 the lack of data shows only European countries.
7 We see the U.S. shows up in there I think. That's
8 Australia. We follow the U.S. and see how income
9 increases we have more emissions.

10 Eventually of course the U.S. is leading
11 the pack in terms of income and emissions and end
12 up right at the top by the time 2005 arrives.
13 This would seem to like the necessity that if you
14 want to develop your economy and you need to grow,
15 you end up emitting CO2, and that's true to a
16 large extent. The next thing is we have China
17 here, India. Somewhere in here I think we have
18 Brazil, Russia, South Africa. Russia is supposed
19 to be somewhere in here as well. But anyway, we
20 have the famous BRIC countries that are following
21 behind and we think there is no way that we are
22 going to be able to -- as they grow, everybody

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1 wants to increase their income, it's natural that
2 people try to better themselves, and they're
3 following and we see like if we have a bad year,
4 you want to grow, you are going to emit, so what
5 can we do?

6 I want to change this a little bit and
7 show you why I am actually thinking optimistically
8 that there are things that we can do about this.
9 Let me deselect everybody and just focus on the
10 path of the United States probably from 1940 or
11 1920 on and just looking at the path of the United
12 States. The first thing to note is that it's not
13 really linear. It's not like we've been growing
14 and parallel to that, CO2 emissions have grown.
15 Of course, some of them are rather turbulent
16 situations like a war or the 1970s price spike. I
17 also note that we had periods in which emissions
18 have descended and actually we are lower now than
19 we were in 1973. So it's not necessarily a link
20 that you grow and you need to emit more.

21 The other thing I wanted to show is from
22 another perspective which is here I have a

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1 different chart and here I have the United States
2 in a chart that has again CO2 emissions per person
3 on the vertical axis, and on the horizontal axis I
4 have one of the measures of development. I grew
5 up in a developing country so I think of human
6 development as sometimes being more important than
7 GDP. So I have the under 5 mortality rate. Death
8 of children under 5. And I have colored the
9 countries by their income levels, so that if you
10 notice, several countries that are have high
11 income levels have lower mortality rates with
12 lower emissions than we do. So I think that
13 welfare of the population doesn't necessarily mean
14 that we need to continue increasing our emissions.
15 So there are ways that we can go about it. Of
16 course, I'm oversimplifying. The people at the
17 top are countries that produce hydrocarbons, the
18 people at the bottom are countries that do not,
19 and we have Cuba hanging out here. So not
20 necessarily we want to follow the policies of
21 others, but I just want to explain that there are
22 choices that can be made by the societies to go to

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1 a lower carbon future.

2 So I'm going to stop with my little
3 gadgetry here and move to where are these
4 reductions going to come from. I'll go back to
5 the slideshow. I think that this is from McKenzie
6 and Company. I'm sorry, I think the shape of the
7 screen cut that off and I need to mention since I
8 took it from of their reports, I should mention
9 that this is from McKenzie and Company's Pathways
10 to a Low Carbon Economy published I think February
11 2009, but it has a cost abatement curve. This is
12 how they look, the costs, the opportunities for
13 carbon abatement will be looked at I think by
14 2030. But we can see that there are some things
15 that pay for themselves, actually, so they're
16 negative on the left side, any things about
17 changing how we use electricity, light bulbs and
18 things like that. There are things about how we
19 treat in agricultural practices. So at the right
20 actually at the very end is where we have changing
21 our infrastructure for electricity production and
22 that's the most expensive because that's where we

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1 tend t focus because those are large emissions,
2 but that might not necessarily where the most
3 cost-effective reductions are. In any case, I
4 don't think anybody really knows where the
5 cheapest abatements are going to come from and
6 that's why we're trusting the market. We trust
7 people to trade. We want this to be revealed. We
8 trust markets to perform this function of
9 allocation. So I think that the CFTC will play
10 definitely a positive role in that, that there
11 will be cash contracts and there will be futures
12 contracts, and there are futures contracts
13 already.

14 Why do I think the CFTC can play a very
15 positive role for this? This is looking like an
16 infomercial and probably CFTC staff has taken a
17 hit so I'm just showing that I want to change that
18 impression, but we think that this just basically
19 makes sense. I have three reasons to feel
20 positive that the CFTC is going to play a role in
21 this. One is it just makes sense. Most regulated
22 markets that come to your mind, there is a reason

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1 why they are regulated. It's not a natural state
2 to be regulated, but there's a reason for the
3 regulation. Often the reason is to mitigate
4 market power obtained from the control of a
5 strategic asset. You have a pipeline that's oil
6 and gas so you have a network in electricity or in
7 telecom. That's a natural monopoly and somebody
8 controls access and it could be uncompetitive.
9 Another reason is when there are informational
10 problems, so we have things like pharmaceutical
11 safety and sanitation. Not everybody is going to
12 be able to check on the safety of a product so we
13 have somebody who checks on that and says what
14 product can go to market and what can't. Another
15 is the public interest over the allocation of a
16 scarce resource like the spectrum for
17 telecommunications and natural property owned by
18 the country as a whole, so we have allocation of
19 leases of land for exploration.

20 These last two, the spectrum and
21 national lands, are the ones that probably are
22 closer to the carbon example. However, generally

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1 those are about how it's initially allocated, it's
2 not really about how they're traded, and most of
3 the concerns that have been expressed about carbon
4 is about the trading. Will it really reveal the
5 price? Will it help achieve this
6 cost-effectiveness in the abatement? It just
7 happens to be that oversight of trading is what we
8 do at the CFTC. We don't do the natural
9 monopolies of networks like other agencies. We
10 actually look at trading. So it makes sense that
11 we do it at the CFTC.

12 We are already doing it. I think I have
13 a slide. Behind me is a slide with the history of
14 emissions trading in the U.S. in the cash market,
15 so they've been up since the mid-1990s and
16 late-1990s. We so far have oversight of the
17 futures markets and not the cash markets of the
18 current emissions programs. We are constantly
19 developing relations with the trading community
20 and other government agencies that participate in
21 this underlying market. In the case of SO2 and
22 nitrous oxide, futures contracts starting 8 or 9

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1 years after the underlying market had started, and
2 they've been trading for some years and they're
3 part of our routine oversight. That's something
4 that people probably don't really know. In terms
5 of CO2, we already have a regional mandatory
6 compliance market with the Regional Greenhouse Gas
7 Initiative in the northeast of the country, we
8 have a voluntary program, and we have futures
9 trading. We expect the same will happen once the
10 Western Climate Initiative starts trading their
11 carbon credits. And we are in frequent
12 conversations with the people setting up the
13 oversight of those markets. We are also in talks
14 with foreign boards of trade that expect to offer
15 futures contracts for trading to U.S. customers in
16 carbon.

17 Another thing I want to mention, and
18 people probably don't this, but inside the
19 Commission we have a briefing every Friday and we
20 select a few contracts to bring up to the
21 attention of the Commissioners. Sometimes there
22 are issues with them with concerns of behavior,

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1 contract design or simply for the Commissioners to
2 be alert about that contract. As regulations
3 change, we want to make sure that we brief them.
4 We heard our first briefing on this topic over a
5 year ago. No market other than those facing some
6 very, very particular issues have been included in
7 these weekly briefings more often than emissions.
8 It's no secret that we're in the process of
9 expanding. We need staff. We need more people.
10 But I can say that at this moment no market has
11 more staff assigned to it than emissions and
12 that's probably something people don't realize
13 about the CFTC. This is partly because we have a
14 multiplicity of trading venues. We have more than
15 one. Usually we just have one futures contract
16 and here we have several futures contract trading
17 at this moment. We have regional plans where the
18 products are being developed, so we have people
19 from product review, market review, lots of people
20 involved. This also shows our seriousness of
21 purpose.

22 The current sulfur oxide and nitrous

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1 oxide markets are more localized in terms of the
2 traders that trade it, the geography and the
3 contract complexity. Carbon is a global market
4 intersecting so many sectors and represent another
5 level of complexity. I'm not being naïve about
6 that. However, many of the issues that people are
7 concerned about regarding carbon, they are already
8 there for us in other markets. They are not new
9 to us. This is a rather negative way to affirm
10 our capabilities and it reminds me once I went to
11 a presentation from somebody from the nuclear
12 industry and they were saying that we will need a
13 dozen or more nuclear power plants in the future,
14 and this was a couple of years back. When he was
15 asked if he would tell the group how they will
16 plan to dispose of the spent fuel and the safety
17 and security problems that people are concerned
18 about, all he said is we'll do exactly as we are
19 going to do with the other 104 plants that are
20 already active. There's a logic to this that said
21 he was not sure what was going to happen, a lot
22 was in the air, but they had to solve it anyway,

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1 that it was not new and they were going to have to
2 solve it, so I feel like that a bit with the
3 carbon markets. A lot of the issues that would
4 complicate the surveillance of CO2 like
5 international jurisdiction, index trading, talk
6 about something that will give you a hedge against
7 the whole economy, CO2 is going to be it. Prudent
8 management of position limits. Ownership of
9 pricing. Clearing of off-exchange trades.
10 Complicated derivatives. Transparency in the OTC
11 markets. Cutting across sectors. And cooperation
12 with a bunch of agencies. Big problems, but we
13 have to solve them anyway.

14 I want to say that it makes sense that
15 we regulate emissions futures from the economic
16 perspective, we are already doing it to some
17 extent, and the upcoming issues are not new to us.
18 From the staff's perspective we are committed to
19 these markets. Thank you.

20 CHAIRMAN CHILTON: Thank you so much,
21 Rafael. We appreciate that. I'd like to open up
22 the dialogue and I'd like somebody in particular

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1 to lead us off. Richard Sandor has been a member
2 of this committee in the past and he's been
3 somewhat of a mentor to me. Some people call him
4 the father of financial futures. "Time" magazine
5 called him a hero of the environment. So we're
6 pleased you're able to spend some time with us,
7 Richard. I'm curious what your initial thoughts
8 are, and then we can open up the dialogue. Again,
9 just put your name tents up if you'd like to
10 participate. Richard?

11 MR. SANDOR: Bart, thank you so much.
12 It's a great pleasure to be here, Commissioner
13 Dunn, Commissioner Sommers, and so many pictures
14 of 30 years are flashing before my mind like Mary
15 Shapiro. It's a great history and I feel very
16 privileged to be associated with the Commission
17 since the law was drafted in 1974. It helped me
18 realize some dreams that I would have never had by
19 taking on this whole new commodity which everybody
20 said this Commission would be incapable and
21 incompetent for financial futures. It was a brand
22 new commodity, you couldn't commoditize interest

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1 rates, you couldn't commoditize equities, and it's
2 80 percent to the business. I bring that up,
3 Commissioner Chilton, because if we could have
4 mastered that so effectively, no manipulation,
5 trillions of dollars and virtually no problems in
6 30 years, what's the big deal with carbon? I
7 don't get it. I'm like Tom Hanks in the movie
8 "Big" I just don't get it.

9 I am executive chairman of a company
10 called Climate Exchange. We run a European
11 climate exchange which is 95 percent of the
12 market. I think, Chuck, we're up to about 600,000
13 open interest, 25,000 contracts a day, growing at
14 300 percent. The market withstood an incredible
15 economic event with the credit crisis. Utilities
16 lost complete access to the capital markets and
17 actually used financial instruments in Europe to
18 fund day to day when the commercial paper market
19 froze. Funding was accomplished through the sale
20 of the allowances on the cash market in order to
21 be a substitute for commercial banks and lines and
22 prices dropped dramatically. No problems

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1 whatsoever. In the United States we have a
2 venture and that venture is the Chicago Climate
3 Futures Exchange which is regulated by the CFTC.
4 We're proud to say we've traded RGGI futures and
5 options, and in the 8 months that that's been in
6 operation, it has grown faster than the European
7 Climate Exchange at its comparable stage. It's
8 got a 30,000 open roughly trading 2,000 contracts
9 a day, 2 million tons. That contract is bigger
10 than pork bellies and milk and lumber in just 8
11 months. The same is true with SO2. The same is
12 true with nox. We essentially have 130,000 open
13 interest fully regulated by the CFTC. Not a
14 problem. And in my 35 years of experience, I have
15 never seen a price move as we have seen in SO2.
16 It lost 97 percent of its value as a result of
17 uncertainty in the market because of lawsuits and
18 regulatory difficulties, and from something to go
19 from \$1,500 to \$62 is about as big as -- not even
20 the Hunt brothers, Commissioner, managed to wreck
21 havoc on the market the way that court case did.

22 I must say in addition to that we trade

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1 20 different environmental products ranging from
2 car on the voluntary side which we're proud to
3 have started, rex, sulfur, voluntary carbon, and
4 just to complete that, we run something called the
5 Chicago Climate Exchange which is voluntary but
6 legally binding and it's 600 million baseline
7 which is about 30 percent the size of Europe, and
8 if it was a country it would be 20 percent bigger.
9 Our regulator was -- by choice so even though we
10 were exempt was FINRA and Mary Shapiro headed that
11 organization and did the audits and verification
12 and it was seamless and not a problem.

13 In addition to that, and I will get to
14 the concluding part of it, we have a venture with
15 the Toronto Stock Exchange and trading one issue
16 Canadian carbon, a venture in Australia with
17 Macquarie Bank, and most recently a venture with
18 the China National Petroleum Corporation, 1.8
19 million employees and the biggest company in China
20 to start environmental markets in that country.
21 What will be of note to you and to the
22 Commissioners and my fellow members of this

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1 committee is that we had the privilege of having
2 the CFO of that organization at the FIA meetings
3 and very interestingly enough that's a state-owned
4 enterprise in a communist country talking about
5 the use of markets to deal with environmental
6 problems and I think he was more bullish than some
7 of the folks in this town about markets and their
8 ability to deal with environmental issues.

9 We are seeing a worldwide nexus. I
10 think the Commission would be very wise to look at
11 what your economist has said, interactions with
12 the FSA if the current stands, we will have
13 foreign allowances. Again our companies are IBM,
14 DuPont, Intel, United Technologies, 22 percent of
15 the great power companies in America from central
16 Vermont to DT, Reliant, NRG, Mirant, the great
17 power people. I guess Betsy you might be partners
18 with one of them soon. And we're seeing 22
19 percent of the power sector, 11 percent of the
20 Fortune Top 100, 17 percent of the Dow Jones, a
21 complete cross-sector of every type of emission
22 operated flawlessly. The key though I think is we

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1 will in my humble opinion, Commissioner, see a
2 worldwide set of emissions markets and with the 35
3 billion tons emissions worldwide I concur with you
4 and there will be a necessity for you to help us
5 on the regulatory front.

6 And I must say just to conclude, we're
7 gone through enormous turmoil in the last 9
8 months. Anything I ever saw in 35 years or
9 everything I've ever studied as a student of
10 economics pales except the Depression. Everybody
11 is coming to Washington asking for money, the
12 financial sector, the S&Ls, the insurance
13 companies, et cetera. The only group within the
14 financial turmoil of a 100-year event that
15 operated seamlessly, didn't ask for federal aid,
16 has been regulated derivatives exchanges. We did
17 have members like Lehman on our exchange, Bear
18 Stearns, the prices moved from \$1,500 to \$62 over
19 a period and the CFTC was absolutely unambiguously
20 impeccable, no counterparty risk, total price
21 discovery, and a clearing mechanism that functions
22 in this thing. So I couldn't be more happy that

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1 you've convened this. I think you've collected a
2 lot of old friends around the table, Jack, and I
3 think you've got the best and the brightest here
4 and I'm sure they can contribute to whatever goals
5 and ambitions you need to effectively operate.

6 CHAIRMAN CHILTON: Thank you, Richard.
7 I got a bunch of questions, but I'll spread it
8 around. What we're looking for is, one, just to
9 begin this dialogue, but, two, potential problems
10 and pitfalls that you think you see and that could
11 be with how the legislation is structured now.
12 The Waxman-Markey Bill is the legislation that
13 appears to be moving. I know it is a moving
14 target. But we're doing something today that's a
15 little bit different in government. Usually a
16 bill is passed and then the government gets
17 together and takes 18 months and puts out a reg
18 for comment, so this is sort of backwards that
19 we're doing this long before legislation is passed
20 in an effort to try and get ahead of the curve.
21 So we don't know all of the questions. Somebody,
22 it may be President Reagan, once said there are

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1 not enough smart people in government because
2 business hires them all. I tried to get you to
3 come back and help us out in government despite
4 the fact that we have some very smart people like
5 Rafael.

6 Again put up your tents if you want to
7 ask some questions, but Richard mentioned
8 utilities, and I'm curious about the take both
9 from Holly from AEP and from Betsy Moler, former
10 Chair of FERC, by the way, and Deputy Secretary of
11 Energy, what you all think is in store for us.
12 You all use the futures markets in general, but
13 how do you see this climate change legislation
14 coming about and what sort of challenges do you
15 see both for your companies but for rate payers
16 and for potentially what we might be doing in this
17 space in the futures markets. Betsy or Holly?
18 Either one of you.

19 MS. MOLER: Thank you for the question,
20 Bart. It's a question to be a new member of this
21 advisory committee. I think we're on the verge of
22 legislation. Waxman and Markey are going to

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1 announce their new deal, pun intended, today, and
2 it has profound implications for us. At the core
3 of it I do agree with the presentation that we
4 have to get it right and that we have to take
5 advantage of market forces in order for us to meet
6 the challenges posed by climate change and the
7 legislation. But in doing so, it is absolutely
8 critical that those who trade understand what the
9 rules are and that everyone have confidence that
10 the regulatory regime does not allow speculation,
11 cheating, manipulation, et cetera.

12 I don't pretend to be an expert in these
13 commodities markets. I know a fair amount about
14 the power sector having spent a long time both as
15 a regulator and now as an executive in a utility
16 company. But to the extent that we can help you
17 get the rules right so that there is confidence
18 both in the marketplace, in government and among
19 consumers, that matters dramatically. Whatever
20 input you seek from us whether it's from bankers,
21 traders, regulators, exchange owners or whatever,
22 we have to come out of this with that confidence.

