



U.S. Commodity Futures Trading Commission
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The Honorable John B. Larson
United States House of Representatives
Washington, DC 20515-0701

Dear Representative Larson:

Thank you for your letter of April 25, 2005 in which you expressed concern over the trading of petroleum futures on the New York Mercantile Exchange (NYMEX). I am pleased to have this opportunity to address your concern, and the concern felt by many of your constituents, that high and volatile petroleum (crude oil, gasoline, and heating oil) prices may be caused by market manipulation. I am particularly pleased to be able to provide you with information on the programs that the Commodity Futures Trading Commission (CFTC) has in place to deal with the possibility of market manipulation.

Let me first assure you that I believe that the detection, prevention, and punishment of manipulative conduct are among the Commission's most important responsibilities. The CFTC has taken aggressive and effective action to punish past misconduct by energy traders who manipulated or attempted to manipulate natural gas prices by misreporting cash market prices to private price reporting services. Since 2002, we have investigated over 40 major energy companies and a number of individuals for alleged violations. Thus far, the Commission has filed over 20 actions and collected over \$300 million in civil monetary penalties. In cooperation with the FERC and the Department of Justice, the Commission took action under provisions of the Commodity Exchange Act to penalize those entities and individuals who took part in the misreporting. While I believe that these actions send a very important message that misconduct will be detected and punished, I also understand that we must continue to be vigilant.

The CFTC has a multi-faceted approach to prevent manipulation. First, the Commission's product review program examines the design of each futures contract to see that it is in compliance with anti-manipulation core principles, part of which involves an assessment of whether the contract has adequate deliverable supply to ensure orderly liquidation of positions at contract expirations. Second, the Commission's market surveillance program continuously monitors activity in futures markets for evidence of possible manipulation. Third, the Commission has placed an affirmative responsibility on exchanges to monitor activity on their markets to detect and prevent manipulation. The Commission's market compliance program

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periodically conducts rule enforcement reviews to ensure that exchanges have programs and personnel to detect and prevent manipulation. Finally, the Commission's Enforcement Division investigates instances of possible manipulation and, when the evidence warrants it, they take appropriate enforcement action.

Commission market surveillance staff closely and continuously monitor trading activity in the petroleum futures markets in order to detect and prevent instances of possible price manipulation. This staff receive daily reports identifying all large long and short positions in petroleum futures and options-on-futures markets. Using these reports, Commission economists monitor trading activity in the petroleum markets, looking for large positions and large trading that might be used to manipulate petroleum prices. In addition, our analysts monitor prices and price relationships, looking for price distortions that might be evidence of manipulation. They also maintain close awareness of supply and demand factors and other developments in the petroleum markets through review of trade publications, and through industry and exchange contacts. Our surveillance staff routinely reports to the Commission on surveillance activities at regular weekly surveillance meetings.

With that as background regarding the Commission's programs to deal with manipulation in futures markets, I would like to respond to the specific questions you raised in your letter.

- How do you account for the increased volatility of NYMEX futures prices over the past two to four years?

Price volatility tends to be high in situations of tight demand/supply balance. When there are abundant stocks of a commodity and/or production can be quickly increased, price volatility tends to be low. If supplies are viewed as abundant and easily augmented, spikes in demand or supply disruptions can be absorbed with only modest price effects. However, when a market is operating on a small margin of supply sufficiency, as has been the case in energy markets during the past several years, it becomes very price sensitive to actual or anticipated changes in demand and/or supply conditions. During the past several years demand for petroleum products has increased more rapidly than has supply. Demand growth has been especially strong in the U.S. and China. So far, higher petroleum prices have not significantly slowed the growth in demand for petroleum products. Over time, the increase in demand has reduced excess crude oil production and refining capacity to very low levels. For example, OPEC's current spare crude oil production capacity is estimated at about 1 million barrels a day compared to daily world consumption of about 84 million barrels per day. Similarly, U.S. refineries are now normally operating at close to peak capacity. Meanwhile, news of disruptions to supplies are commonplace, whether it be destruction of a pipeline in Iraq, political unrest in Venezuela, labor unrest in Nigeria, bankruptcy concerns of a large Russian oil production company, or hurricane damage to production facilities in the Gulf of Mexico. With both demand and supply highly price inelastic, these types of actual or anticipated changes to the demand/supply balance can produce sharp price adjustments and increased price volatility.

- In your market surveillance have you seen any evidence of price manipulation, abuse or fraud in relation to futures prices?

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We have not found evidence of price manipulation in the petroleum futures markets. We have very closely monitored positions in these markets, especially during the final days of trading in expiring futures contracts, when futures contracts are most vulnerable to being squeezed or cornered. Such a manipulation could be accomplished as a result of a large long (buy-side) position that could demand delivery of oil in an amount greater than the capacity of shorts to deliver. In such an event, shorts who could not deliver would have to buy back their positions at high and possibly artificial prices. In fact, however, we have not seen any evidence consistent with this scenario. Long positions going into the final days of trading have generally not been extraordinarily large, and demand for deliveries has been relatively small in the petroleum markets.

- How does CFTC ensure hedge funds operators are not cornering the market to their own advantage (i.e. abuse, manipulation or fraud)?

The CFTC's large trader reporting system ensures that all large positions in NYMEX energy markets, including those of hedge fund operators, are reported to the CFTC every day. CFTC economists closely monitor these positions every day in order to detect large positions that could create manipulation concerns. In fact, based on our daily review of these data, we have had no manipulation concerns with respect to hedge fund trading in petroleum futures markets.

- What is your evaluation of the March 15, 2005 NYMEX study addressing the causes of increased volatility in oil and natural gas futures prices?

We have not analyzed the NYMEX study in any great detail and have not evaluated the methodology of the study. However, we believe that the primary cause of increased price volatility in oil and natural gas prices has been very tight fundamental supply and demand conditions. CFTC research economists have recently studied the relationship between futures prices and the positions of managed funds, commonly known as hedge funds, in the natural gas and crude oil markets. The study found no evidence of a link between price changes and managed fund positions in the natural gas market, and found a significantly negative relationship between managed fund position changes and price changes in the crude oil market. Their findings also suggest that managed fund traders provide liquidity to large hedger. Rather than increasing volatility, funds were found to be dampening market volatility by providing liquidity to commercial hedgers.

I appreciate your interest in this issue and in the Commission's programs. I can assure you that the Commission will continue to conduct vigilant surveillance and vigorous enforcement to combat the possibility of manipulation in petroleum futures markets. I hope this information has been helpful to you, and if I can be of any further assistance to you on this or any other matter, please do not hesitate to contact me.

Sincerely,



Sharon Brown-Hruska