

REVIEW OF THE FUTURES MARKET AND GASOLINE PRICES

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Goodlatte, Hon. Bob, a Representative in Congress from the Commonwealth of Virginia, opening statement	1
Graves, Hon. Sam, a Representative in Congress from the State of Missouri, prepared statement	4
Peterson, Hon. Collin C., a Representative in Congress from the State of Minnesota, opening statement	3
Sodrel, Hon. Michael E., a Representative in Congress from the State of Indiana, prepared statement	5
WITNESSES	
Lukken, Walter L., Commissioner, Commodity Futures Trading Commission ..	6
Prepared statement	46
Newsome, James E., president and chief executive officer, New York Mercantile Exchange, New York, NY	8
Prepared statement	63

REVIEW OF THE FUTURES MARKET AND GASOLINE PRICES

THURSDAY, APRIL 27, 2006

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m., in room 1300, Longworth House Office Building, Hon. Bob Goodlatte (chairman of the committee) presiding.

Present: Representatives Lucas, Moran, Gutknecht, Johnson, Osborne, Graves, Rogers, Neugebauer, Boustany, Schwarz, Kuhl, Conaway, Fortenberry, Schmidt, Peterson, Holden, Etheridge, Baca, Case, Cardoza, Scott, Marshall, Herseth, Butterfield, Cuellar, Melancon, Costa, Salazar, Barrow, Pomeroy, Boswell, Larsen, Davis and Chandler.

Staff present: William E. O'Conner, Jr., staff director; Ben Anderson, Bryan Dierlam, Craig Jagger, Kevin Kramp, Josh Maxwell, Tyler Wegmeyer, Callista Gingrich, clerk; Lindsey Correa, Rob Larew, Clark Ogilvie, and John Riley.

OPENING STATEMENT OF HON. BOB GOODLATTE, A REPRESENTATIVE IN CONGRESS FROM THE COMMONWEALTH OF VIRGINIA

The CHAIRMAN. Good morning. This hearing of the House Committee on Agriculture to review the futures market and gasoline prices will come to order.

Before I give my opening statement, I would like to announce to all the members that all opening statements will be made a part of the record and only the statement of the chairman and the ranking member will be given orally. Everybody will have an opportunity to voice their views and ask questions of these witnesses.

Let me begin by welcoming the distinguished witnesses who have agreed to appear before our committee to offer their insight and comments the futures markets and gasoline prices. Thank you for your willingness to participate in today's hearing.

The airwaves and print media are awash in stories about increased gasoline prices. In fact, I think it is safe to say that this is one of the primary topics of conversation in the Nation's coffee shops and places of business. People are concerned, and rightly so, about the growing cost and availability of a commodity that is so essential to the American way of life. This, of course, extends to rural America, where long car trips are a part of the daily routine and farmers and ranchers rely on large amounts of gasoline and diesel fuel to run their equipment. Higher import costs do place a

significant burden on our producers, and I want to ensure that no one is bearing the burden unwarrantedly.

There are a number of factors contributing to the high price of gasoline. Therefore, it is virtually impossible to point the blame at any one factor, but it is important to recognize some of the primary causes.

The increased energy consumption of the burgeoning economies of countries such as China and India has increased global competition for the shrinking supplies of oil. Simple economics dictates that an increase in demand without a change in supply leads to higher prices.

Then there are geopolitical considerations such as the instability in Nigeria, currently the fifth biggest source of oil for the U.S., the overall instability in the Middle East and threat of an increasingly militant Iran.

In the wake of Hurricane Katrina, many U.S. refineries are still operating below pre-storm levels. Overall, increased refining capacity has failed to keep up with demand for a product.

While several of these factors are well beyond our immediate control, we must also look at the factors that we do have control of, our own energy policy. While there are consequences for every action, there are also consequences for inaction.

Over the years, Congress has considered multiple legislative packages aimed at increasing domestic production and streamlining regulations. After many years of delay, a comprehensive energy package encouraging an increased production of many conventional and new sources of energy was passed by Congress. This energy package included a bipartisan contribution from this committee supporting increased production of energy from our Nation's renewable agricultural resources. However, that delay is palpable today as the needed increases in energy sources have not kept up with demand.