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1 I would also add one thing. The
2 legislation that's wending its way through the
3 House of course does not give this Commission what
4 I view should be its proper role here. Having
5 spent a lot of time on the Hill in my youth, I
6 recognize some of the jurisdictional issues that
7 are presented by the committee structure and who
8 has jurisdiction over commodities and who doesn't,
9 and that is of course at the core of why the
10 legislation doesn't do what it needs to do. But I
11 hope that we can help you secure the
12 jurisdictional nod that you need to do the job
13 that we all need you to do.

14 MS. KOEPPPEL: Thank you, Commissioner
15 Chilton, Commissioner Sommers, Commissioner Dunn.
16 It is an honor to be here today. I could
17 certainly echo what Betsy has said although I
18 don't have her expertise in matters of Washington,
19 D.C., but what I can say as American Electric
20 Power and former responsibilities for our energy
21 commodities trading activities, we need markets.
22 The most telling evidence of that was the slide

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1 presented here today showing that the lowest-cost
2 solutions can be brought to bear and there's a
3 pretty wide spectrum of cost and benefit that with
4 the appropriate market structure, price discovery,
5 regulation, along the lines of what you have
6 outlined can serve our economy, our country and
7 parochially, my company quite well. We have been
8 very effective in managing impact on our energy
9 customers, the 5 million customers that AEP
10 serves, by utilizing the SO2 markets, the nox
11 markets, and allowing for price discovery to
12 occur, and then when it made sense to invest
13 capital to provide for abatement, and we took that
14 move, but only with a forward price discovery
15 mechanism could we make a prudent investment
16 decision. Therefore I would strong encourage all
17 of us to work toward the appropriate market
18 structure to ensure that we accomplish not only
19 our environmental objectives, but also the outcome
20 that is in the best interest of our economy and
21 the energy consumers of the United States.

22 CHAIRMAN CHILTON: Thanks, Holly. Seth,

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1 did you way something about investing? Seth has
2 been with the Calvert Foundation, but he is the
3 TEO of Honest Tea and he didn't promote this, we
4 put the Honest Tea out in front of you and
5 government paid for that. But do you just want to
6 talk briefly about that sort of nexus between
7 investing and environmental stewardship?

8 MR. GOLDMAN: For us it's a very clear
9 and tangible benefit. Green business is clearly
10 on the rise, there's clearly consumer demand, but
11 we've also seen very direct economic benefit, and
12 I have a very tangible one that everyone can put
13 their hands around. We all have a bottle on our
14 table that's empty. It's 38-1/2 grams of PET
15 resin. We have just developed a new bottle that
16 to most appearances really looks the same except
17 this one weighs 31 grams. So a 22 percent
18 reduction is a direct environmental benefit. Our
19 truckloads become 500 pounds lighter so we're
20 using a lot less freight, and of course our
21 margins expand by even more than 22 percent. So
22 as a business strategy, the demand from the

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1 consumer is there, it has to perform in the
2 marketplace like anything, but the economic
3 benefit is very direct and there's no question
4 that we've seen consumers increasingly look for
5 this kind of opportunity, investors it certainly
6 makes sense, and what we've seen as our business
7 has flourished is that this is something consumers
8 and investors are seeking out. So there are
9 already a lot of natural market forces in play.
10 The other thing I didn't mention, but for our
11 company this will contribute millions of dollars
12 to our bottom line.

13 The other point that's worth mentioning
14 is that this technology for this new bottle was
15 developed in York, Pennsylvania. The change
16 equipment which was several million dollars was
17 developed in Toledo, Ohio. So this is American
18 technology fueling American growth and a lot of
19 that happens organically just based on the
20 economics.

21 CHAIRMAN CHILTON: You said organically.
22 Thanks. We'll go to you, Eileen. Go right ahead.

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1 Eileen Claussen with Pew.

2 MS. CLAUSSEN: I just wanted to pick up
3 on something Betsy said and make a slightly
4 different point. I think many of us are really
5 pretty excited about the prospects in the House
6 and for what will emerge from the committee
7 hopefully next week, but that's the beginning of
8 the process. The Senate is still to go. So the
9 pieces that we may not feel are exactly right in
10 the House bill with respect to you and with
11 respect to oversight and regulation of the markets
12 can be fixed and I think we have a window of time
13 here to work on this. So the fact that you're
14 starting early is really important because I think
15 by the time something emerges from the Senate
16 which many of us wish would be this year but which
17 may be next year or whenever, there is some time
18 here, but it's really important that you get
19 yourselves together, get yourselves up on the Hill
20 and make sure that we end up with the right thing
21 in the end.

22 CHAIRMAN CHILTON: Thank you. That's a

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1 good point. Following-up on Holly's point about
2 good for the economy, good for business and Seth's
3 point about what he has been doing, we have some
4 markets up and running as Richard was saying, and
5 it's pretty amazing. So I'd like both Jonathan
6 Schrag with RGGI and Gary Gero from the California
7 Climate Registry to each maybe give people a
8 minute or two of what you're doing, how that's
9 working, why is this good. Either one of you,
10 whoever wants to go first. Thank you both for
11 being here.

12 MR. GERO: Thanks, Commissioner Chilton,
13 and thanks to the Commission for inviting us to be
14 part of this. We're very honored and pleased to
15 do so.

16 I guess I will start by saying that the
17 California Climate Registry was created really to
18 help start incubating and testing ideas around how
19 these markets ultimately will function. The point
20 was that businesses and others wanted to take
21 action. They recognized that there were these
22 items on that McKinsey Curve that was pointed out

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1 that makes sense actually financially today to do.
2 They also recognized that a future regulation
3 would be forthcoming and that if they took
4 emission reductions today they may not be
5 recognized in the future. So we were created as a
6 nonprofit organization and we are a 501(c)(3)
7 nonprofit organization dedicated to protecting the
8 environment that would provide some level of
9 assurance. The state they would recognize
10 activities that were registered against standards
11 that we set forth, voluntary standards, to ensure
12 that companies and others that wanted to take
13 early voluntary actions to reduce their emissions
14 would in fact receive regulatory recognition for
15 that.

16 Those fall into really two categories.
17 The primary work of the California registry and
18 really where we have the bulk of our experience is
19 in emission inventories, 98 percent of the
20 electric utility industry in California, percent
21 of the refining capacity, a large portion of
22 manufacturing capacity, actually voluntarily

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1 report their emissions to us and make the publicly
2 available. To the extent that they can show
3 reductions over time, the State of California has
4 promised that it would recognize those reductions
5 in the allocation of emission allowances in the
6 future.

7 The second and probably the piece that's
8 more significant here I think is there are
9 reductions that are going to take place outside of
10 any cap sector whether it's a cap in California or
11 the Western Climate Initiative where we're
12 primarily working on a federal scale, and this is
13 the notion of offsets. We also want to encourage
14 those early voluntary actions and serve as a
15 testing ground for how do you set good quality
16 standards to ensure that these emission reductions
17 are real and that they can actually count against
18 the real emissions that go into the atmosphere.
19 So the State of California has also directed us
20 and we've written standards for how to quantify,
21 verify, register, track and ensure title around
22 emission reduction offsets. I think this is where

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1 we can bring some experience to this body and talk
2 about the underlying commodity for which
3 derivatives futures options are actually being
4 developed. There are a lot of companies, and now
5 we are not simply a California organization, as we
6 have projects in 24 U.S. states so we almost got a
7 majority of the states, where people are actually
8 taking action today well in advance of any
9 regulatory scheme to reduce emissions and they
10 want to make sure that they get recognition for
11 those emission reductions. So it's a voluntary
12 market but a voluntary market that is developed
13 and implemented and designed as a regulatory
14 mirror and we're a voluntary program that sets
15 compliance and creates standards with the notion
16 that these actors, these forward looking companies
17 that are acting today, should and will be
18 recognized under future regulator regimes. I
19 think this is kind of the most important part of
20 what we can bring to the table, and Johnathan will
21 go next, in the United States there isn't a
22 mandatory trading program up and running today

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1 that is purely regulatory and I think this is the
2 time. This is the window whether it's the next 18
3 or 24 months where we have the opportunity to
4 really explore how these markets work and use the
5 experience of organizations such as ourselves to
6 see where markets function well and where they
7 don't function well. I'm pleased that there is
8 now a futures contract for the credits that we
9 issue trading because that gives us insight into
10 how that market will start to work, and I think we
11 can help inform this process.

12 CHAIRMAN CHILTON: Gary, and if I get
13 this wrong, correct me. Part of this is a
14 learning process for some of the folks who haven't
15 been involved in these things and for us and for
16 our staff. So it's okay if we ask questions that
17 might seem juvenile to folks, but I wanted to make
18 sure that I understood this right and others did
19 too. In California, when they get these credits,
20 it's all bilateral trades. There is not an
21 exchange yet. There is legislation that's been
22 passed by the legislature, supported bipartisan in

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1 that it was supported by Governor Schwarzenegger.
2 That's going through the reg writing process as I
3 understand it. So there is legislation to create
4 this, but now it's all bilateral trades, you get
5 notified when these take place. And if you could
6 just, one, correct me to make sure I'm right.
7 Two, tell people how you actually track these
8 things. Are these things in the ether somewhere
9 or what's going on?

10 MR. GERO: The answer to the first
11 question is, right, there are bilateral trades
12 that occur. Let's take a project. We issue a set
13 of standards, what are called performance based
14 standards for how you quantify the emission
15 reductions from a specific activity, take landfill
16 methane destruction. We then set standards for
17 verifiers and oversee train of credit verifiers
18 and make sure that the landfill is actually
19 performing in accordance with the regulatory based
20 standards that we've written again on a voluntary
21 scale. Those verifiers say 10,000 tons of
22 emission reductions occurred in 2007 and we review

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1 those reports, verify and register and approve
2 them, and then issue a unique serial number. So
3 there is a serial number for every single ton of
4 emission reduction and that serial number has
5 information about the vintage, the location, the
6 project type, and this is all public information.
7 This is all an open and public system.

8 CHAIRMAN CHILTON: Excuse me. The
9 vintage. How long would that to back? To when
10 you started? Was it a couple years ago maybe?

11 MR. GERO: The first vintage we issued
12 was 2006 and that was for a forestry project. We
13 were created in 2001, so we would consider
14 projects going back that far but we haven't seen
15 any. The transaction of those specific tons then
16 occurs outside of our system. We are not an
17 exchange. We don't take a financial position in
18 any of the transactions either at the front in
19 developing projects or at the back end in the
20 exchange portion. We really serve as kind of that
21 quasi-regulatory role in just setting the
22 standards. Over-the-counter bilateral

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1 transactions occur and then are reported to us and
2 those reports then allow us to move the tons,
3 specific serial numbers from one account to
4 another account, everybody needs to have an
5 account in our system, and we can track the
6 transaction over time. Ultimately if somebody
7 wants to make a carbon neutral claim either around
8 their company or a specific product perhaps, they
9 can retire tons. They can purchase tons and
10 retire them and they will be in our system
11 permanently marked as retired serial numbers for a
12 specific purpose, and all of that is demarcated
13 and publicly accessible.

14 CHAIRMAN CHILTON: This is a little bit
15 off subject, Gary, but you see these things on the
16 internet where you're going to take a flight some
17 place and you can reduce your carbon footprint?
18 Is that something you are involved in or are there
19 other people who do that?

20 MR. GERO: We're not involved in the
21 financial transactions so we don't directly sell.
22 We don't own these credits. We're simply the

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1 registration system for them. There are retailers
2 that are account holders who purchase either
3 developed projects or purchase tons and then use
4 them to sell ultimately to customers. So
5 TerraPass for instance is an account holder. It
6 has tons in our system. When somebody buys
7 offsets from TerraPass, potentially they're
8 getting tons from us, credits from us, but
9 necessarily. They're not specifically demarcated
10 in the TerraPass system.

11 CHAIRMAN CHILTON: It's too bad that the
12 U.S. Didn't move faster on these things in
13 general, but without beating that horse, we have
14 the experience of Europe and we can see some of
15 the starts and things that didn't work out.
16 That's good for us I think as we're developing
17 these markets. In addition to what Gary's talking
18 about, we've got this tremendously successful
19 Regional Greenhouse Gas Initiative. Jonathan is
20 going to tell us what they're doing. RGGI they
21 call it. They just won some EPA award not long
22 ago. They seem to be getting this right. Nobody

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1 is worried about manipulation. I'm curious how
2 you are monitoring on your part this thing and the
3 successes you've had, and congratulations by the
4 way.

5 MR. SCHRAG: Thank you very much, and
6 thank you for the opportunity to provide
7 information.

8 The RGGI is a cooperative effort among
9 10 northeastern states from Maine through
10 Maryland, excepting Pennsylvania, to reduce
11 greenhouse gas emissions. I think it's important
12 to note that RGGI Inc is a private not-for-profit
13 corporation. I'm the Executive Director of RGGI
14 Inc established by those 10 states to implement
15 the programs. Each state has their own CO2 budget
16 trading program in statute and regulation that is
17 the basis for their own state regulations. The
18 states remain sovereign. RGGI Inc implements
19 while the states make policy. In that context,
20 I'm happy to talk about the mechanics of the
21 system and leave to the agency heads of each state
22 agency the policy speculation on things like

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1 Waxman-Markey.

2 To your question, I think that the
3 states when they designed the program understood
4 that the pieces need to work together, that there
5 needs to be some meshing of the auction component
6 with the offset component, how one sets the cap as
7 well as the market monitoring. I think that's a
8 very important perspective to carry forward.
9 There is a defined mission for implementation.
10 RGGI focuses on the power sector which is an area
11 of the last 3 years that they've learned how to
12 approach very effectively and taken in small steps
13 potential moves into other sectors.

14 I think as far as performance goes, the
15 market monitoring has been effective. We have a
16 terrific firm that understand the energy markets,
17 and one important aspect of RGGI is the
18 integration of the energy commissioners from each
19 of the states with their environmental
20 commissioners, and so there is currently a
21 foundation among these 10 states for cross-agency
22 collaboration on a whole range of issues between

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1 the energy and environment agencies. So Potomac
2 Economics which is the market monitor for the New
3 York ISO and the New England ISO is very
4 experienced in those electricity markets and also
5 functions as the market monitor for the RGGI
6 allowance market, and that function comprises both
7 monitoring their actions as well as the actual
8 secondary market. RGGI has no affiliation with
9 any of the exchanges and we understand that there
10 is more than one exchange that functions and we're
11 very happy for that, but we don't take a position
12 on how those secondary markets engage with the
13 RGGI allowances except to say that we're very
14 grateful for having a pretty broad collaboration
15 with your staff and we're continuing that and look
16 forward in information sharing moving forward.

17 I think as far as getting the right
18 types of market participants, it's a market and we
19 can't control who comes to each auction. We've
20 just completed a review for auction four, there
21 are a number of participants, and people need to
22 send us the applications. It's important to know

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1 that everyone is eligible and a long compliance
2 period in which people can evaluate how the market
3 evolves not by the quarter or not by the year, for
4 RGGI it's a 3 year compliance period. That's very
5 important and that's a very distinct innovation
6 over what the Europeans did. They have a much
7 greater amount of volatility within their early
8 ETS, the phase one because of those 1 year
9 compliance periods. And I think keeping the
10 administrative burdens for participation in the
11 auction relatively low is an important piece.

12 Then finally, to understand that for our
13 system there really are two types of market
14 participants, those that have a compliance
15 obligation under the regulations of each state,
16 and everyone else, and that may be somewhat
17 different than the other markets in which the CFTC
18 is active.

19 CHAIRMAN CHILTON: Thank you, Jonathan.
20 I was neglectful in seeing who put their name
21 tents up first, so I'm just going to start with
22 Tyson and we'll go around the room to Sean and

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1 finish. I'm sorry about that. I'll pay better
2 attention. Tyson? Thanks for being with us.

3 MR. SLOCUM: It's my pleasure, and I
4 really want to thank the CFTC and particularly
5 you, Commissioner Chilton, for your leadership on
6 this issue. As the only organization seated at
7 the table today that represents American
8 households, I think that getting broad input on
9 the adequate regulation of energy and
10 environmental markets is critical. My
11 organization is one of America's largest and
12 oldest consumer advocacy groups. We receive our
13 financing from the generosity of the more than
14 100,000 families across the United States that are
15 dues paying members of my organization. Unlike
16 some of my esteemed Wall Street banking holding
17 company participants here today, we do not accept
18 any government money. We also do not accept any
19 corporate money. That helps maintain our
20 independence and ensures our allegiance to our
21 constituents, the American people.

22 I think that from our perspective, the

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1 adequate regulation of emissions markets is
2 informed by recent experiences in the energy
3 commodity markets and I think it's very clear that
4 a lack of adequate regulation over energy markets
5 wrecked havoc and I think that particularly the
6 lack of any effective regulation over the massive
7 and growing OTC markets played a damaging role on
8 fueling speculation which created genuine hardship
9 among American families. So I think that we need
10 to learn from the experiences of the lack of
11 adequate regulation over markets in the energy
12 commodity business as we look to how to adequately
13 regulate emissions markets.

14 The experience in Europe I think is
15 informed by two key issues. The prices of CO2
16 standards in Europe were heavily influenced by
17 allowance policies, the issuance of allowances, how
18 many were allocated for free and so forth, and the
19 prices are also extremely dependent upon and
20 influenced by energy commodity prices,
21 particularly natural gas and oil. So it is
22 critical that as we move forward on a regulatory

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1 structure that the CFTC have adequate regulation
2 seamlessly over both energy commodity markets and
3 emission markets so that we have full and adequate
4 transparency. For years we were informed by a lot
5 of market participants that self-regulation was
6 all that was required and so public policy was
7 such that we did not have full regulatory
8 oversight over these markets. I think that that
9 assumption as articulated best by Alan Greenspan
10 recently was wrong, that we can no longer afford
11 to rely on self-regulation alone because we are
12 now paying the consequences of self-regulation.
13 The legislation that is currently before the House
14 Energy and Commerce Committee is a long way from
15 being realized. There is going to be considerable
16 input from other committees in the House,
17 particularly Ways and Means, who have a lot of
18 other ideas about how prices of pollution are
19 going to be set, and the details on how exactly
20 these markets are going to be regulated are still
21 in flux. But Public Citizen strongly supports a
22 strong, effective, fully transparent market headed

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1 by the CFTC that includes a requirement that all
2 OTC trades in energy commodities and in emissions
3 trading be cleared through exchanges fully
4 regulated by the CFTC. I really appreciate the
5 CFTC's attention and commitment to these issues
6 and I look forward to continuing to work with the
7 Commission. Thank you.

8 CHAIRMAN CHILTON: Thank you, Tyson, and
9 thank you for being here. Striking that right
10 balance is so critical. James Madison said
11 something like if men were angels, no government
12 would be necessary. I know everybody is not an
13 angel. Commission Sommers I think had a question.

14 COMMISSIONER SOMMERS: Thank you, Bart.
15 For either Jonathan or Gary, the markets or the
16 programs that currently exists, are there caps or
17 limits on the allowances or the credits that one
18 entity can hold?

19 MR. SCHRAG: Within RGGI there is not a
20 cap on positions per se. Within the auction rules
21 there is a bid limit of 25 percent for each
22 auction participant and there is a set of

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1 regulations within the auction notice that is
2 issued to gauge corporate associations, to
3 identify affiliates as well as bidding
4 organizations. That is one role of our market
5 monitor, to go through the kind of information
6 that's revealed in SEC filings and FERC filings to
7 understand really focused on the utility and the
8 financial industry who owns who and who's bidding
9 at the auction in the name of who. That's
10 something that happens on an ongoing basis, but
11 that 25 percent limit is the only constraint that
12 we have.

13 COMMISSIONER SOMMERS: I just want to
14 clarify because I'm not familiar with all of this.
15 Twenty-five percent of one auction or 25 percent
16 of total historically?

17 MR. SCHRAG: It's a rule that's imposed
18 for each auction of 25 percent. If an entity wins
19 25 percent, they may then go on to the secondary
20 market and purchase any number of additional
21 allowances, and that's not something that would
22 affect the 25 percent, although it would be

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1 something that the market monitor would continue
2 to reserve report on and the states do have
3 general oversight of how those auctions work.

4 CHAIRMAN CHILTON: Sean Cota, you wanted
5 to make a comment?

6 MR. FELDMAN: Thanks to the Commission.
7 It's an honor to be here. I think Rafael's
8 presentation really brought to light something
9 that's important from the big picture which is the
10 scale of the transformation that's being driven is
11 just tremendous. This is probably the greatest
12 mobilization of capital in history to turn over
13 the energy, transportation, industrial
14 infrastructure of the country over a period of
15 time. That really does speak to the mobilization
16 of tremendous resources to develop, deploy new
17 capital that's a long-lived low-carbon
18 infrastructure. At the back of that of course is
19 a policy structure that provides some regulatory
20 certainty about how this unfold over time and a
21 market design that hopefully brings efficiency so
22 that risk can be allocated and investment can in

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1 fact be made effectively.

2 It's within that context that we look at
3 the legislation that is currently being discussed
4 and it's the leading vehicle, but as Eileen
5 rightly says, there will be another stop at the
6 Senate where further consideration will happen.
7 We do see within this context some concerns
8 starting with the premise that of course the
9 regulators should have adequate oversight and
10 regulatory authorities and there should be
11 transparency in exchanges, and clearinghouses play
12 a vital role in that transparency. As written, it
13 appears that the legislation would largely
14 eliminate if not completely eliminate OTC
15 derivatives. This is actually a very important
16 consideration when we think about financing
17 large-scale capital stock in the economy
18 particularly if you think about for example
19 financing power plants over the long term.
20 Frankly, today in a power plant financing
21 arrangement, the developer is going to need to
22 manage the input price, that is, fuel inputs, the

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1 power sales price, that is, power outputs, in a
2 manner that's sufficient to cover the note, the
3 underlying financing structure, and that tends to
4 a long-term financing arrangement, perhaps 7 to 10
5 years. You could not do that today in the fuels
6 or power markets. That is, you couldn't go on to
7 an exchange or a clearinghouse and hedge that
8 price out for the period of time that's necessary
9 to meet the underlying financing obligations. So
10 it's a critical consideration.

11 If we think about over the long-term the
12 amount of capital stock that's going to be turned
13 over, the amount of investment that has to take
14 place, having recourse to the mechanisms in the
15 market that allow that financing to occur, and in
16 particular this is I think in today's credit
17 environment a particularly important thing to have
18 in mind, that financing structures such as second
19 lien financing on power plants which don't require
20 initial margin and the balance sheet commitment
21 that implies for large infrastructure projects is
22 going to be a very important part of this picture.

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1 We say that with full recognition that continued
2 recourse to the OTC derivative market, what comes
3 with that is indeed adequate regulatory oversight,
4 transparency and market structure to provide
5 confidence. But we do want to emphasize the
6 importance of the OTC derivatives market in the
7 overall commodities nexus particularly as we move
8 toward a climate change policy that has these
9 implications, and also stress very much the
10 symbiotic relationship between OTC derivatives and
11 exchanges which is the laboratory of course in
12 which things are standardized and bubble up to
13 become exchange tradable products over time.
14 Thanks very much.

15 CHAIRMAN CHILTON: Thanks, Ben. We'll
16 to Jack in a minute, but Richard, did you have
17 something on this point before we go to Jack?

18 MR. SANDOR: Yes, I did. I want to
19 emphasize what my fellow member JP Morgan said.
20 The predecessor to the Chicago Climate Exchange
21 basically did the first registered trade in SO2 in
22 the EPA, and what we did was went to the city of

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1 Henderson, Kentucky that was going to borrow in
2 the municipal market to fund a scrubber. They
3 were going to pay something like 5-1/2 percent.
4 We went to them and said we will present value the
5 20 year allowances that you have and finance the
6 50 million and you won't have to leverage the
7 city, you won't have to worry about paying back
8 the debt, you won't have interim construction
9 financing, and we'll do it 150 beeps better than
10 you would in the muni market. We took that 30
11 years of allowances, sold it to another utility,
12 attached it to a zero and then split it off as if
13 it were a government bond with a -- payments and
14 they used that for compliance.

15 That kind of trade and financing to
16 utilities would be not be possible under anything
17 like that, and you're taking some real capital
18 particularly with the cap expenditures necessary
19 for SCRs for nox and selective catalytic
20 refineries, scrubbers for SO2, maybe carbon
21 capture and storage and other things, and one has
22 to be cautious. We are as a matter of fact in

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1 RGGI seeing virtually all of the trades done on
2 exchanges but they're short term because people
3 don't want to take the counterparty risk and the
4 spreads are a penny or two in allowance with 10-
5 to 20,000 up bid to offer. So one does not
6 preclude the other and I think we have to take
7 account of the financing needs in the power sector
8 and the fact that some of these projects are 30
9 years or 20 years and you can't do them on
10 exchanges are you rightfully indicate. We don't
11 trade a 30 year future, we go 5, 6 or 7 years, and
12 the life and vitality of the power sector is very,
13 very critical. So we have to have a balance. You
14 may find that odd coming from an exchange whose
15 business is to capture all of that, but I think
16 that there is a natural relationship between the
17 OTC markets as long as they are regulated,
18 transparent, preventing manipulation, the kind of
19 coordination with the spot market. It doesn't
20 mean the exchanges should have a monopoly. It
21 means that they should be harmonized with the OTC
22 market.

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1 CHAIRMAN CHILTON: Thank you. Jack with
2 Natsource. Thank you for being here, Jack.

3 MR. COGEN: Thank you, Commissioner.
4 There was a senator a number of years ago, and I
5 apologize, I forget who said it, but his quote was
6 something of the order of everything that can be
7 said about the subject has been said, but not
8 everyone has a chance to say it. I won't just
9 repeat what the last two speakers said and way
10 that the over-the-counter markets are absolutely
11 necessary before you have an exchange market, that
12 they work hand in hand. But I'll make a couple
13 comments representing the International Emissions
14 Trading Association. For those not familiar with
15 it, we represent about 170 corporations around the
16 world, many in the U.S., many very large
17 industrials, but also the support services and
18 finance services are necessary for a carbon
19 market. In the letter we just wrote to Mr.
20 Waxman's committee, we strongly support two
21 things. One is regulatory oversight by the CFTC
22 as the natural derivatives regulator, so I want to

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1 make that comment. By the way, another
2 organization in London, the Carbon Markets
3 Investors Association, also made the same comment.

4 The reason for that is what we found in
5 our experience in Europe, and this won't surprise
6 people when they think about it, is that carbon
7 trade is highly correlated with the energy complex
8 until it doesn't. That means it's part of the
9 dispatch algorithm for utilities of what plants
10 they turn on and what they burn and they take the
11 fuel costs and the carbon associated with that and
12 the power price and determine what to turn on
13 until there's a specific carbon event which very
14 often is a regulatory announcement, the Commission
15 comes out and says something about carbon or a
16 very large carbon project comes to market or
17 there's something carbon specific, and then the
18 correlations disappear. As Richard said earlier,
19 one of the interesting things we saw in Europe was
20 as the financial markets collapsed or stopped
21 working for a while that people actually looked to
22 the various commodity markets for funding and

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1 carbon was no exception, and they worked very
2 well. People had an asset on their balance sheets
3 and they could sell it and it was a good way of
4 doing that.

5 The other example with that is what
6 Rafael said when he pointed out in passing that
7 the SO2 market existed for 8 years without a
8 futures contract. During that time my firm in
9 particular was very active in forward derivative
10 transactions. So we had many, many years of a
11 very robust derivatives market frankly with almost
12 no regulation and no failures and not a problem.
13 There were a number of reasons for that including
14 that most of the entities that traded were
15 regulated and so there may be in some other
16 markets a failure of regulators to do their jobs
17 whether the market is directly regulated or not,
18 but I think that you have to look at that issue as
19 well.

20 So we support a very active
21 over-the-counter market and I think that the
22 challenge will be in getting the information in

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1 one place so that you can see what's being done in
2 OTC and what's being done on the exchanges and see
3 if there's a problem. I think that's a very
4 difficult thing in any of the markets and I know
5 that there are a number of congressional
6 committees that are looking into that at the
7 moment.

8 A few final points on that. I would
9 like to see where will carbon be in the future?
10 I'd like to see it look like anything else in the
11 financial system, that it's not special, and then
12 we will truly have a successful capital market.
13 If it has an exceptionalness to it, it will fail,
14 so I think that that's a driving principle that
15 you want to keep in mind in these things. That's
16 one.

17 The other is I just want to give an
18 example so people can see why exchanges are not
19 always appropriate. When we do carbon projects at
20 Natsource, and I'll take off my IETA hat for a
21 moment, we've developed carbon projects under the
22 Clean Development Mechanism where we have expected

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1 deliveries from outside sources who have said
2 about 120 million tons of the projects we've done,
3 so that makes us one of the largest carbon
4 developers in the world. A couple things about
5 that in terms of market scale especially now. A
6 good year in the carbon market is a really bad day
7 in the bond market. It's a tiny marketplace.
8 We've done a couple billion dollars of business.
9 That's nothing. We're talking about the economy
10 now. So in all of these things, you have to
11 remember that for a number of years this is going
12 to be a very small market. It may eventually be
13 tremendous, but this is beginning markets and
14 beginning markets don't have liquidity and don't
15 have price discovery. When you do the very first
16 trade in a marketplace, how do you mark it to
17 market? You are the market. How do you talk
18 about only having a 20 percent market share or a
19 10 percent market share? You're the only trade.
20 You have 100 percent market share. So there are
21 start-up things that have to be done.

22 The other is when you go into the world

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1 of offsets and you do a transaction, you don't
2 know what's going to be delivered. Typically in
3 futures contracts we talk about absolutes, that if
4 you sold 10 tons of something you're going to
5 deliver 10 tons or you're going to buy 10 tons.
6 In the offset market, trades are unit contingent.
7 That's if in fact the project works and delivers,
8 you get to buy it. What volume do you associate
9 that to put through the clearinghouse? The
10 contract may say you're getting a million tons.
11 In reality you don't get anything. So what do you
12 clear? These are all very difficult issues that
13 make it very natural for an over-the-counter
14 market and very unnatural for a clearing market.
15 Thank you.

16 CHAIRMAN CHILTON: Those are really
17 great questions. Could you get the answers in a
18 few minutes here for us? I'm interested in that,
19 Jack, and particularly from the exchanges, your
20 thoughts on what he's proposed. One of the
21 differences, and I guess we have it in the SO2
22 market, acid rain was a big problem and it's still

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1 a problem, but somebody correct me if I'm wrong,
2 emissions have been reduced in half. This is a
3 program that's worked well and if we had that sort
4 of success from an environmental perspective on
5 carbon, it would be a big boon. Everybody would
6 be clapping and we'd be saving the planet in
7 addition to creating these great markets and
8 helping our economy. I know it's not going to be
9 quite as easy. One of the things you said, Jack,
10 about what's different about carbon. Ultimately
11 we've succeeded if it's like everything else. The
12 environmental markets are a little bit different
13 in that, and again tell me if I'm wrong here
14 folks, but it's not like corn or wheat or crude
15 oil where what's the supply and how many
16 refineries do you have, nat gas. The sum of these
17 credits, the government is going to be involved in
18 what the pool is out there, so it's not whether or
19 not there's a drought and you have corn or whether
20 or not you get too much wheat on the market and
21 prices go down. There's this added component
22 which makes it a little bit of a different animal.

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1 I take your point and I agree that you have a lot
2 of folks, some in this building, and Richard sort
3 of alluded to this, who will just say it's just
4 another contract and you just trade it like
5 anything else. But we've seen that there have
6 been some fits and starts in Europe, and this is
7 so important. We're at this tipping point they
8 tell us on the environmental part that we don't
9 have 4 or 5 years to figure it out which is why
10 this is so important and the questions that Jack
11 raises I think are key.

12 We'll go to De'Ana, Laura, Tyson, and
13 Michael. Then I am interested to hear from ICE
14 and Eurex if you have anything to say on this.

15 MS. DOW: Thank you, Chairman Chilton,
16 and thank you for allowing me to substitute for
17 Jim Newsome today on this panel.

18 I think you're exactly right. I'm
19 fourth in line. I had my card up. So a lot of
20 what I was going to say has already been said, and
21 I completely agree particularly with Dr. Sandor
22 and with the description of some of the types of

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1 transactions that would be appropriate for
2 exchange trading.

3 I'd like to start out by saying right
4 now there are a lot of skeptics on the Hill about
5 going forward with a market based solution and
6 that ties back to obviously all the issues and
7 concerns surrounding the energy markets, NYMEX
8 being one of the main focal points of a lot of
9 hearings and legislation and just targeted in
10 general. Being at the highest tier regulation,
11 not only are we regulated by the CFTC, but we are
12 also subject to self- regulatory duties and
13 responsibilities. In a sense of self-regulation
14 being a key component, it is important and we are
15 charged with implementing and enforcing a number
16 of rules and regulations. When you look at the
17 markets that are not regulated, there are a lot of
18 things out there that we don't know, that we could
19 not see, but if you look at the study that the
20 CFTC did when they took it upon themselves to look
21 into what was going on in the swaps market and
22 what was behind some of those trades, I think what

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1 they found was people were not actually
2 circumventing rules and using that mechanism, that
3 exemption, as a mechanism for going above or
4 exceeding position limits. So I thought that not
5 only that study, but studies by GAO and other
6 reputable institutions out there found that that
7 there really were no problems in the form of
8 manipulation that was going on, that the markets
9 were functioning properly and the fundamentals
10 were supporting where the markets were. As you
11 can see, it has corrected, it has gone back to
12 what may be considered normal bounds, but it's
13 reflected by supply and demand. The demand has
14 decreased because the markets have declined and
15 there is just not as much money out there to
16 impose this demand on the market.

17 So I think we have a steep hill to climb
18 in terms of convincing those in the Hill that a
19 market based solution is the right approach and
20 it's the best way to achieve the environmental
21 goals that we have, and that's one reason I think
22 that this particular commodity differs from other

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1 commodities in the respect that there are these
2 specific environmental public policy goals that we
3 seek to achieve through this market so we do need
4 to get it right. When you look at again the
5 concept of clearing, not all contracts and
6 transactions are not appropriate for exchanges,
7 not all things are appropriate for clearing.
8 They're just not suitable. They're just too
9 highly individualized to be something that you can
10 submit to a clearing mechanism.

11 What we were looking at as a possible
12 alternative is saying, yes, encourage clearing. We
13 should incentivize clearing for these products
14 because that's going to provide you with the
15 transparency, that's going to provide you with
16 some recordkeeping, that's going to provide you a
17 regulated forum where these transactions are
18 coming in. For those that cannot be cleared, then
19 build some sort of special exemption and
20 specifically identify those types of transactions
21 that would be eligible to trade over the counter
22 without going through clearing and have some

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1 additional reporting requirements because I do
2 believe that for this product it's going to be
3 important that there be some additional
4 transparency and that's the only way we're going
5 to be able to have the legislation go the way we
6 want it to and have a market based approach, if we
7 can offer them something that will give them some
8 comfort about what's going to be going on in the
9 OTC market, and we absolutely do need to have both
10 of those particular components for this to be a
11 vibrant and liquid market.

12 CHAIRMAN CHILTON: Thanks, De'Ana. I
13 did want to note that not everybody agreed on the
14 swaps report. I dissented. Not everybody is not
15 going to agree on these things. Bob Pickel
16 deserves a star for not yelling at me already
17 today. We're not going to all agree. I didn't
18 agree on the swaps report. I think there were
19 some flaws in it. Laura?

20 MS. CAMPBELL: Thank you, Bart. You
21 said something a moment ago about nat gas and
22 there's supply and demand and you know what the

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1 supply is. What we have to remember is that with
2 this carbon market, if the value of the carbon
3 contracts go up, it's therefore going to make the
4 value of natural gas go up. So they're seamless.
5 The markets to me are seamless. Therefore, the
6 regulation should be seamless. I think everyone
7 should keep that in mind. Then also keep in mind
8 the consumers. Those consumers are going to have
9 a double-whammy on their utility bills. Now their
10 natural gas has gone up and their electricity has
11 gone up. So let's just keep in mind also those
12 consumers who are going to be the ones who bear
13 really the results here.