Other practical, feasible plans have not garnered the bipartisan support to needed to create a sound domestic energy plan. Many proposals aimed at increasing domestic energy production have been consistently stymied by environmental extremists and their friends in Congress. The opportunities have been there, but we have not been able to capitalize on them due to this lack of support.

For example, the Arctic National Wildlife Refuge holds the Nation's single largest deposit of untapped oil and if explored could increase U.S. reserves by 50 percent. However, despite repeated attempts, ANWR remains untapped; and we are forced to continue our reliance to foreign oil.

Despite the growth of energy technology and innovation, we are no closer to a reliable domestic energy source than we were 20 years ago. We are now realizing the severe consequences of inaction: an insatiable dependence on unstable foreign oil sources and insufficient progress on reliable, sustainable domestic energy.

Reports indicate that this problem is far from being over, and I am sure it will continue to generate much discussion throughout the Nation as well as the halls of Congress. Regardless of perspective, I am hopeful there will be a healthy and bipartisan debate on what we as a Nation can do to limit our dependence on unstable

foreign sources of energy, while increasing our options at home. It goes without saying that energy is critical to fueling our industries, heating our homes and facilitating travel and commerce in this great land.

Today, we will look into the role of the futures market and what it does in determining gasoline prices. As the committee has oversight responsibility over the futures market, I want to ensure that activity on the futures market is not allowed in any way to unduly influence the high price of gasoline. There have been many theories generated about the causes of our current energy dilemma, including the impact of the futures market and speculators on the gasoline market. The goal of today's hearing is to determine if there is indeed reason to believe there are problems in the futures market, what type of surveillance is being conducted to prevent and detect manipulation and if the regulators are equipped with the appropriate authority and enforcement mechanisms they need.

I would like to note that this committee passed bipartisan legislation last year directing the Commodity Futures Trading Commission to find and stop manipulation in natural gas pricing and increase transparency through the surveillance of natural gas trading. The reauthorization also included several other provisions that clarified and/or strengthened the CFTC's overall regulatory authority. The House passed H.R. 4473, the Commodities Futures Trading Commission Reauthorization Act of 2005, in December.

There has been considerable debate and conjecture about the role of the futures market with regard to the current prices we are paying for oil and gas, and I look forward to any light today's witnesses can shed on this timely subject.

It is now my pleasure to recognize the ranking minority member of this committee, the gentleman from Minnesota, Mr. Peterson.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman; and thank you for calling this hearing.

We are holding this hearing today because retail gasoline prices, as you said, are out of control. While our hearing is meant to focus on whether or not our futures markets are working properly, neither of our witnesses will suggest that the futures regulatory system is a problem at this time; and that is a good thing. We will work with you, Mr. Chairman, on continuing oversight of our Nation's derivative markets.

The real problem is that rising record-level gas prices are sucking the disposable income out of family's pocketbooks and compounding the hardships of needy Americans and threatening to put our farms and small businesses out of business.

With a lot of folks, you can make some adjustments. Some of the industries are able to compensate for this by adding surcharges, like the trucking industry and so forth, but in agriculture you really have no place to pass this additional cost to. And it is not just the gasoline and diesel fuel, it is fertilizer that is impacted by these prices. I am getting calls every day from farmers wanting to know what they are going to do because they have all these extra costs,

and there is in way for them to get compensated out of the marketplace. So I would suggest that farmers are probably impacted more by these prices than anybody else and have less ability to deal with it.

Now, with every problem comes an opportunity, usually; and the one thing that is a positive thing out of all of this is that these high prices are finally causing the alternative fuel situation to really take off. The only farmers that are really dealing with this problem with are the ones that bought equity in ethanol plants, because they are making enough money to offset the extra costs they are incurring on the other side and probably making more money than it is costing them on the other side of things.

That is an area that we can have some influence on in this committee; I am hoping as we move ahead, looking into the farm bill, that we will really examine the way that we can keep farmers engaged in the equity ownership and control of this new industry that is developing.