14 As we look at what that regulation
15 should be, I'm also as always a proponent of
16 transparency. As it relates to clearing I think
17 everyone has made that point, but as for a
18 utility, there are two things. There are some
19 long term contracts that we go into that without
20 that OTC that structure is just not viable. So we
21 have to have some other mechanism for us to manage
22 that risk.

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1 The second thing is that there are a lot
2 of small utilities who just don't have that cash
3 management function that maybe some of our Wall
4 Street folks have, so we need to have that OTC
5 component so that we can manage that risk without
6 having to manage the margin calls.

7 Also there was a question from
8 Commissioner Sommers who asked how have things
9 changed since last year. I think for me I was
10 looking at being drawn and quartered in January,
11 so I'm pleased that the price of natural gas has
12 come down. However, with that it's also that the
13 media attention has come down. But really the
14 fundamental issue for us making sure that there is
15 a true supply and demand response and a true price
16 discovery. So whether there is manipulation of
17 prices higher or lower, it's a burden to our
18 consumers. If prices are too low, we're sending
19 the wrong message to our producers and it's going
20 to hurt our consumers in the long term. Really
21 what we're looking for is a marketplace that's
22 free from manipulation which transparency can

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1 bring to it and yet have that level of development
2 for the carbon market because having a viable
3 carbon market I think is important to everyone.
4 But never lose sight of the fact that those
5 markets are seamless. They're inextricably
6 linked.

7 CHAIRMAN CHILTON: Thank you, Laura. We
8 really appreciate your participation in this, and
9 you have always been very helpful. We're going to
10 go Tyson, Michael, John, Skip, Gary. Then I think
11 we're going to take a break after that.

12 MR. SLOCUM: Thank you. I just wanted
13 to very quickly address the issue of relationships
14 between our experiences regulating or not
15 regulating SO2 markets compared to carbon markets.
16 First, I think we need to fully understand just
17 how miniscule the SO2 markets are compared to the
18 scale that we're talking about with carbon that
19 makes an exact analogy very difficult to uphold.
20 The SO2 markets I believe have about 9 million
21 allowances per year, whereas with carbon we're
22 looking at the order of 5 billion or so allowances

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1 a year. So it's an order of magnitude that is
2 massive.

3 Second, the mitigation technologies for
4 SO2 were relatively easily deployable, whereas for
5 carbon we are still discussing whether or not
6 carbon capture and storage is even going to work
7 in 5 year, 10 years or at all. So the ability for
8 us to implement technologies based upon signals
9 coming from the marketplace to mitigate carbon is
10 not exactly resolved. So I think that lessons
11 learned from the lack of regulation and the
12 relative success in the SO2 market is not always
13 informative as we move forward on regulating
14 something the size and scale of carbon.

15 CHAIRMAN CHILTON: Good point. Michael?

16 MR. PROKOP: Thank you, Commissioner,
17 and Commissioner Sommers as well. Again thank you
18 for having us today.

19 I would submit that as one of the
20 largest facilitators of over-the-counter
21 transactions in the marketplace, Amerex certainly
22 sees is fair share of business daily from the

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1 natural gas markets, the power markets and the
2 carbon markets. We've been facilitating
3 transactions in the carbon market since 2001 now
4 and are very active participants in the CCX and
5 the CCFE, and then obviously in energy commodities
6 in both ICE and NYMEX. What I would submit is
7 certainly the over-the-counter market I do not
8 believe is fearful of clearing. The legislation
9 that's coming down now I think is being embraced
10 by many of the counterparties in the marketplace.
11 It provides a much more stable platform for
12 credit. You're going to see in the climate
13 markets smaller players that need to participate
14 in this market to effectively move credits in and
15 out now being able to participate with some type
16 of clearing mechanism in place. So I don't think
17 it's any secret or it's going to come as any
18 surprise that the Markey legislation that comes
19 down is going to promote this clearing.

20 What I would say though is whether it's
21 in the form of legislation that comes down or the
22 regulation that ensues afterwards, that not one

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1 clearing facility be embraced as the be all, end
2 all clearing facility. One of the things we've
3 noticed since 2004 with the advent of clearing of
4 natural gas is the competition that exists there
5 now, the fierce competition between ICE and NYMEX.
6 For our consumers it keeps their fees low which in
7 the end does go all the way down to the consumer
8 level. But it also keeps innovation high in
9 cutting-edge. We see both platforms introducing
10 products continually. Week by week it seems
11 they're adding new products and giving people
12 better options on being able to more perfectly
13 hedge their products. But without that
14 competition between these clearing entities which
15 are regulated by the CFTC both in the form an ECM
16 and a DCM, this is good for the market and it's
17 helped us tremendously in our business and it's
18 helped our consumers get business done.

19 Going onto the carbon markets the
20 direction we're going now, we're talking about
21 clearing carbon, it seems to me that it's the
22 perfect choice to have the CFTC as the regulatory

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1 body over this. You've done a fantastic job in my
2 personal opinion up until now with the energy
3 markets and the turmoil we've seen in world
4 events, and I see no reason why that would be
5 otherwise.

6 CHAIRMAN CHILTON: Good points, Michael.

7 MR. SHELK: I'm John Shelk with the
8 Electric Power Supply Association and we represent
9 both generators and marketers in competitive
10 wholesale markets, and so we strongly support well
11 regulated markets including for carbon, and we
12 very strongly believe for all the reasons we've
13 heard today it's both a moral imperative
14 environmentally but also a business imperative.
15 The lack of resolution of these issues at the
16 federal level is really an impediment to
17 investment from our perspective. We have a very
18 active Climate Change Working Group that's looked
19 all the options and I would underscore what Betsy
20 and Eileen and others have said that we believe
21 that the CFTC is the appropriate agency here and
22 believe that the Congress will eventually see that

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1 that would be the case in the legislation.

2 I think it's also important to note that
3 I had the privilege at a very young age a long,
4 long time as Betsy said being on the Hill to work
5 on the 1990 Clean Air Act. I think the models
6 that we've all heard from the presentation earlier
7 show why markets are the right way to go. Having
8 said that, I think it's very important to always
9 keep in mind that at least for the power sector
10 which is what -- that the emissions that the
11 electricity industry in 2009 looks a lot different
12 than the industry looked in 1990, so it's
13 important that as you go forward and as the
14 Congress goes forward that all of the various
15 segments of the industry, there are different
16 types of companies, different regional markets,
17 different state rules, everyone is going to need
18 them for compliance purposes and the excellent
19 point on investment. So I think that's got to be
20 kept I mind.

21 I have a question and frankly no answer
22 but something I think as the legislation evolves

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1 and folks around the table who are more intimately
2 involved in it than I am, it looks like from what
3 we've all heard that there will be for
4 understandable reasons a transition period of free
5 allowances and later an auction, and I just don't
6 know how that impacts the regulation of the types
7 of products, but that's something to put out
8 there.

9 And last but not least, I make this
10 observation with some trepidation but it I think
11 picks up on what Tyson said and others said. I
12 yesterday attended the Electric Power 2009 Trade
13 Show in Chicago and senior executives were there
14 from Exelon and AEP and others spoke on a very
15 good executive panel, but it was preceded by a
16 gentleman whose name I apologize that I don't
17 remember his name. He was the keynote speaker.
18 It goes to the point that the lady representing
19 Mr. Newsome said if he had six pictures of Gordon
20 Gecko in his slide deck, he had at least six, and
21 he spent most of his time, and this at 1,000 if
22 not 2,000 people at the plant operating level in

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1 the companies, and he is making the case, and I
2 think this is an impediment to those of us who
3 believe in markets and why it's so important,
4 you're doing what you're doing today and we all
5 work together to show the public this is well
6 regulated, it can work, and it's being done for
7 environmental reasons. His whole pitch was this
8 was all a new market. This was just all financial
9 engineering. It was quite disturbing, frankly, I
10 thought to myself I know from past experience and
11 we all know that working on this day to day that
12 markets are the way to go, but if someone like
13 this gentleman speaking at this kind of conference
14 is making those kinds of comments and having the
15 same picture of Michael Douglas over and over in a
16 20 minute presentation, it just underscores the
17 importance of the work that the agency has done so
18 well and why I know I do and others around the
19 table want to make sure we get this right early.
20 And I think it's not backwards. I think you're
21 doing exactly the right thing convening now and
22 getting this work done long before there's a Rose

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1 Garden signing ceremony which we all hope is
2 sooner rather than later.

3 CHAIRMAN CHILTON: Thank you. I was a
4 little facetious. I think we're doing the right
5 thing too. Skip?

6 MR. HORVATH: Thank you much,
7 Commissioner, and thank you for holding this
8 meeting. It is prescient. If you're taking any
9 sort of heat for having it backwards, blow it off.
10 This is a good idea.

11 I want to echo all the pro-market
12 comments around the table. I don't want to repeat
13 any of them. But that's where am I aligned on the
14 way markets work and provide solutions. A quick
15 example is that chart that McKenzie put together a
16 few months ago is already out of date. There is
17 no mention on it of pre-combustion CCS for natural
18 gas. It exists as a technology out of a Canadian
19 company and it's relatively cheap, so that markets
20 do work to spur innovation.

21 The point I want to emphasize that
22 people have only touched on is the scale of this

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1 market and what makes it difference is scale.
2 It's an easy thing to make the leap and say what
3 we do now works for these smaller markets so it
4 will work for a bigger market. My training is as
5 an engineer and that's just not the case in
6 engineering. You start with a pilot test of
7 technology on a table, you scale it up to a pilot
8 plan that's the size of this building and it often
9 does not work at all. What works on that table
10 top does not work in the pilot plan. Even if it
11 does work in a pilot plan and you scale it up to
12 the size of something that's building of the CFTC
13 here and that may work. This is a market is a
14 market on steroids. This carbon market is the sum
15 of all the physical markets and then the financial
16 market on top of it, let's say it's five times.
17 There is nothing like it. We have nothing like
18 it.

19 The question I really want to hear that
20 I haven't heard around the table and I want you to
21 think about is the CFTC scale, your rules and
22 regulations and your processes and your staff, do

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1 you have enough Martinezes here to handle the
2 kinds of work that's going to be thrown at you?
3 It's important because the downside is huge. If
4 this market fails and all the derivatives and all
5 the other markets attached to it over time fail,
6 it will make this last recession look like
7 nothing. And while I appreciate the concern of my
8 colleague on my left that these markets start
9 small, this market is not going to stay small.
10 This is a huge market coming up and we may only
11 have a year or two. So I just wanted to think
12 about CFTC scaling appropriately.

13 CHAIRMAN CHILTON: Those are good
14 points. I always want to pick up a ball when
15 somebody says we need more staff. Yes, we need
16 more staff. I can tell you that I've been very
17 pleased with the administration's recognition
18 which is also foresightful on their part that we
19 need more folks. I think we should probably be
20 looking at 700 people would add another couple
21 hundred people to the agency. As most of you
22 know, we're pretty small. We have about 500

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1 folks. The SEC has 3,300 or something. Our
2 market cap is actually greater than the securities
3 world. We've got an uphill fight. But I don't
4 want anybody to take away from what anybody says
5 here that we aren't ready to deal with these
6 markets, that we're not going to be on the ball,
7 and that we're not going to have the resources to
8 do the job that's required to avoid fraud, abuse
9 and manipulation and protect consumers.

10 We're going to go Gary, Chuck, and then
11 we're going to take a break.

12 MR. GERO: Just really to respond to a
13 couple of questions and clarify a couple of
14 points. I'll be very quick. I know Commissioner
15 Sommers asked about position limits and we are a
16 voluntary offset program, so I want to draw a
17 distinction here between allowances within a
18 capped program such as RGGI where you may want to
19 impose those kinds of limits and offsets in a
20 voluntary market where there really is no reason
21 to have such limits. We don't impose those kinds
22 of limits in the voluntary offset arena.

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1 Responding to something Jack said, I
2 think it is important to note that offsets are
3 issued only on an ex post basis, that is, only
4 after the emission reduction has been verified to
5 have actually occurred. So you can have forward
6 contracts or future contracts, but if the
7 equipment isn't functioning or the metering data
8 isn't there or other things go wrong, there will
9 not be the supply. So it's kind of like I guess
10 to use an analogy in other commodity markets the
11 weather changing in an agricultural sense.
12 Something can go wrong and the future supply of
13 offsets can be disrupted. That's on a small
14 scale.

15 The final point is today is a voluntary
16 market with regard to offsets and because it's a
17 voluntary market, it's left really to those of us
18 who administer these programs to impose the
19 regulation itself because there is no regulatory
20 structure in place. Because of that, we've had to
21 take on a lot of that ourselves at what we've
22 named the Climate Action Reserve to reflect our

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1 national status. At the Climate Action Reserve we
2 actually impose terms of use and legal
3 requirements. We have title assurance documents.
4 We are moving now in our terms of us to preclude
5 beneficial ownership so we can make sure that we
6 know what's going on in our system. We want to
7 make sure that there is transparency. Those are
8 things that we have discovered as we implement the
9 voluntary that are necessary to ensure that there
10 is a degree of certainty and standards in the
11 program itself. I just wanted to point that out.

12 CHAIRMAN CHILTON: Thanks, Gary. Chuck
13 with Intercontinental Exchange?

14 MR. VICE: Thank you, Mister Chairman.
15 I of course predictably echo all the pro-market as
16 well as pro- CFTC as the appropriate regulator
17 remarks as well as I think Mike's comments about
18 competition that's often minimized and left out of
19 the debate and I think that the energy markets
20 benefit from that quite frankly unlike any other
21 derivatives market, OTC or futures, so I think
22 that it's important that we encourage it.

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1 The one point I would add to this is I
2 think the international aspect of this should be
3 emphasized more. If it's a global market, it's
4 carbon more than anything else. These markets
5 will trade in synch globally and I think the CFTC
6 has through not the least of which the F -- rule
7 making and going beyond information sharing with
8 international regulators, but actually cooperating
9 on the implementation of each other's regulatory
10 regimes which are pretty intense relationships
11 there. It's going to require that in the carbon
12 markets. I'm not aware of other federal agencies
13 that have built this bridges, so I think that's
14 very important.

15 CHAIRMAN CHILTON: Thank you. That's
16 actually a perfect spot to break. Commissioner
17 Sommers and I met yesterday with, they will remain
18 nameless. We went with a group and one of the
19 things we started talking about was the
20 fungibility of credits globally and how are we
21 going to work with our brethren regulators
22 overseas and on this continent. Ultimately this

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1 is a global problem. Clearly China is a big
2 emitter and they need to come along on this
3 journey too or we don't be successful as a planet.
4 But I'd like for people to maybe think about that
5 during the break. I know that's way out there.
6 We're talking about how you get this bill out of
7 committee right now and I'm talking ultimately how
8 do we deal with the fungibility of credits
9 globally. I'm interested in your thoughts.

10 What I plan on doing is taking a 20
11 minute break and then we'll come back. Maybe
12 we'll finish up on the carbon discussion for a few
13 minutes on that question or anything else anybody
14 wants. I know a few people have to leave, that
15 they have other appointments. I appreciate the
16 time that you've been with us today. Then I'd
17 like to move on to energy. We'll have two quick
18 presentations on energy, and I'm going to get
19 everybody out of here at noon sharp. Again,
20 thanks for being here, and we'll take a 20 minute
21 break.

22 (Recess)

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1 CHAIRMAN CHILTON: If we can all take a
2 seat, we're going to go ahead and resume our
3 meeting. Sorry about being a little bit tardy
4 there. I think people had some time to get some
5 good conversations. I did want to go back to this
6 question of fungibility, and I'm thinking that
7 we're going to talk on carbon, although it's your
8 committee as well as mine and Commissioner
9 Sommers's. Then we would move into the energy
10 area. Before we talk about fungibility, Dan
11 wanted to make a few comments. Dan, thank you for
12 being here.

13 MR. POTRATZ: Thank you very much for
14 letting me present to the Commission. My name is
15 Dan Potratz. I'm a member of the Industrial
16 Energy Consumers of America. A lot was discussed
17 this morning and one of the things that came to
18 light for me is what Commissioner Sommers talked
19 about earlier about speculative limits, and I
20 wanted to emphasize the need for that not only
21 within one exchange but across several exchanges
22 to make sure that market players don't have the

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1 opportunity to control the market to any great
2 degree.

3 Price transparency is something that we
4 talked ad nauseam about this morning. It's
5 something that we feel very strongly about. Thank
6 you.

7 CHAIRMAN CHILTON: Thank you, Dan. Do
8 people have any thoughts about this fungibility
9 issue? This is a global problem and they're
10 trading these credits in Europe, they're trading
11 them in the Northeast. They're doing bi- lats on
12 the West Coast. I'm just curious ultimately could
13 somebody look in a crystal ball and give us your
14 thoughts on how this ultimately works. What is a
15 credit that's been established on RGGI that
16 somehow morphs into the U.S. cap and trade system?
17 Is that something that will have an equivalent
18 value in Europe? What about what some of the
19 investment banks are doing, projects in South
20 America? How is a credit in South America for
21 doing the right environmental thing? How is that
22 going to play in the U.S. Or in Europe or

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1 hopefully ultimately with the participation of
2 China? Does anybody have thoughts on this whole
3 subject? Jonathan?

4 MR. SCHRAG: With respect to RGGI
5 allowances and RGGI offset allowances, the value
6 of those allowances is fundamentally linked to the
7 standards of the issuing entity. In our case it's
8 a mandatory state government. I think those
9 standards mean two things. On the one hand it's
10 the cap, what's the level of the cap and the
11 stringency of enforcement of the cap, how tight is
12 the cap, what triggers are there to increase the
13 cap. In RGGI there are none. The 188 million
14 tons is set on an annual basis. With respect to
15 offsets, it's what are the standards and the
16 methodologies for issuing offset allowances? What
17 are the verification processes? RGGI will be
18 issuing later this month very prescriptive
19 standards for five offset categories, applications
20 that are 70 pages long that require significant
21 environmental engineering expertise to engage with
22 for project sponsors. CCAR has similar types of

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1 standards and materials. So if one is talking
2 about fungibility, one needs to make sure at that
3 level of environmental engineering for offset
4 categories that there is some matching or is that
5 there is some ability to translate those into
6 other instruments that would be fungible.

7 CHAIRMAN CHILTON: That's very
8 interesting. That's helpful. I'm going to be a
9 little more pointed in my question. There are
10 mandatory markets that are operating in the E.U.
11 Folks in the E.U. exchanges would like to trade
12 with U.S. consumers, so they'd like screens in the
13 U.S. that would require a no action letter from
14 us, from the Commission. Likewise in the future
15 for lack of a better word, there will be U.S.
16 exchanges that want to have terminals. CME has
17 terminals in 84 countries or 86 countries or
18 something. As we're thinking about this from a
19 regulatory perspective, rather than everybody get
20 parochial about our markets and it's this,
21 ultimately it seems that this going to need to be
22 global. I wonder if anybody, particularly the

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1 exchanges, have any thoughts about this on how we
2 should be maybe working with our brethren
3 regulators overseas, but what's the competition
4 going to look like in this space?

5 MR. VICE: Since you asked the
6 exchanges, I'll take the bait on that. I don't
7 know that I have any answers other than as I said
8 before I think we got our first taste with WTI and
9 crude oil, for example, on the kind of
10 coordination beyond information sharing that's
11 going to need to be made amongst the regulators.
12 And not even the regulation, but I think as
13 Jonathan pointed out, if the underlying
14 requirements are vastly different in terms of the
15 reduction levels individual countries have to get
16 to or what the requirements are to get an offset,
17 that's going to create issues I think. I don't
18 know if it's problems necessarily, but there are
19 going to be issues that some people will perceive
20 as problems whether it's an arbitrage opportunity
21 that shouldn't be there or a price spike in one
22 market that you can't explain relative to another

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1 market. I don't have the answers for all of
2 those. I think we're all going to have to learn
3 as we get through this. As I said, the more we're
4 doing this type of thing as early as possible and
5 I think the regulators are talking with each
6 other, the better off we're going to be.

7 CHAIRMAN CHILTON: Thanks. Mike is
8 stepping in for Dr. Sandor. Mike Walsh with CCX.
9 Do you have a comment on this?

10 MR. WALSH: Thank you, Commissioner. I
11 couldn't agree more with Chuck's observation and I
12 can assure you that if you reached out to the
13 European Union and the FSA which you do in regular
14 course, they would welcome that discussion as soon
15 as possible. I would emphasize that while there
16 are numbers pathways that the draft legislation
17 proposes to allow for international trade among
18 allowances for relatively comparable programs,
19 among project based credits potentially from the
20 existing clean development mechanism structure and
21 as well tropical forest conservation credits which
22 are articulated at great depth, there's kind of a

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1 long way between here and there in terms of having
2 international recognition. It's unclear whether
3 it will be a one way recognition or a two way,
4 it's unclear whether the U.N. system or some
5 sequence of bilateral agreements will be needed to
6 get that mutual recognition. So the market
7 dimensions of that are critically important and I
8 think that this Commission as well as the European
9 market regulators should be involved in that
10 policy environmental discussion given the market
11 ramifications.

12 CHAIRMAN CHILTON: Thank you. I got
13 worried. I don't want to be parochial and I want
14 to think about the overall environmental good, but
15 a lot of the decisions that we would make in this
16 regard would have competitive advantages and so
17 it's something that we're going to have to be
18 thinking about in the future.

19 One other thing that I was curious
20 about, and I don't know if anybody is brave enough
21 to speak about it, but we'll see. I've talked at
22 several different events and the people who are at

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1 these events on carbon are new. Investment banks
2 are setting up new trading desks. Law firms are
3 having people who specialize on carbon. This is
4 all in anticipation of these markets being large
5 and robust. I'm just curious if any of you in
6 this room on the committee can tell me a little
7 bit about that, what you're doing, how you're
8 preparing. I guess it's your chance to some
9 extent to make a little commercial for what you're
10 doing at your companies.

11 MS. DOW: I recognize that Rich Sandor
12 was certainly a trailblazer on this front, but
13 right now there is a new initiative that's
14 underway at the CME Group that was started with
15 the NYMEX. It's called the Green Exchange. Right
16 now we are trading nox, SO2, EUA, CER, and we are
17 gearing up in preparation for what we believe will
18 be a cap and trade market based program for these
19 products. It will be a designated contract
20 market. We will soon submit an application for
21 DCM status and we are partnering with a number of
22 other folks in this venture. Again it is our

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1 effort to get in front and be prepared for what we
2 believe is going to be a very large and vibrant
3 market. Gary, did you have something? I'm sorry
4 if I missed you.

5 MR. GERO: No, that's fine. I just
6 wanted to point out that I think Jonathan is
7 absolutely right and it goes back to this question
8 of standards and fungibility. When we think about
9 offsets there are really five criteria that define
10 an offset. These are not commodities that exist
11 in a warehouse that you can go look at, but
12 they're really defined by rules and those rules
13 ensure that they're real and they're permanent and
14 they're additional and they're verifiable and
15 ultimately enforceable. This is where I think the
16 international context comes in is because we're
17 working now in Mexico. In the next 2 months we'll
18 have protocols for defining offsets in the Mexican
19 context. The State of California has indicated
20 its desire to actually include Mexican offsets in
21 the California cap and trade under AB-32. The key
22 struggle here is the enforceability. How does a

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1 State of California agency enforce standards in
2 another country? If I had answers for you today
3 I'd provide them, but I can tell you that there's
4 an awful lot of thinking going on in Sacramento
5 around this question. When you can solve that
6 question whether it's a bilateral agreement
7 between the Mexican states and the State of
8 California, you can start to get to that sort of
9 next level of regulation which you're right, this
10 is a global problem and we can't deal with it on a
11 state by state basis and California will be the
12 first to say that as well, or even a nation by
13 nation basis, but truly on a global basis and so
14 we need a consistent set of global standards for
15 both defining the commodity itself, but then for
16 regulating the markets that grow up around that
17 commodity.

18 CHAIRMAN CHILTON: That's a good point.
19 I think it's going to be a big issue. When you
20 were talking about it it reminds me of that famous
21 line in "Butch Cassidy and the Sundance Kid" where
22 Sundance says, "You keep thinking, Butch. That's

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1 what you're good at." So we'll all keep thinking.

2 Bob, I want to thank you for being here
3 and putting up with us. We do appreciate your
4 participation and are glad you're here. Go right
5 ahead.

6 MR. PICKEL: I'm thrilled to be here and
7 happy to be part of this committee. I think the
8 expansion that you've brought to the environmental
9 issues is very prescient and preparing for the
10 future.

11 You were talking about initiatives that
12 different organizations have been involved in. As
13 you might expect, ISDA has been focusing on
14 documentation. We've produced some documentation
15 already in the emissions area, principally in
16 Europe, but we think that the opportunities here
17 are significant. One of the things we try to do
18 there since we deal with this whole structure of
19 different markets and different jurisdictions, is
20 try to first of all make sure our documentation is
21 as consistent with other documentation that may be
22 out there and we've worked with IEDA in trying to

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1 make sure that what they've produced is consistent
2 with what we've produced.

3 Also achieving consistency in treatment
4 of these contracts partly from a regulatory
5 perspective but also from a legal certainty and
6 enforceability perspective. If people are using
7 the documents that we produce for emissions it
8 will be pursuant to or under the overall ISDA
9 master agreement, and therefore bringing those
10 transactions in potentially with completely
11 different types of transaction like credit
12 derivatives and interest rate derivatives, it is
13 essentially for particularly the financial
14 institutions, but also some of the providers and
15 corporations that use these to have the ability to
16 net out those positions in a comprehensive way is
17 something that we're always actively involved in
18 to make sure that that's developed not just here
19 in the United States but really everywhere these
20 markets develop around the world.

21 CHAIRMAN CHILTON: That's great to hear,
22 actually. That's fantastic news. Holly, Steven,

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1 Ben, and then if there's nothing else after that,
2 we'll move to energy unless there's something
3 else. Then Michael and then we'll move off.
4 Holly, we had a great conversation during the
5 break. I don't know what you're going to say, but
6 if you would share some of that, I think it would
7 be interesting for the committee.

8 MS. KOEPPPEL: I'll try and be brief, and
9 I am taking you up on the opportunity to talk
10 about what we are doing at American Electric Power
11 to address CO2 and to prepare for a future where
12 carbon is the largest market in the world.

13 CHAIRMAN CHILTON: Holly, you're a
14 utility holding company and you're in 11 states?

15 MS. KOEPPPEL: We're in 11 states.

16 CHAIRMAN CHILTON: So you're really
17 monolithic in the utility arena.

18 MS. KOEPPPEL: We're in Texas up through
19 Michigan, over to Virginia, so through the center
20 portion of the U.S. We are the largest generation
21 utility, predominantly a coal based generator, and
22 therefore have a large natural position in CO2.

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1 We are very large participants now in both the SO2
2 and nox markets. That said, we have completed a
3 \$5 billion retrofit program. So we're actually on
4 the supply side in some of those commodities now.

5 Back to CO2, fundamentally we are
6 looking to address our carbon footprint in a
7 modest way through agricultural offsets, methane
8 capture and destruction, purchase of renewable
9 energy credits, participation in taking the power
10 from renewable energy projects, reducing our
11 transportation CO2 emissions. We move 70 million
12 tons of coal a year, and so that alone has a
13 carbon footprint very much like what our friend
14 from Honest Tea was talking about.

15 We're moving to make our buildings LEED
16 certified and being more energy efficient not only
17 in our production of electricity but also in our
18 consumption of electricity. We're also working in
19 the policy arena. It is very important to the
20 electric utility industry that we have a clear,
21 sustainable, enforceable policy that defines a
22 rate of reduction that is reasonable and

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1 affordable for the American economy. That rate of
2 reduction will actually reduce CO2 in the
3 atmosphere and it will define the supply stack
4 against which we as fundamental participants in
5 that market can analyze the cost or the expected
6 price at which CO2 will clear and make informed
7 choices about whether we should buy a solution,
8 build a solution, or change the physical operation
9 of our infrastructure, our power plants.

10 As we saw from the McKenzie graph,
11 depending on that rate of reduction and depending
12 upon how broad and global this market is, the cost
13 can be vastly different. So it's very important
14 for us that we have the largest possible market.
15 We're very supportive of master agreements,
16 fungibility that will allow for a sustainable
17 transaction. Given the cost of credit in this
18 market environment is going up and some instances
19 in fact is unknown at this time, we are strong
20 supporters of a clearing mechanism and certainly
21 master netting. That said, I would say we're
22 looking, learning and hoping to be supportive on

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1 all fronts in addressing this global challenge of
2 CO2.

3 CHAIRMAN CHILTON: Thank you very much.
4 That's very interesting and I commend you for
5 being proactive in this regard. Steven?

6 MR. SCHLEMER: Thank you. Steve
7 Schlemer from Barclays Capital. I actually want
8 to address the questions, first on what we're
9 doing in the U.S. and then this issue of linkage.
10 Barclays Capital is one of the largest traders in
11 the E.U. emission trading system. We've been very
12 active there from the beginning. Over the last
13 couple of months we've established a trading desk
14 in the U.S. We've been trading SO2 and nox.
15 We've been participants in RGGI since the
16 beginning, but now we're actually very actively
17 trading RGGI, and as other markets are starting to
18 come on, California and the WCI, we'll be actively
19 participating in those as well. We haven't really
20 been that active in the offset space yet. We did
21 develop with some others a standardized contract
22 for RGGI which we're hoping will be accepted.

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1 We're starting to work with clients to get that
2 spread throughout the community that's trading it
3 right now.

4 In terms of linkage, the one additional
5 I think to think about that's not so obvious with
6 one carbon and one way that it is different, and
7 Gary talked about this or hit on this earlier,
8 that what the product is serial numbers on a
9 computer and what you do is you have a carbon
10 allowance is a serial number or an offset is a
11 serial number that's thrown into the trash or
12 something when it's used. If you're going to link
13 a bunch of different markets, what you need to do
14 is link the systems of those markets so that the
15 serial numbers can be -- if you're retiring in the
16 U.S. an allowance from the E.U. ETS, you need to
17 transfer that serial number over and then retire
18 it in the U.S. system, and one thing that you need
19 to think about is making sure that that transfer
20 can happen, and also working with the agencies of
21 the foreign governments to make sure that it's not
22 retired twice, that once it gets moved over it's

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1 moved over, it's not retired over there and not
2 retired over here at the same time.

3 CHAIRMAN CHILTON: That's very helpful.
4 That's what I was looking for. That's great to
5 hear. Ben?

6 MR. FELDMAN: I'm going to echo a little
7 bit of Steve's remarks. Similarly, JP Morgan has
8 a trading desk in Europe actively trading the E.U.
9 allowances and certified emission reductions
10 associated with the Kyoto Regime. That's housed
11 within an energy franchise and there's an obvious
12 linkage between fuels markets, power markets and
13 the emissions space. So that's what we've been
14 doing in Europe. In the U.S. we've established an
15 environmental markets group within global
16 commodities to assist clients, manage risk and
17 opportunities associated with the issue. We're
18 active in RGGI and other emerging markets here.

19 I also want to take a little bit of a
20 piece on the fungibility part and just back it up
21 for a second and say it's a global issue. It
22 doesn't matter where the emissions occur. It's a

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1 global issue. It doesn't matter where it happens.
2 Really from an economic efficiency perspective,
3 you want the cost curve to be one cost curve as
4 opposed to a bunch of different ones in a bunch of
5 jurisdictions where you have this lumpiness and
6 the pricing doesn't quite work. So over the long
7 haul you'd want to get something like a linked
8 system with fungibility and then there are short
9 haul steps which I think everybody has eloquently
10 stated to get the regulatory infrastructure in
11 place to do cross-jurisdictional trading as a
12 first step along that pathway.

13 CHAIRMAN CHILTON: That's what I'm
14 talking about. That's very helpful stuff.
15 Michael?

16 MR. PROKOP: Thank you. Some of my
17 thoughts were reflected here in the last two
18 gentlemen who spoke, but what I would say is you
19 were mentioning some of the investment firms are
20 now getting active and opening trading desks and
21 what have you to look at these commodities. I
22 think we're in an unusual situation from past

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1 experience now that we are actually holding
2 meetings like this talking about regulation before
3 the market for the most part comes into existence.
4 So we're now being given this rare opportunity to
5 actually look at this ahead of time rather than
6 being reactive to anything that possibly could be
7 on around the marketplace.

8 I would throw into the mix also in the
9 international aspect of some of these contracts
10 that perhaps some consideration be given to some
11 type of a standardization of a contract. I know
12 Rafael, you and I had spoken many years ago about
13 market standardization in the power markets and
14 all the different nuances that go in those markets
15 and now here we are in the United States but none
16 of those groups talk to each other and in many
17 ways are able to act together but instead
18 independently. There is probably going to be
19 discussion about that internationally if there is
20 some type of standard contract in addition to the
21 contracts we're looking at now.

22 CHAIRMAN CHILTON: That's very helpful.

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1 This has been a super conversation on carbon.
2 Unless my colleagues have any questions on carbon,
3 I was going to go ahead and we'll move to our
4 topic today, energy, and there were a lot of links
5 here on some of the issues that we've talked
6 about. I'd like to ask Rafael Martinez again to
7 give us a little presentation. I will give his
8 disclaimer again that he is not speaking for the
9 Commission, he's speaking for himself, but he's
10 told me what he was going to talk about and I
11 think it will be interesting to everybody.
12 Rafael, thank you again for being with us and
13 participating in the committee's deliberations.

14 MR. MARTINEZ: Thank you, Commissioner
15 Chilton. Before I start, it's funny, I circulated
16 these comments yesterday among different people
17 and some people read as if it was a mea culpa from
18 the economist of the CFTC. Others read it as if
19 it were a hit job on some of the discussions that
20 have happened about what has happened in the last
21 year in the energy markets and who caused it.
22 Actually I think the intention is trying to

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1 suggest that we move forward and that we have a
2 very honest analysis of the events over the last
3 year in the energy markets in the context of the
4 global economy and that economists sometimes need
5 to be able to say usually we get asked one
6 question and we give two or three answers and very
7 often we don't know what happened and we sometimes
8 need to be frank enough to admit that.

9 So now I go to what I actually have
10 prepared to say. Energy prices, indeed all
11 commodities, have had a rollercoaster year. There
12 are many losers suffering from whiplash, losers on
13 the way up, losers on the way down. Some people
14 might have made a lot of money, but certainly
15 rational planning in a capital intensive market
16 doesn't benefit from these kinds of price swings.

17 I have behind me a chart and just to
18 change a little bit instead of showing you the
19 futures prices of different commodities, this is
20 performance since August 2004. This is data from
21 the EIA. This is from the point of view of a
22 power generation plant and these are the different

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1 common fuels for a power plant. We can see
2 obviously what we know that natural gas and fuel
3 oils moving dramatically up and then collapsing.
4 I want to note that coal as well had a very, very
5 sharp increase. There are some explanations for
6 this, as economists we always have to have an
7 explanation, and we say that there were rains in
8 South Africa and Australia problems and this might
9 just represent Western Appalachian coal which is
10 the one to export anyway. This is actually the
11 data to the EIA of what has been paid by the
12 generators. We see coal how it moved, and they
13 happened to not trade in the futures market as
14 they are cleared, there are contracts that clear
15 in clearinghouses but they're not really traded
16 openly in the futures market, and to my knowledge
17 they are not part of any index, though I might be
18 wrong on that. So there are no index traders in
19 there and we saw the sharp rise of coal as well.