Out there in Minnesota, we have been a leader, we have had a mandate, our plants are owned by farmers, and that is a good thing.

But I just talked to one of the biggest ethanol plant builders in the country Thursday, and out of the new plants that are being considered in the U.S. right now, over 50 percent of those are being financed by private money coming from outside of the rural area; and I would suggest that is not in the best interests of rural America. We need to do whatever we can to try to make sure that those equity ownerships are available to our rural residents and our producers.

Mr. Chairman, while I appreciate your responsiveness to the House leadership in holding this hearing, at the end of the day I think the record is going to show that, while we have a big problem in this country, the solution probably doesn't have much to do with what is going on in regulation of the futures market. At least that is what our witnesses are telling us.

But I think that our Nation's farmers, as I said, are centerpiece to solving the long-term critical energy problem; and our committee should and I think will have an important role to play in addressing our Nation's long-term problems in this area.

So I am grateful today for the testimony of our witnesses, and I especially look forward to the day when we can get to work and get to the point where they are in Brazil where 60 percent of their gasoline is produced by farmers. I look forward to the day when the 2 billion bushels of corn that we are now exporting at a loss can be turned into ethanol and help reduce the prices of fuel for Americans.

The CHAIRMAN. I thank the gentleman for his comments, which are well taken. Any statements for the record will now be accepted.

[The prepared statements of Messrs. Graves and Sodrel follow:]

PREPARED STATEMENT OF HON. SAM GRAVES, A REPRESENTATIVE IN CONGRESS FROM
THE STATE OF MISSOURI

Thank you Mr. Chairman for giving me this opportunity to address the gas crisis we are currently experiencing. This is a very important issue to me, my constituents, and this country, and I appreciate the time to look into this matter.

Many factors affect the price of gasoline. Supply and demand, weather, international affairs and stability, speculation, taxes, environmental regulations, transportation, refining capacity; the list goes on and on. All these factors are contributing to the high price of gas at this time, and we must do what we can to address them. However, some of these factors are more controllable than others.

It gets my blood boiling when I hear that speculation raises the price of gasoline. Speculation! What is that? Someone hears on the news that there are tensions between Iran and the United States so the price of gas goes up? That's not right, that's not a factor in supply and demand. I think it's greedy traders trying to make a buck at the expense of you and me, the consumer.

Some of these other issues, like the weather, are uncontrollable factors; however, speculation is something we can crack down on with increased oversight on the markets. These traders and speculators are artificially driving the price of gas up purely to make a profit off the consumer and that is wrong!

I look forward to hearing from the panel today, and what they plan to do to keep a closer eye on these speculative traders and ensure the consumers that they are paying for the true cost of gasoline and not for some trader's new Mercedes.

PREPARED STATEMENT OF HON. MICHAEL E. SODREL, A REPRESENTATIVE IN
CONGRESS FROM THE STATE OF INDIANA

Thank you, Mr. Chairman for holding this timely hearing to examine an important issue in the debate on fuel prices.

There is no doubt the rise in gasoline prices are hurting America's families, businesses and farmers. High prices for energy can reduce profit margins and increase the cost of operations. No one understands that better than I do. I spent my career in the transportation business. The current round of price hikes in both diesel and gasoline have negatively impacted our family budgets; small business budgets; and rippled through our entire economy.

Supply and demand are at a point where every drop will make a difference in stabilizing prices. The President has taken some action to address the price increases being experienced at the pump. The suspension of purchases of the oil to fill the strategic petroleum reserve and relaxation of clean fuel requirements will help in very modest ways. But these are only stop-gap measures.

The demand will continue to increase as our economy continues to grow. Therefore, the United States needs to find more supply from domestic sources. I voted for the energy bill last year but must tell my colleagues on this committee I was upset it did not include provisions to allow oil and gas exploration in ANWR.

Ethanol, biodiesel and other renewable energy sources all have the potential to contribute to the solution to our problem. I am happy to say I currently use biodiesel in my personal vehicle back home in southern Indiana. Since I started using it, my vehicle runs quieter, performs better, the exhaust is cleaner and it smells like french fries.

But if we are going to use more renewable fuels we need to increase production. The Energy Information Administration estimates the U.S. ethanol industry may fall almost 130,000 barrels short this year in terms of meeting the demand set by the renewable fuel standards. I look forward to hearing the NYMEX and CFTC CEOs discuss how this potential shortfall will impact the supply of RBOB, how it is affecting the marketplace and what we in Congress can do to address this issue.

There is no silver bullet to address rising gasoline prices. We cannot wave a magic wand today and build more refineries, produce more oil and decrease demand tomorrow. But we can begin to set the stage for a more strategic energy policy based on the lessons learned from the past. I think Congress should address issues like increasing refinery efficiency and increase research to promote cellulosic ethanol produced from agriculture waste, switch grass, biomass, and wood chips. Congress should create new incentives for renewable fuel vehicles and retool the biodiesel tax credit to make it more effective.

We should also open ANWR and the Outer Continental Shelf to oil and gas exploration to increase domestic supply. This is more than just an issue about energy policy but also an issue about national security. We can not continue our reliance on energy from foreign countries.

Finally, we must pass legislation to reduce the proliferation of boutique fuels. The fact we cannot sell the same type of fuel in southern Indiana as we do across the Ohio River in Louisville, KY makes the least sense in terms of economic or environmental policy. I plan to work with my colleagues this year to resolve this issue. Again, I want to thank you, Mr. Chairman for holding this hearing and I look forward to hearing from our panel of witnesses.

The CHAIRMAN. I will introduce our panel of witnesses: the Honorable Walter Lukken, Commissioner of the Commodity Futures Trading Commission of Washington, DC; and Dr. James Newsome, president and chief executive officer of the New York Mercantile Exchange of New York, New York.

Gentlemen, welcome to both of you.

Commissioner Lukken, we will begin with you.

STATEMENT OF WALTER L. LUKKEN, COMMISSIONER, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. LUKKEN. Mr. Chairman, Congressman Peterson and members of the committee, I appreciate the opportunity to testify on behalf of the Commodity Futures Trading Commission concerning our oversight of the energies futures and options markets.

The CFTC has been paying particularly close attention to futures trading in energy commodities because of the importance of energy prices and supplies to our Nation's consumers, producers and its economy in general. Based on our surveillance efforts to date, we believe that crude oil and gasoline futures markets have been accurately reflecting the underlying fundamentals of these markets.

Futures markets play a significant risk management role in the U.S. economy. They provide risk management tools to producers, distributors and commercial users of commodities who use these products to protect themselves from unpredictable price changes. The futures market also play a price discovery role as participants in related cash and over-the-counter markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors. Both functions would be harmed by the manipulation of our markets.

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

The CFTC's market oversight begins with a review of the terms and conditions of the contract to determine it is not readily susceptible to manipulation. Once listed, CFTC staff closely monitors on a real-time basis trading on the exchanges to detect unusual activity or price aberrations that might indicate actual or attempted manipulation.

The cornerstone of our market surveillance program is the Large Trader Reporting System, which requires traders to file daily reports concerning their own and their customer's positions in a particular contract. Through the Large Trader Reports, the CFTC becomes aware of concentrated and coordinated positions that might be used by one or more traders to attempt manipulations.

In addition, each futures exchange is required under the CEA to supervise trader practices, prices and positions and must impose trade position limits, when appropriate, to guard against manipulation.

When the CFTC staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications

to work to resolve the situation. Typically, the CFTC staff coordinates activity with exchange regulatory staff. CFTC staff may contact the longest longs and shorts in the markets to obtain information on their delivery intentions and their capabilities to deliver and their price objectives in liquidating trades.

The traders are advised of the CFTC's concern regarding the orderly expiration of the futures contract and reminded that they are expected to trade in a responsible manner. This regulatory oversight of the CFTC and its staff is usually quite effective in resolving most potential problems. Should more action be needed, however, the CFTC has broad authority to limit, liquidate or halt trading through its emergency authorities.

Fortunately, most issues are resolved without emergency action. In fact, the CFTC has only taken emergency action four times in its history. But this authority represents an important hammer in our toolbox.