20 Some analysts say my model does not
21 predict these prices, therefore the prices are
22 wrong. Some note that price movements share

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1 trends with the inflows of some particular form of
2 trading, speculative traders, and are ready to
3 blame speculative traders for creating these
4 distortions. Usually no reasonable mechanism of
5 how one led to the other has been put forth. We
6 hear the paper barrel -- I've worked on this for
7 years and I still don't know what that is supposed
8 to mean exactly in trading. And as highly
9 unscientific reasoning as it is, it resonates with
10 the public looking for simple explanations. Just
11 like those in the 1980s who said that AIDS could
12 spread by handshakes or the H1N1 virus from eating
13 pork, CFTC economists have been backed into a
14 corner arguing against the particular hypothesis
15 that we know and have tested it to be false.
16 We've really worked at it. Denying this fallacy
17 in the public discourse has given the impression
18 that we are market apologists, blind believers in
19 the infallibility of markets to the outrage of
20 many in Congress and on Main Street. One thing
21 you can trust me on is that if we believed in the
22 immaculate nature of markets, we would be looking

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1 at the most boring careers, and it has been
2 anything but. I believe that what we have here is
3 that we've just reached a point where we have
4 talked past each other and leaving the public
5 confused. Our expertise at the CFTC together with
6 the access to a wealth of information even from
7 some of the so-called dark markets, when actually
8 they are not necessarily dark to us, gives us a
9 control tower view of markets and so we soon
10 realize that markets are simultaneously very
11 resilient, but they are full of imperfections.
12 Markets are human constructs that are awesome but
13 require permanent reinvention. That's where we
14 see all the innovation coming along, new contracts
15 defined, rules being changed. Traders of both
16 stripes take decisions on the uncertainty and at
17 least do so with a view of what the future is
18 likely to bring. I have trader friends who tell
19 me I just think about tomorrow, but I think that
20 those whatever mechanism they use, if they somehow
21 didn't represent something of their expectation
22 for future consumption, they probably would be

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1 wiped out. I believe some evolutionary theory of
2 market trading does happen, so even those who
3 don't know it are reflecting some kind of view of
4 the future.

5 Expectations have been over the years
6 often right and at times wrong, sometimes terribly
7 wrong. I have now behind me a chart that has
8 prices. This is prices of natural gas, the same
9 from the point of view of a utility of a
10 generator, and the expectations of consumption
11 that was put out by the EIA. The EIA is not
12 trying to push a market view, with very serious
13 analysts and I'm very glad we have that
14 institution in this country. They put a forecast,
15 the Short Term Energy Outlook, and they put out
16 what they see will be the consumption for the rest
17 of this year and the next year, and I took the
18 twelfth month average consumption, what they
19 expect will be the average daily consumption for
20 the next month, for the next year, and I plotted
21 it in blue. You can see the variability of that.
22 It moves something like within a few years 8

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1 percent up or 9 percent up, and then the collapse
2 after October or September of last year. These
3 were the expectations people were having. I don't
4 go through the whole chart, but you can see the
5 prices respond to these expectations. When you
6 have some constraint in production and you have at
7 least the expectation consumption that way, you
8 are going to see the price reflect that. The
9 question is should it have been priced at 9 or 13,
10 natural gas BTU, and the answer is I don't know.
11 I don't know how many know because most people
12 have models that are for normal times and their
13 modes are based on things that don't necessarily
14 work in times of stress.

15 You probably remember that I had a car
16 crash, an SUV rollover in the picture behind me.
17 I'll tell you why I have that. You probably
18 remember at the turn of the century there was a
19 spate of deadly road accidents with SUVs that
20 rolled over as a consequence of tire failure. The
21 public reaction was immediate, that the immediate
22 cause of the problem were the tires. The tires

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1 blew up, there was an accident and people died.
2 Or was it the road conditions? In most cases the
3 road was really, really rough. Was it the driver?
4 In many cases they were speeding with
5 under-inflated tires and carried heavy loads. Or
6 was it the car? Most SUVs, this is a particular
7 brand that I won't mention right now, seemed to
8 have a propensity to roll over and most didn't.
9 The point is that in any case the fact that the
10 tire failed should have not ended up in a
11 catastrophe. The lessons I take from this -- why
12 did I put this up? First, we need to think of the
13 system as a whole. Second is that the search for
14 the immediate cause might lead to the wrong
15 conclusion. Applying it to the case of energy
16 markets, we need to think of energy markets in the
17 context of the whole economic framework. At the
18 time that prices were going up, and looking for
19 does that make sense, we started looking at what
20 people thought would be the consumption going
21 forward of different countries, of different
22 sectors, and what was the production capability,

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1 some markets are tight. At some point you just
2 say this is going to be defined by the cost of
3 production, people tend to think of the cost of
4 production marginal cost, but at some point
5 there's a willingness to pay when you're rationing
6 things. Nobody really knew what that was and
7 people would say oil will go to 200 and somebody
8 would say it has to be 60 because that's the cost
9 I see in my production, and the fact is nobody
10 really knew.

11 What I do know is that probably at some
12 point we'd say it cannot be that China will
13 growing at 11 percent with prices for oil at 140
14 or 200 or whatever. There was some feedback that
15 probably should have worked, there was some piece
16 that was not making sense and eventually, it's
17 easy for me to say it now looking back at it, but
18 eventually there were some things that were
19 unsustainable and they exploded. This is not
20 necessarily just the housing mess. Actually
21 yesterday when I got home I got my MIT magazine
22 that I receive twice a year and it had interviews

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1 with some economist in there and they happen now
2 to be thinking the crisis was two of them. The
3 first one was housing and the other one was a
4 crisis of confidence that doesn't necessarily have
5 to do with housing. The point is we need to think
6 of the system as a whole. How did we end up? And
7 not to much why did we get expectations so wrong.
8 Markets should correct themselves, but why did
9 they end up being so messy? Why the catastrophe?
10 To me that's the bigger question.

11 Ignoring for a moment that this was an
12 economy- wide event, I think that we can try to
13 think about aggravating factors in our markets.
14 Our markets are human constructs and made by many,
15 many people. This is not central planning. I
16 think we can look into our markets to try to see
17 things that might have made this system less
18 stable or less capable to absorb information or
19 react to the information or realize where we were
20 heading. Perhaps there is nothing, but I think we
21 owe it to ourselves to try to understand it.

22 There are things like our energy markets

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1 and let's hope not carbon, but energy markets have
2 a lack of demand response. The market that did
3 respond the most, the gasoline market where people
4 see the price at the pump, we had an amazing
5 response with that last year from the U.S., places
6 where they were subsidized in other countries we
7 didn't see that response. We had problems with
8 bid week trading in natural gas in that the -- is
9 traded as a physical basis. We have regulators at
10 the state level who believe that the safest thing
11 to do is to tell utilities to trade at the index,
12 be a little passive. Just pass through the cost
13 and just be worried about the basis relation. I
14 don't know. That's one thing that should not be
15 considered safe to trade at the index. It should
16 be considered safe to be passive. Passive is not
17 safe, and that's a big mistake that we've been
18 suffering.

19 We've had consumption subsidies which
20 was not a great idea. Another problem is the
21 composition of financial trading. When I was
22 studying finance there was question of informed

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1 versus uninformed traders and the uniformed
2 traders were supposed to be noise not all on one
3 side. I don't think that they drove the prices
4 passive longs, but I have to think what does it
5 make to the system to have large passive longs? I
6 say that there were not immediate costs, but how
7 did the system behave with them in there?

8 A lot of people trade in spreads. They
9 don't have a view on what the price is going to
10 be. A lot of the open interest that we put is
11 actually in spreads and they win or lose no matter
12 what the price level is. It's the differential
13 between contracts. How does the market behave
14 when a lot of the trading is in spreads? Maybe
15 there's no cost efficiency of price discovery, but
16 we have to study that.

17 There is a lot of information on free
18 riding. I use the Sagat guide for restaurants and
19 I never sent back a review. At some point the
20 system doesn't work. The market is a
21 participatory entity and if you don't give your
22 feedback, put in your 2 cents, then don't complain

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1 about the market not reflecting fundamentals.
2 People need to trade and I know it's costly. I
3 know it's hard. I know it's hard to compete for
4 salaries. Maybe not so much now with Wall Street,
5 but people need to realize that you need to trade.

6 We have analysis tools and they have
7 memories. We have the problems of -- risk, the
8 problems with time series and technical trading,
9 that based on the last 5 years of data if you
10 haven't had a crisis in the last 5 years then
11 you're going to miss the turn. That's the way we
12 do it, and my original training was as a
13 statistician and it's like a sausage, you don't
14 want to know how it's made. But we have to go
15 beyond a lot of these things.

16 We this notion of the benchmarking
17 because we -- liquidity, but then it happens that
18 the storage of WTI is full and why is WTI so
19 different from Brent? The storage is full and
20 it's a world benchmark but it the storage is on
21 place and there is only so much. So we have
22 modeled investment signals because we have to get

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1 the capacity payments right in power, we have to
2 get the financial transmission right. We have to
3 keep working on those things. There are
4 production subsidies. The source of ethanol, have
5 we thought that through completely? Corporate and
6 bond ratings, we have problems with that as well.
7 Are they doing their homework, the people doing
8 the ratings? And regulators. Do we need more
9 information? Yes, we can always use more
10 information. This has been addressed currently.
11 I don't have much to say on that. Regulatory
12 risk. We're a big, big source of risk. We have
13 to see the nox market just to understand how big a
14 risk we are. The regulatory risk is really high
15 and we need to do a better job at that.

16 I think the truth is a combination of
17 several factors of things that might affect our
18 system and we could try to improve on. The rating
19 system in general, the financial commodity system.
20 I might even be right in one or two of my lists,
21 but I leave those for more academically minded
22 people. I don't think that system weakness is

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1 necessarily by calling it excessive speculation.
2 I don't think that's the right word for this. The
3 point is governments and people around the world
4 are making decisions now with a view to reduce the
5 impact of crises like the one we've had and
6 they're doing so I believe on the wrong premise
7 and may end up making things worse. The best way
8 to avoid repeating the past is understanding what
9 happened, and we owe it to ourselves to examine
10 the latest experience with full candor and
11 dedication. I think we should talking past each
12 other and get back into honestly analyzing any
13 plausible, sensible and specific hypothesis for
14 why the underlying dynamics led us to far off.

15 CHAIRMAN CHILTON: Thank you, Rafael. I
16 don't agree with everything he said. Here's what
17 you don't get in government a lot of times. You
18 don't get candor from career employees. It's the
19 party line and like he said we shouldn't be an
20 apologist for anything. You said things on both
21 sides. So I really appreciate the fact that
22 you're willing to talk and it's certainly thought

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1 provoking and I just commend you for doing it.
2 Thank you, Rafael. Dominick Chirichella is going
3 to give us a little presentation her for a few
4 minutes. Dominick has one or several different
5 newsletters and he can explain a little bit more.
6 I get them every day in my email. One of the
7 things that Dominick did also that people might
8 now is our Enforcement Division last year as part
9 of our national crude oil investigation hired
10 Dominick. We do this regularly when we're doing
11 an investigation, we'll hire somebody who maybe
12 adds to our quiver of arrows and enlightens us.
13 Dominick held a really great 2 day session in this
14 room. I attended it which is where I met him
15 first. He gave us all the scams and how we could
16 be duped and what to look for in markets. He's a
17 super interesting guy. He's part of the committee
18 now and I'm really pleased he's with us.
19 Dominick?

20 MR. CHIRICHELLA: Thank you very much,
21 Bart, and Commissioners Sommers and Dunn. Thank
22 you for having me.

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1 I agree with many of the things that
2 Rafael mentioned and it's probably a pretty good
3 segue. I'm just going to give you a little short
4 overview as to how I see what's happening right
5 now in the marketplace. Just before I do that I
6 think just in following Rafael's comments that
7 stuck in my mind as he was speaking is that the
8 thing that we've strived for over at least the 40
9 years that I've been in this business is more
10 information and more transparency, and now that
11 we've achieved a lot of that, there's a lot more
12 to go, but achieved a lot more of that, what we've
13 done is we've opened up the marketplace to the
14 world's interpretation of that information. The
15 thing that makes these markets move the way they
16 move and whether things overreact or underreact is
17 that all of our interpretations are very, very
18 different when we look at the same information.
19 One thing we know is it's not a complete picture
20 of the information. We don't have the complete
21 picture. The CFTC has a tremendous task in
22 regulating these commodities, but yet we have

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1 three major commodity markets for every commodity.
2 We have the physical market that gets traded many,
3 many, many multiples of what we consume. We have
4 regulated financial instruments like NYMEX, like
5 ICE. Then we have over-the-counter markets that
6 are not regulated. The thing that's lacking from
7 both the physical side and the over-the-counter
8 side is really an understanding or visibility of
9 what's actually getting done. We know what's
10 reported in the publications. We know what we
11 read. But we don't see commitment of traders
12 reports for bilateral over the counter. We don't
13 see commitment of traders reports for the physical
14 market. I've been in the physical market
15 especially on oil going back to the 1970s before
16 NYMEX was even started and we traded just millions
17 of barrels on barges in New York Harbor of which
18 50 barges get delivered. How does all of that fit
19 into the picture? I think in regulating carbon,
20 the CFTC needs to look at more information. I
21 think it's not whether something should be cleared
22 or something should be borrowed. I think we

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1 shouldn't overact to the word over-the-counter
2 instruments like people got nervous with the word
3 derivatives in the 1990s. That's not the issue.
4 The utilization of over-the-counter instruments is
5 not the issue. The issue of truly just
6 visibility. It's one of visibility. I think more
7 visibility and with more information that's made
8 available to all of the participants and the
9 general public a much better understanding comes.

10 Just last but not least, my last comment
11 is there is no advocate for the consumer. The
12 consumer, I know that we have public citizen's
13 groups here, but when the consumer hears the word
14 oil or natural gas, immediately they think of
15 manipulation. Immediately they think of we don't
16 believe the oil companies, we don't believe the
17 trading companies in Wall Street, we certainly
18 don't believe the government has a handle on it.
19 So again there's no advocate. So lots of times we
20 get an overreaction coming from the wrong
21 direction.

22 With that said, in the energy sector and

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1 in the oil sector, everything has changed. In the
2 last 8 to 10 months, every relationship that we
3 know, every relationship that we understood has
4 changed. We don't know which one of those changes
5 is going to be permanent. We don't know which one
6 of those changes is going to be temporary. And we
7 still don't know how it's all going to sort out in
8 the end. Yes, we had a tremendous move to the
9 upside and now we have the makings or the early,
10 early, early makings of what was actually leading
11 up at least in my view to what evolved in 2007 and
12 2008 and that is we've had this catastrophic move
13 to the downside which is just as damaging to the
14 future of energy as the upward move we had last
15 year. Look around at all of the major resource
16 companies. Cap ex budgets are down tremendously.
17 Drilling rig counts are down to less than half of
18 where they were just a year ago. What we're
19 seeing is more and more the formation of that next
20 cycle that's coming. And it's coming. Maybe it's
21 a year from now or maybe it's 2 years from now or
22 maybe it's 3 years from now, but we are going to

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1 higher prices again because the global economy is
2 going to recover and as the global economy does
3 recover, demand is going to go back up again and
4 supply is going to be lagging, and that's really
5 the beginning of where we are right now. We're
6 seeing it already in the way the market is being
7 traded.

8 I have put together this little
9 unscientific table here that I like to call A
10 Recovery Premium. We spent 2007 and 2008 and all
11 we talked about was the risk premium and how to
12 calculate out that risk premium, and that's what
13 was driving the market higher. We don't have a
14 risk premium right now. We have a recovery
15 premium. The energy complex is mostly trading on
16 externals right now. We all know and we can all
17 see the fundamentals are overwhelmingly bearish in
18 every energy product that exists today and have
19 been at least for the last 5 or 6 months. The EIA
20 just came out yesterday with their monthly short
21 term energy outlook and once again they lowered
22 global demand by 400,000 barrels a day versus last

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1 year and chopped down about 500,000 barrels a day
2 in what they're projecting as growth for 2010. So
3 we are really, really at surplus, but yet the
4 price of oil is approaching \$60 a barrel again.
5 Natural gas should probably be \$2.50 BTU is over
6 \$4 in BTU once again. All that's happening is
7 inventories are increasing, demand is going down.
8 So what's actually happening? What's driving the
9 markets today? It's the externals and it's the
10 euphoria that's come over from the financial
11 sector where you have the global equity markets
12 rising and now what we have is that's flowing into
13 the energy sector which is saying a recovery is
14 coming if not already here and as that recovery
15 comes what actually happens is demand is going to
16 go up. As demand goes up we want to get in on the
17 bottom line here and we want to get on the bottom
18 of the market and we want to start pricing it out.
19 So when we look at the slide that we see here,
20 this is true I think yesterday or a couple of days
21 ago, but it's even higher than that as of
22 yesterday, but we're approaching almost a 50

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1 percent premium. Again it's my very unscientific
2 way of calculating what I believe the price should
3 be based on the fundamentals. I think that's a
4 little bit a moving target. It could be a little
5 bit lower than what I'm showing for some of the
6 oils, but I think it's somewhat realistic and I
7 think yesterday's EIA report supported that.
8 Again when we compare it where the prices were
9 just a couple of days ago, crude oil is trading at
10 about a 50 percent premium over where I believe
11 the fundamental value should be. Natural gas as
12 of yesterday was trading at about a 50 percent
13 premium over where I believe it should be based on
14 its fundamentals right now. Who's doing that?
15 Where is it coming from? The externals. It's
16 certainly not traders based on fundamentals. It's
17 certainly not traders based on an understanding of
18 what's going on in the supply and demand
19 characteristics of the market. It's the people,
20 what I like to call the forward viewers, who are
21 viewing a recovery in the marketplace. So it's
22 that recovery premium that's driving it. And it's

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1 all worked in with the elements that we see here,
2 and that is fundamentals are driving prices.
3 Obviously it drive them all the way on down to
4 bottoming for WTI at \$32.48 a barrel on December
5 19 of this past year. Now it's being ignored a
6 bit. OPEC is having a significant impact. Yes,
7 OPEC is not at 100 percent compliance, but they're
8 continuing to cut and their cuts are averaging at
9 about 3-1/2 million barrels at day, and at the end
10 of the day given a long enough period of time, the
11 surplus situation will go away. OPEC will regain
12 control of the pricing mechanism once again.