Should a violation of the Act occur, the CFTC aggressively pursues any individual that intentionally seeks to disrupt or undermine the integrity of our markets. The CFTC's Division of Enforcement investigates and prosecutes individuals and entities for violations of our Act, including manipulation, false reporting, and trade practice abuses.

Sanctions in prosecuted cases serve as a powerful deterrent for would-be violators and send a clear message that improper conduct will not be tolerated. These investigations may be conducted with cooperation of the applicable exchanges, State and regulatory authorities and other Federal regulators such as the Federal Energy Regulatory Commission.

I would note that the CFTC and the FERC entered into a memorandum of understanding last October that coordinates our joint activities in ensuring the price integrity of the energy markets.

Also, the CFTC is an active member of the President's Corporate Fraud Task Force. The Commission has referred and will continue to refer criminal matters involving energy markets to the Department of Justice for further investigation.

Our policing of the energy market reflects an approach to regulatory oversight that emphasizes tough enforcement against malfeasants. Since December 2002, the CFTC has filed 32 enforcement actions, charging 27 companies and 23 individuals for misconduct in energy markets, resulting in nearly \$300 million in penalties; and the Commission continues to pursue potential violators of our Act.

Currently, there are over one dozen open investigations involving the energy markets. Real-time enforcement continues to serve as an important complement to our surveillance of these markets.

In recent years, with increased economic growth in China and elsewhere, demand for petroleum products has risen faster than has supplies of these commodities, supplies which have been impacted by geopolitical instability among oil-producing nations, limited refinery capacities due to Hurricanes Rita and Katrina, and the transition from MTBE to ethanol as a component to reformulated gasoline. This has created very tight demand/supply balances in these markets. Both supply and demand for crude oil and unleaded gasoline are "price inelastic" in the short run. As a result,

near-term changes in supply or demand can have disproportionately large effects on price.

Although U.S. energy prices have been volatile in recent months, it is precisely during these volatile times when the risk management and price discovery features of futures markets are needed most by commercial users of energy products. All the evidence that we have seen is consistent with the notion that futures markets for crude oil, unleaded gas and natural gas and other energy products have been properly performing their risk management and price discovery roles. The staff of the Commission will continue to conduct very close surveillance of these markets to ensure that they remain functioning properly. Improper conduct will not be tolerated, and CFTC will continue to pursue aggressive enforcement actions against those who break the rules.

Mr. Chairman, some have said that blaming the futures markets for high commodity prices is like blaming a thermometer for it being hot outside. The CFTC's role is to ensure that no one is holding a match under this thermometer; and, in my view, we are doing a very effective job.

Thank you, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Lukken appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Commissioner Lukken.

Dr. Newsome, welcome.

STATEMENT OF JAMES E. NEWSOME, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEW YORK MERCANTILE EXCHANGE, NEW YORK, NY

Mr. NEWSOME. Thank you, Mr. Chairman. Let me say it is an honor to share the table with my former colleague, Commissioner Lukken; and I know that the CFTC is working hard and doing a great job.

NYMEX is the world's largest forum for trading and clearing physical-commodity-based futures contracts, including energy and metals. We are a federally chartered marketplace, fully regulated by the CFTC both as a contract market and as a clearing organization.

NYMEX provides an important economic benefit to the public by facilitating competitive price discovery and hedging. As the benchmark for energy prices around the world, trading on NYMEX is transparent, open and competitive and heavily regulated. Contrary to some beliefs, NYMEX does not set prices for commodities trading on the exchange. NYMEX does not trade in the market and does not influence price movement. Instead, NYMEX provides trading forums for market participants to come together and execute trades at competitively determined prices that best reflect what they think prices will be in the future, given today's information.

Gasoline is the largest refined energy product by volume sold in the United States and accounts for almost half of the national oil consumption. It is a highly diverse market, with hundreds of wholesale distributors and thousands of retail outlets, often making it subject to intense competition and price volatility.

NYMEX trades, among other things, New York Harbor unleaded gasoline futures contracts, which is a wholesale contract. Average

daily trading volume in these contracts has set record levels in recent months, and prices have been volatile.