13 Geopolitics. All of the geopolitical
14 situations that were driving prices in 2007 and
15 2008 are still there. Nothing has changed. It's
16 just that nobody pays attention to them anymore.
17 The media is not covering it like they used to
18 cover it primarily because that's not what's
19 driving the market right now. That's not what's
20 selling the interests of the people. It's the
21 economy that's of interest so far. So be aware
22 that the geopolitics haven't gone away. Actually

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1 in some places and in some cases they're worse or
2 more of a potential problem than they were just 6
3 months ago. Obviously we have weather and
4 technicals. But the economy or the perception of
5 the economy is what's actually driving. When we
6 look at the EIA numbers, again this is based on
7 the previous short term energy outlook, the new
8 one came out yesterday, but when we look at it
9 here, we're looking with the new numbers about a
10 1.8 million barrel decline in demand in 2009 in
11 just the United States alone. And growth now in
12 2010 of less than 800,000 barrels a day on a
13 global basis and not the United States alone. But
14 yet the financial markets like the equities
15 markets are saying to the people who are not
16 investing and trading energy that the recovery is
17 going to be much shaper than what the forecasters
18 are saying. So there's a bit of a divergence that
19 exists between perception and reality of where
20 we're going and we're just not there yet, but the
21 fact of the matter remains that we still have
22 significantly higher prices.

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1 And when we look now at relationships
2 that have changed, as I mentioned in the first
3 part of my talk, everything has changed, here's
4 one that's changed at absolutely just the
5 opposite. For years and years and years when we
6 looked at high oil prices it was almost always
7 inversely correlated to the direction of the
8 equities markets, but yet since the major
9 collapse, now we have the equity markets and the
10 price of oil highly correlated together right now
11 primarily because it's viewed as the equity
12 markets rise, that's a view that the economy is
13 recovering, therefore the view is demand is going
14 to go up. So at some point in time that
15 correlation is going to have to go back to reality
16 and the reality will be higher oil prices will
17 negatively impact the economy. We haven't
18 digested \$60 oil yet. We haven't paid attention
19 to that primarily because we're still looking at
20 things like retail gasoline prices half of where
21 they were last year. People are still saying I'm
22 only paying \$2.20 a gallon for gasoline. What a

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1 cheap price that is. I might go buy another
2 Suburban. At the end of the day, we haven't seen
3 \$3 and \$4 again, so we're not absorbing all of
4 this stuff into the marketplace. But sooner than
5 later we will and this correlation is probably
6 going to start turning around a little bit and
7 it's going to change the dynamics of the way we're
8 seeing the price of oil going.

9 This euphoria of the equity markets'
10 recovery is around the globe. If we just look at
11 markets that I look at on a daily basis on the
12 equity side, we can see that the U.S. equity
13 market is the last of the euphoric markets. Most
14 of the gains we're seeing on the equity side are
15 coming more from the developing world, from China,
16 from Hong Kong, from locations like that that are
17 already up 30 and 40 percent year to date as
18 compared to we're still down on the Dow 3 or 4
19 percentage points. But again it's that recovery
20 and that enthusiasm that's doing nothing other
21 than driving the market. Then when we look at
22 who's doing it, who's playing it, and again this

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1 is far from a complete picture. I just took the
2 three most visible futures commodities that are
3 regulated by the CFTC and just looked at heating
4 oil futures, gasoline futures and WTI futures, I
5 did not include cleared OTC or anything else like
6 that, and just looked at the Published Commitment
7 of Traders Reports this year. Interestingly
8 enough, when we look at the noncommercial sector
9 for those commodities, they tend to have been net
10 long both heating oil and gasoline, and I want to
11 say something about that. I can understand
12 gasoline a little bit because of all of the
13 commodities that exist on the energy sector right
14 now, the supply and demand balances for gasoline
15 are almost in balance, not so oversupplied right
16 now, but we've never had the size of the overhang
17 we have we have right now in heating oil and
18 diesel fuel, over 40 million barrels coming into
19 this week's inventory, but yet we're seeing the
20 spec sector taking a net long position. Whether
21 we call it the spec sector or the investor sector
22 going through the ETFs, again it's a position

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1 based on the perception that the economy is going
2 to recover because one of the first early
3 indicators of an economic recovery on the oil side
4 will be an increase in diesel demand, and as
5 trucks start rolling and as rails start rolling
6 again we'll see that coming and so we're seeing
7 that.

8 Interestingly enough, the most visible
9 and the largest volume activity commodity in this
10 complex being WTI, it's the spec sector is still
11 showing a short position and seemingly, paying a
12 little bit more attention possibly to the
13 fundamentals, but yet the commercial sector is the
14 sector that's net long and has been net long as we
15 see on the red line over here on the second chart
16 has been relatively net long and increasing their
17 net long position on WTI going forward. So
18 there's a lot of again divergences, there's a lot
19 of interesting things that are going on, of which
20 the final story is not written and of which I keep
21 coming to the conclusion that I'm a main, big
22 proponent of market based systems and utilization

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1 of markets whether being carbon or energy and I
2 think that we all participating on this committee
3 and hopefully in making our comments to the CFTC,
4 that we regulate wisely and I think wisely first
5 of all involves visibility. I believe we need a
6 lot more visibility and not so much negative
7 feelings toward those words over the counter or
8 physical business or anything else like that.
9 Thank you very much.

10 CHAIRMAN CHILTON: Thank you, Dominick.
11 I told you he was a great presenter, and those
12 were interesting. You answered everything I was
13 going to ask about that, but I'll just say that
14 I'm hearing these same sorts of things. People in
15 London had mentioned China stockpiling
16 commodities, everything from some of the ags to
17 the metals and even some of the softs. So you're
18 not the only one I've heard say this. The other
19 day a group of people who I was with talked about
20 the comments from a CNBC reporter, Sharon
21 Epperson, on the floor who was saying the same
22 things. It's very interesting and I appreciate

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1 the update.

2 Let's move to our dialogue again. Kevin
3 has his name tent up.

4 MR. FOX: I'd like to address my
5 comments to Rafael. I don't know if you know who
6 I am. I'm Kevin Fox. I work at D.E. Shaw and I'm
7 an energy trader. I'm in the trenches every day
8 and I've been doing this for about 20 years. One
9 of the things I always say to the traders is you
10 better have an opinion. In fact, you're paid to
11 have an opinion if you're a trader. I just wanted
12 to say that it's refreshing to hear you give your
13 opinion independent of the CFTC. So I
14 congratulate you on that. One of the things you
15 mentioned is that the CFTC received some heat
16 because of the run-up in prices last year, and in
17 fairness I have two comments both of which you
18 probably won't hear from a guy in my position.
19 The first is 100 percent confidence that the OTC
20 markets need to be regulated. I have no doubt in
21 my mind that that needs to happen and it needs to
22 happen fast. The second thing is that there's a

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1 problem with hedge exemptions. In fact, the
2 terminology I've seen recently is bona fide hedge
3 exemptions which would imply there are non-bona
4 fide hedge exemptions. Probably the easiest way
5 to fix that would just be to add clarity. I would
6 like to know who has a hedge exemption and how
7 much of a hedge exemption they have and for how
8 long they have it, and for some reason there's a
9 veil of secrecy about that. I've asked for this
10 information in the past and have been flatly
11 denied and I don't see any reason why that should
12 not be public information. If you're a speculator
13 and you have a hedge exemption, then I think you
14 should be held accountable for that to explain
15 your position.

16 CHAIRMAN CHILTON: Thank you, Kevin.
17 John, do you want to make a comment?

18 MR. SHELK: Two quick comments. I
19 thought Rafael's presentation was very thoughtful
20 and from the electricity perspective, the first
21 thing to note, and I think this underscores the
22 fact that markets do work, his first slide very

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1 dramatically the decline in fuel costs for power
2 generators and that's been actually matched at the
3 wholesale level by declines in power prices of as
4 much as 50 percent in New York and other markets.
5 I think while there is the impact that was
6 mentioned by Dominick that lower prices obviously
7 impact investment, I think it's important to note
8 that as we're talking about markets that the
9 wholesale market has responded.

10 The other comment to make again on a
11 positive note is he made the general observation
12 quite correctly that energy markets generally
13 don't have enough demand response. Again one of
14 the success stories of the past year or so with
15 wholesale electricity markets is that the amount
16 of demand response has increased very dramatically
17 particularly in what we all call the organized
18 markets that are in about two-thirds of the
19 country, but if you look at New England and the PJ
20 market, mid-Atlantic to Chicago, they've got these
21 new capacity markets and the amount of demand
22 response that's participating has gone up very

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1 dramatically, and that's something I think that's
2 important to crank into the mix from the
3 electricity perspective.

4 CHAIRMAN CHILTON: Thank you. Sean, go
5 right ahead. Thanks for being here.

6 MR. COTA: Thanks, Commissioner Chilton,
7 Acting Commissioner Dunn and Commissioner Sommers.
8 Thank you for having us here.

9 I'm a heating oil guy primarily and
10 consequently I deal in the smallest portion of the
11 heating oil contract and that is heating oil. All
12 the rest is paper and lots of other stuff. Since
13 we've spoken, there has been some modest amount of
14 regulation of the markets, but the dark markets
15 are still largely dark. The over-the-counter
16 markets still do not have visibility. The
17 relationships with the foreign boards of trade
18 although I think are improving, we need to
19 continue to work on our relationship with the
20 foreign regulators as much as possible because
21 this is a worldwide market and we in the retail
22 petroleum industry understand that.

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1 I just want to reiterate that position
2 limits across platforms really need to be taken
3 into account because it makes a huge impact. The
4 financial trades seem to me to be very large
5 momentum trades and that's very concerning. I
6 agree with Dominick's analysis. I see the numbers
7 in my consumers. Demand is down. Demand was down
8 dramatically as we were running up. Demand from
9 my consumers year in year is 15 percent down.
10 It's not coming back, and I'm looking at record
11 high inventories and there's a complete
12 disconnect. There is almost a 20 percent contango
13 in a market that makes absolutely no sense. I
14 feel like if I wanted to gamble on crude oil
15 prices, I could gamble that if the Dow goes up,
16 crude oil is going to go up even though it's a
17 complete disconnect. It makes no sense.

18 So I think the CFTC has been reaching
19 out to foreign regulators and I think they need to
20 continue, and I think they need to continue to
21 look at our existing regulators. One of the
22 current trades that is very troubling to our

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1 industry is SEC jurisdictional unregulated index
2 funds in energy, things like USO. Those types of
3 trades, the back end of them run into our markets
4 and they drive the markets up. So you have what
5 Rafael was commenting on earlier, large passive
6 investors which I call invesculators, they think
7 it's an asset class and although, yes, it is an
8 asset and it won't go to zero like a Lehman bond,
9 it still is something that people consume. So if
10 they don't consume it there is not a supply and
11 demand relationship. The only supply and demand
12 relationship that I see in the energy markets at
13 this point particularly in the heating oil
14 contract is the supply and demand of the paper
15 contract, that as an economic model, the buying
16 and selling of the heating oil contract because of
17 its volume is a sustainable contract even if
18 demand in the physical part of the market goes to
19 zero. You might as well call it the coconut oil
20 contract. It really makes no difference. All of
21 the essential trades that are cleared for the
22 physical markets don't have that relationship.

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1 One of the many concerns we have in the
2 retail end of the industry with the index funds
3 that aren't regulated is that of it looks like
4 something that would be regulated by the CFTC if
5 it's a commodity type of instrument, we feel that
6 the CFTC may want to reach out to the SEC and say
7 we need to have some more -- if it's an energy
8 index, it probably ought to be regulated by the
9 CFTC with the other energy types of trades. Those
10 types of trades are creating this ridiculous
11 contango. Why is there a 20 percent contango in
12 the heating oil market when there is no place to
13 put any of the product? It makes no sense to us.
14 The types of contango that you're seeing are
15 eerily like the Ameranth types of trades, so it's
16 across all months, and I'm just a little oil guy
17 so I really don't know what I'm talking about, but
18 the types of trades that appear to be occurring
19 are very similar to what happened with Ameranth
20 where you build contango through the same sorts of
21 trades that they had. Ameranth got caught because
22 they were on the NYMEX exchange. We as an

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1 industry favor exchanges. We favor speculators.
2 We are not anti- speculator. But if the
3 surveillence unit of the New York Merc can no
4 longer look at that because it's not related to
5 that type of trade, you're not going to know that
6 that sort of trade is occurring and the CFTC won't
7 be able to do an intelligent investigation to find
8 out whether a similar type of trade is occurring.
9 Those are my comments and concerns.

10 CHAIRMAN CHILTON: Thank you, Sean.
11 Don?

12 MR. CASTURO: Thank you, Commissioner.
13 I'd just like to make a few broad comments about
14 the performance of the markets. I think in
15 Rafael's presentation we saw with demand coming
16 off prices did come down and though the timing may
17 not be perfect, there still is a connection with
18 prices and the fundamentals of the market. Again
19 even if you're talking about Dom's presentation
20 about current small disconnects between what he
21 views to be the fair price of commodities and
22 where the price action is, ultimately as we saw

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1 last year, fundamentals will reign as long as we
2 have clear and proper contract design, and I think
3 that's important not just in energy and
4 agriculture, but even the environmental contracts
5 that we're talking about developing now. It has
6 to be a proper contract design to ensure that
7 fundamentals will in the long run dictate the
8 price action in these markets.

9 To Sean's point about the contango in
10 the markets, I think that goes back to show that
11 the fundamentals are actually performing in the
12 pricing of these markets now. You're correct to
13 say that we're filling storage and that's why
14 there is a big contango and the contango is going
15 to get bit enough just to incentivize people and
16 if consumers aren't buying, your demand is down.
17 By the way, your demand being off is why I think
18 prices, while you may think they're too high today
19 relative to fundamentals, they're a lot lower than
20 they were last year because demand came off so
21 much, so it's just perhaps a delayed reaction.

22 The contango that's in the current

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1 market is a reflection of the fact that demand is
2 down and the only consumer of the heating oil
3 right now is somebody willing to store it, but
4 eventually fundamentals will rule in that case too
5 because storage will run out and the contango will
6 get even bigger and prices will have to come off
7 if there is not any true end user demand. The
8 index investor who you speak of is paying the cost
9 of that contango and his eventual outlet will be
10 at 20 percent a month this not a good investment
11 and they will rationally decide to get out of the
12 market too because at 10 percent there is not
13 enough end consumer demand to justify the pass of
14 long and pay 20 percent a year in contango. So
15 ultimately my point is that if we have proper
16 contract design, it makes the regulator's role
17 much easier too because you can come back and
18 confidently say it's the fundamentals and the
19 fundamentals will rule.

20 CHAIRMAN CHILTON: Thanks, Don. Chuck?

21 MR. VICE: One housekeeping first on
22 Sean's points. ICE has been obviously involved in

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1 this discussion in the last few years as a central
2 player, and on electric OTC markets we don't trade
3 any heating oil and on our ICE Futures Europe
4 Foreign Board of Trade Market we don't trade any
5 heating oil. So there is absolutely no regulation
6 you could put on either one of those entities that
7 would do one single thing to heating oil.

8 My bigger point though I think has
9 really to do really with Dominick's presentation,
10 and no disrespect, but I don't think it's helpful
11 to have a presentation where someone is making the
12 point that the obvious price of natural gas is \$40
13 a barrel. That's not what the market is saying it
14 is. I think that's a dangerous precedent. The
15 market reflects a lot of different people's
16 expectations. It doesn't always get it right.
17 Sometimes it overshoots, sometimes it undershoots,
18 but if you look at the housing market where there
19 are essentially no supply constraints like you
20 certainly have in crude oil, no geopolitics, none
21 of the complicating factors and yet almost no one
22 recognized the fact that housing prices could not

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1 continue to go up at 6 percent a year forever, an
2 obvious fact in retrospect. So I think to be here
3 today and say natural gas should be this or crude
4 oil should be that is a very dangerous thing and
5 it's part of what fuels I think what Rafael was
6 trying to guard against which is drawing quick
7 conclusions, and even worse, drawing quick
8 remedies that really don't solve the problem.

9 I think the other takeaway from one of
10 Dominick's slides where he showed supply as a line
11 across the top of crude oil, roughly between 80 to
12 85 million barrels a day. That \$1.3 million
13 barrel day difference is 2 or 3 percent. It's a
14 hair margin, and we're in the worst recession
15 since as long as anyone can remember. Yes,
16 consumption is down, but from an absolute level
17 it's down very little, and I don't think there is
18 any question at least in my mind that demand will
19 return probably much faster than supply and if you
20 look out at the oil curve now, at the end of 2011,
21 2012, 2013, oil is at \$75 a barrel and I suspect
22 it's only going to go up from there as things

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1 recover. I think we need real solutions,
2 productive solutions and not knee-jerk reactions
3 to things that have been discussed for years, and
4 quite frankly action and effective action has
5 already been taken in terms of in the Farm Bill or
6 the electronic OTC markets and with the amended no
7 action letter for the Foreign Boards of Trade. I
8 think would ICE would support if there's
9 legislation that formally adopts that as law, we
10 support that, and we consider what's going on
11 there as an adequate solution and we need to
12 figure out how to solve some of these tougher
13 problems. And I think just recognize that again
14 the market may not always get it right, but it is
15 sending an important signal, and I think part of
16 the signal it sent last summer was at what price
17 does the U.S. Consumer actually reduce their
18 gasoline consumption. My complete amateur view,
19 this is not an ICE view, I'll give the same
20 disclaimer as Rafael, my take on that was the
21 market was going to find out at what point is
22 there actually demand destruction there and it

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1 seemed to find that out. Unfortunately, as far as
2 the economy, we have what happened in the last
3 half of last year and we don't know what energy
4 prices would have been after that in a more normal
5 situation, but I suspect we're going to find out
6 once the overall financial markets recover.

7 CHAIRMAN CHILTON: Thank you, Chuck.
8 Just let me say that everybody has their own view.
9 I respect Dominick for giving his views and he's a
10 guy who I've come to appreciate. That doesn't
11 mean he's right, it means based on his experience
12 and I appreciate having everybody's views
13 including yours, Chuck. I gave a little statement
14 at the beginning that I think we need to do more.
15 I think we need more information. I agree that on
16 the Foreign Boards of Trade thing we've got a good
17 temporary fix to that. ICE has certainly worked
18 well with the FSA and with us on the look-alike
19 WTI contract, but I think we need to codify that.
20 It can happen in other markets across the world
21 and we see that migration and arbitrage take place
22 all the time. So we've all got our own views and

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1 that's why this is great to have everybody here,
2 and let's continue with that. Brian, did you want
3 to talk?

4 MR. KELLY: Yes, thank you,
5 Commissioner. I just wanted to reiterate some of
6 the points that Chuck and Donald made in terms of
7 the pricing signal to the market. Maybe the
8 demand response wasn't quite as big or quite as
9 fast as people would have expected. But the other
10 side, and certainly on the natural gas side, the
11 supply response was dramatic. Anybody who could
12 spell drilling last year was drilling natural gas.
13 We've seen with our small and moderate sized
14 producers who we deal with a dramatic cutback in
15 that regard, so I think some of the "premium"
16 that's in the market now is a price signal to
17 those producers that maybe down the road they can
18 start drilling again a little bit earlier this
19 time and hopefully we won't get ourselves quite as
20 short in terms of perceived supply and perceived
21 demand going into the future, so that those price
22 signals are very important.

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1 CHAIRMAN CHILTON: Thanks, Brian.
2 Laura, did you have yours up?

3 MS. CAMPBELL: I want to correct
4 something I said earlier. When we talk about the
5 price coming back down, I certainly wasn't
6 alluding to any manipulation, my point being that
7 even though the heat is off, we still need to
8 maintain that focus. Also I appreciate the work
9 that Mr. Martinez has done to go back and look
10 and see what exactly happened.

11 I have to note though the chart that you
12 had up was interesting to me because during the
13 price spike on the natural gas, the price went up
14 before DOE's expectation went up, so it's like a
15 feed forward loop instead of a feed back loop
16 which is more unstable in a control system. I
17 just wonder there what's going on in that
18 marketplace to make the price perhaps a little
19 unstable. If you think about back in the 1980s
20 when we had the very first control systems on
21 cars, the cruise control, and you went up a hill,
22 you had that huge gun effect and then over the

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1 years we have learned to tame that control system
2 so that we don't have that gun effect that we used
3 do, so that's why we are very much in favor of the
4 position limits. Also the reporting of both
5 cleared and uncleared positions with significant
6 price discovery contracts because I see those as
7 tuning of the control system so that we can make
8 sure that we're getting proper feedback and that
9 we're getting a true signal for our consumers.

10 Also just the last thing that I want to
11 make a point of is that most people don't
12 understand this and it's very hard to describe
13 this to them. Really what they're counting on is
14 confidence and trust in the marketplace so that we
15 can put on hedges because if our regulators don't
16 understand it then we'll be forced to be passive
17 in this marketplace. What we know is that doing
18 nothing is much more risky than doing something,
19 so we still need to have confidence in those
20 markets.

21 CHAIRMAN CHILTON: I've been to Laura's
22 company in Memphis and they're very active

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1 traders, but we've had a conversation and I was a
2 little surprised that a lot of her members of the
3 American Public Gas Association aren't involved in
4 these markets. Per what she just said, they're
5 complicated and some don't often understand them
6 and so it's an important business thing for her
7 and her company and I'm hopeful that we can do our
8 part to make sure that they feel comfortable about
9 these markets, that they don't think something
10 nefarious is going on. Bob?

11 MR. PICKEL: I want to just circle back
12 a little bit on this whole question of OTC markets
13 and OTC derivatives. It's a convenient term and
14 it's used a lot, but let's dig down a little bit
15 in terms of what that means. In fact, in our
16 statement of mission, ISDA doesn't refer to OTC,
17 over the counter, we refer to privately negotiated
18 bilateral contracts, and that's really what we're
19 talking about here. These are contracts where two
20 parties get together and they negotiate. In the
21 early stages of product development that Ben
22 referred to earlier, those negotiations can take

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1 easily days, weeks, sometimes even months to get
2 to terms. Hopefully over time contracts get more
3 standardized, they move down that pipeline, and
4 pipeline is definitely the right analogy here for
5 all the derivatives products, and that
6 standardization process is central to the
7 development. The great thing about the OTC
8 product is that there is still stuff coming in at
9 the top of the pipeline so as we have that
10 standardization we get the best of both worlds,
11 and I think we need to make every effort to
12 preserve that.

13 We recently had our annual meeting.
14 We're an international organization so we have it
15 in different locations around the world. Two
16 years ago we chose to have this year's annual
17 meeting in Beijing which we bit our nails about as
18 we were facing the economy, but we had a good
19 turnout with a lot of discussions and a there were
20 a lot of senior regulators there from the Chinese
21 regulators. But actually probably the most
22 interesting thing is to go over to the silk market

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1 there. If you want to talk about an OTC market, a
2 bilateral market, you walk into the silk market
3 and if you want to buy a scarf, if you want to buy
4 jewelry or whatever, you've got many different
5 options just as you do in the OTC markets. You
6 can go in there with the evil intent of driving up
7 the price of a silk scarf, but good luck doing
8 that. I'm not suggesting that we have quite as
9 many vendors and dealers in the OTC derivatives
10 market as the silk market has silk vendors, but if
11 you don't like what you hear from JP Morgan, you
12 go to Bank of America or Merrill Lynch, you can go
13 to Morgan Stanley, you can go to Barclays, you can
14 go all the way down the line, Goldman as well, and
15 negotiate products. It is very, very hard in that
16 bilateral process even if you have the most evil
17 of intents in terms of manipulation or whatever
18 excessive speculation may be, even if you have the
19 most evil of intents to actually carry that out in
20 that process, you've got to go through other
21 mechanisms, typically trying to go on exchange and
22 influence the prices there where CFTC will come

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1 down pretty hard on you if you're doing that. So
2 I just want to make sure people understood that
3 perspective.

4 CHAIRMAN CHILTON: Good point. Thank
5 you, Bob. Tony, do you have something?

6 MR. MANSFIELD: I just want to add a
7 couple of comments. I was struck as the
8 discussion turned to how much more information we
9 need to have access to, but I think that as Chuck
10 pointed out, there's also got be a recognition
11 about how much information has now been provided.
12 The concern I think we have is just that there not
13 be necessarily the expectation that once we get
14 all that information that it's going to provide
15 the answers to the questions that we may not be
16 able to answer today. I think that Rafael made a
17 very good point about the fact that even with all
18 the data, one result may be that we still don't
19 know the answer to the question. And the point
20 that Dominick made which is that with all that
21 information, what it may mean is that we have a
22 lot of different interpretations about what it

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1 means.

2 From Shell's perspective we absolutely
3 support the transparency and the information flow.
4 What concerns us is when the discussion turns more
5 to the question about participation and who may be
6 a participant that is a proper participant and who
7 may be participating who's not a proper
8 participant because we view that as a concern
9 about liquidity.

10 Another point that I wanted make which
11 is that as you were talking on the carbon
12 discussion about what lessons can we take from
13 what we've done in terms of regulating markets and
14 this will be a truly global market, I think that
15 there has been a tremendous amount of learning
16 that has flowed through as a result of the crude
17 markets which really are in and of themselves also
18 a global market. I think that one of the things
19 that at least from my perspective that the agency
20 has done very well is that when dealing with the
21 different regulatory bodies and the international
22 regulators, there certainly has been more

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1 cooperation, there's been more information
2 sharing, but my sense is that there's also been a
3 lot more discussion about how different regulators
4 use the same information that they're looking at,
5 how do they interpret what they're seeing. Again
6 from our perspective, I think ultimately we're not
7 going to control what a particular regulator says
8 should and should not be done, but what we are
9 looking for is to get as much clarity about how
10 each regulator may view conduct in its
11 marketplace. So I think that we certainly
12 appreciate the efforts that the Commission is
13 making not just to share the information and to
14 respect and assist in the regulation of markets,
15 but also in the dialogue that seems to be going on
16 about how the CFTC looks at market, what it seems
17 in markets, because frankly both can be a teaching
18 tool to other regulators, but also can serve as a
19 check on the CFTC to the extent the way that it's
20 approaching enforcement of markets or looking at
21 markets is not necessarily the best way to go.

22 CHAIRMAN CHILTON: Thank you, Tony.

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1 Skip?

2 MR. HORVATH: I just want to add on a
3 point. I get the impression from some people
4 around the table that we're looking for a perfect
5 market, and there isn't such a thing as a perfect
6 market. So I think we have to make sure our
7 expectations are that we have to understand and
8 appreciate the inherent lags built into all of our
9 markets. In my industry, natural gas, if you're
10 looking at our drilling chart, it's literally
11 fallen off a cliff. In the last few months it
12 went from bumping around the 1,400 range down to
13 around 700 over the last 2 or 3 months. Why is
14 there not a decrease in supply? Because those
15 rigs that would have been built now won't see an
16 effect for another 6 months or a year. We're now
17 pulling natural gas out of rigs that were put in
18 place 3 years ago, so there's no perfect market.
19 We're going to have lags no matter what and when
20 these signals are sent there's a lag inherently
21 involved in getting the permits, going through the
22 EIS statements, doing all the due process you have

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1 to do to get the rigs out there. So I think no
2 matter what we do as my colleague to my right just
3 said, no matter how much light we shed on these,
4 we're not going to get to that perfect market and
5 I think we have to have our expectations lowered
6 to realize that.

7 CHAIRMAN CHILTON: Thank you, Skip.
8 Michael?

9 MR. PROKOP: Thank you. I just have a
10 very brief comment. Dominick and Sean and the two
11 comments that were made earlier about the
12 nontransparency in the OTC markets and especially
13 the OTC market being referred to as the dark
14 market, I would provide empirical evidence from
15 the trillions of cubic feet that we transact on a
16 regular basis that now clearly 60 to 65 percent of
17 that is cleared on either ICE or NYMEX, and about
18 40 percent of the electrical power right now that
19 we're doing is also cleared as well. Those
20 numbers are increasing. We're seeing fewer and
21 fewer bilateral deals, and certainly I know the
22 transparency picture is getting much better. With

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1 ICE as an ECM they've increased their level of
2 cooperation with the CFTC which I applaud them
3 for. NYMEX is in a situation obviously as a
4 futures market to be required to do that and ICE
5 has taken that on voluntarily as an OTC market to
6 do that.

7 CHAIRMAN CHILTON: Thank you, Michael.
8 I want to go to Tyson and then I think we'll wrap
9 up and see if my fellow Commissioners have
10 anything to add. Tyson?

11 MR. SLOCUM: I just want to very quickly
12 respond to charges that calls for strong
13 regulation are simply knee-jerk reactions to short
14 term events. I think we need to pull back a
15 little bit and go back a decade or two to this is
16 not a new debate. The issue of adequate and
17 strong regulation over energy and commodity
18 markets has a long history and there are
19 credibility issues with all due respect to certain
20 entities that at every turn have always argued and
21 actively fought against efforts to strongly
22 regulate markets. My organization played a

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1 leading role for example in California in 1998
2 sponsoring a ballot initiative to undo that
3 state's unanimous decision in the General Assembly
4 to deregulate that state's electricity market. We
5 were outspent more than 100 to 1 as we always
6 outspent by vast numbers because of our limited
7 resources by companies like Enron and others.
8 When our predictions of catastrophe unfortunately
9 came true in that state, we were ridiculed.
10 Instead the argument was made that it was market
11 forces such as California's strong environmental
12 laws and droughts affecting the Pacific Northwest
13 that contributed to the crisis. And it was only
14 on the public release of tapes where traders in
15 their own words gleefully explained how they
16 actively manipulated a market that created
17 enormous hardship for millions and millions of
18 working families did Public Citizen's predictions
19 come true.

20 So I ask that folks at the table
21 understand that there is a lot of history here,
22 that there are a lot of organizations that have

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1 always claimed that effective regulation over
2 their industry was not necessary and in fact have
3 spent enormous resources successfully fighting off
4 strong, effective regulations over markets, and I
5 do not want to continue to be in a position of
6 saying we told you so, that there are enormous
7 benefits and that I would much rather err on the
8 side of overregulation and make adjustments after
9 the fact than be prepared to explain to the
10 American people and to folks who are losing their
11 jobs and their livelihoods because markets have
12 not functioned properly. So I think that's just
13 something to keep in mind. Thank you.

14 CHAIRMAN CHILTON: Thank you, Tyson.
15 It's great to have divergent opinions.
16 Commissioner Dunn, did you have some questions or
17 comments?

18 COMMISSIONER DUNN: I certainly do.
19 Mister Chairman, I really appreciate your chairing
20 this group. I again apologize for having to step
21 out earlier this morning on what was a most
22 interesting and for me education discussion, and

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1 I'm sure you're with your exuberance in this
2 particular area will get me totally up to speed on
3 it.

4 I'd like to just comment on a couple of
5 things that I've heard in this last session.
6 First of all, there is a great deal of concern
7 about what's going on and whether there are opaque
8 dark markets that are somehow or another obscuring
9 the marketplace and there have been attempts by
10 Congress and by the administration and by us here
11 at the CFTC to try to have as much transparency as
12 we possibly can. I mentioned at the opening here
13 about the special call information and the report
14 that our staff put out last September and we're in
15 the process of implementing that, and Kevin, that
16 term bona fide hedge exemption, that is something
17 that is in our statute, so that's where that comes
18 from. But that is one of the things that I had
19 indicated that we put out for comment and I'd
20 certainly like to encourage all of you to comment
21 on that.

22 Another piece of the puzzle under our

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1 reauthorization as part of the Farm Bill is we
2 were told to look at significant price discovery
3 contracts and we have begun doing that.
4 Preliminary reports to me are that they've been
5 rather surprised that it's much larger than we had
6 originally thought. So it is an area that we are
7 looking at and we will get additional information
8 out as we go about implementing that provision of
9 the reauthorization. Part of what we said we
10 needed was additional staff to be able to do that
11 and I'm very thankful for our appropriators giving
12 us a 31 percent increase this last time around,
13 and the President's budget asked for an additional
14 10 percent increase this year, and I hope we go
15 above that again.

16 The Senate Agriculture Committee will be
17 having a hearing next Wednesday and I will be
18 testifying there and I will drill down on some of
19 these issue that you've talked about today and
20 what you have said will help me tremendously as
21 I'm preparing that particular testimony.

22 Finally, as a little teaser, this

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1 afternoon at 4 o'clock I will be joining Secretary
2 of the Treasury Timothy Geithner and the Chair of
3 the SEC, Mary Shapiro, where we will be laying out
4 what we have been working on as far as putting
5 together recommendations on reform of the
6 over-the-counter derivative regulatory structure.
7 I won't be talking about any specifics on that
8 until that 4 o'clock meeting, but certainly many
9 of the things that you have talked about here
10 today are exactly what we've been looking at. I
11 can say that the staff here at the CFTC has been
12 working with the President's Working Group for the
13 last 3 months that I have been the Acting Chair of
14 the Commission on this particular issue and I
15 think folks will be surprised and pleased at some
16 of the things that will be coming out of that.

17 CHAIRMAN CHILTON: Thank you,
18 Commissioner Dunn. The Acting Chairman had a town
19 hall meeting with our employees last week I
20 believe and I said at that time that I think he's
21 just done a fantastic job serving as our Acting
22 Chairman. There have been a couple of news

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1 articles that ask if the CFTC hitting on
2 cylinders, and I want to say unequivocally yes,
3 and it's through his leadership and the
4 cooperation and work with Commissioner Sommers,
5 and I just thank you for all that you've done,
6 Mike. Commissioner Sommers, did you have
7 anything?

8 COMMISSIONER SOMMERS: I just wanted to
9 give a quick thank you. I identified a few issues
10 that I was interested in learning more about today
11 and I was given a lot of answers and a lot of
12 things to think about, and I'd like to just say
13 thank you to all of you who participated. Thanks
14 for being here.

15 CHAIRMAN CHILTON: Thanks, Jill. I
16 think we're going to try to stay as close as we
17 can and adjourn now. I do want to thank all of
18 you personally. I really appreciate the fact that
19 you've taken time out of your days to be here. I
20 know some of you do this as part of your job, but
21 by the same token, you've got other things to do,
22 you're important people in many regards, and we

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1 really do appreciate your expertise. As I said, I
2 will let you know TBD on the September 16 meeting
3 that will be virtual or you can be in one of our
4 offices, even less of a carbon footprint, if you
5 will.

6 In the meantime, I think that we may
7 want to have some discussions that would be
8 conference call like. I've talked with Rafael
9 about I think there are some things that we could
10 learn more in depth. So I might be sending all of
11 you a questionnaire and the conference calls would
12 follow that questionnaire. Likewise, several
13 people came to me in the break and said there are
14 some things they'd like to discuss that they
15 didn't necessarily want to talk about in public
16 now, but that they have some other recommendations
17 for things we should be considering. So we'll do
18 that. This will be an ongoing process. I very
19 much appreciate you being here. I just want to
20 thank the staff. Holly Arenas works with me, Roy
21 Charavelli, Elizabeth Ritter, Laura Gardy, Tammy
22 Semega, Lamar Jones, Yvonne Williams, Jill Young,

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1 the tech folks, Robert Holfield, David Gary, and I
2 want to thank my fellow Commissioners for being
3 patient with me and attending and I appreciate the
4 fact that Commissioner Dunn is working on
5 something which is very important, something I
6 talked about at the beginning of this meeting and
7 wish him God's speed on it. Thank you very much.
8 We're adjourned.

9 (Whereupon, at 12:08 p.m., the
10 PROCEEDINGS were adjourned.)

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