NYMEX closely monitors the gasoline futures market and increases surveillance during periods of price volatility. We have seen no evidence to date to suggest that recent price rises in gasoline futures being traded on our markets are attributable to volatile activity.

Our analysis of the gasoline market has identified three key factors that are contributing to higher gasoline prices in both the cash and futures markets: one, high crude oil prices; second, the MTBE phase-out; and, three, reduced refinery capacity.

Crude oil is the main feedstock for gasoline production. Last week, crude oil prices reached all-time highs of over \$75 due to continued concerns about Middle Eastern and South American security and rising global oil demand.

The gasoline market is currently in a difficult transition period between the phaseout of MTBE and the related transition to ethanol. Ethanol, which is chemically different from MTBE, contains more volatile compounds than does MTBE and, therefore, is harder to use in reformulated gasoline in the summertime. In addition, ethanol cannot be carried in the Nation's pipeline system and must be segregated from the wholesale distribution system until its addition at the truck rack. Finally, ethanol presents new demand and supply implications, which must be factored into the pricing of gasoline.

Even though no new gasoline refineries have been built in the United State in decades, this imbalance has been mitigated somewhat by higher efficiencies from existing plants, which have generally operated at a high rate of utilization in recent years. However, such a high utilization rate also means that when utilization rates are reduced for any reason, there will be an immediate impact on the availability of new supplies.

This year, the gasoline supplies have been constrained by lower refinery utilization rates due to heavy refinery maintenance. Some refineries reportedly had delayed maintenance work in the aftermath of Hurricane Katrina to ensure adequate gasoline supplies at the end of last year and early this year. Furthermore, additional refinery work is needed this year to comply with the new low-sulfur requirements in both diesel and gasoline. The end result is tighter gasoline supplies in the short term until the higher refinery utilization rates can be restored.

NYMEX has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. NYMEX consistently has been deemed by the CFTC to maintain adequate regulatory programs and oversight, in compliance with its regulatory obligations under the Commodity Exchange Act.

Mr. Chairman, it is widely, yet inaccurately, theorized that speculators can drive prices up. With hundreds of commercial participants and instantaneous dissemination, any speculative price would be met with an equally strong commercial reaction. If markets move in a direction inconsistent with actual market fundamentals, a vast number of market participants, including energy producers, wholesalers and retailers, will respond to ensure that

prices rapidly return to where the industry consensus believes they should be.

Speculators do exist and they play a valuable even necessary role in the marketplace. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. By nature of their roles, speculative traders seek to participate in price trends that are already under way, but because they lack the capacity to either make or take delivery, they will never be in a position to be able to hold a market position through the delivery process. Thus, speculators create virtually no impact on daily settlement prices, which are the primary benchmark used by the marketplace.

The NYMEX marketplace continues to perform its responsibility to provide regulated forums that ensure open, competitive and transparent pricing. We can only imagine the market uncertainty and further devastation to consumers if NYMEX were unable to perform its responsibilities.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Newsome appears at the conclusion of the hearing.]

The CHAIRMAN. Thank you, Dr. Newsome.

Both of you have testified that the CFTC and the New York Mercantile Exchange do continual oversight of market conduct. We would like to ask both of you if you and your organizations have stepped up your oversight and surveillance of efforts in response to the recent increases in gasoline prices.

Commissioner Lukken.

Mr. LUKKEN. Certainly we have. One statistic I will throw out to you is, over the last year, 75 percent of our surveillance briefings that we hold weekly at our Commission deal with energy issues. This is despite the fact in part they represent less than 10 percent of the marketplace; and that is because of the fears that you talked about, manipulation and other concerns that Congress has provided us in our mission. So we certainly pay particularly close attention to energy markets, particularly in times of volatility.

The times that we do focus our surveillance efforts are during expiration months, as Dr. Newsome mentioned. So we, during those times, that is when there is a heightened concern on surveillance over speculative positions we watch where these markets may be going. But our surveillance staff does an appropriate job of ensuring that manipulation is not occurring.

The CHAIRMAN. Dr. Newsome.

Mr. NEWSOME. Mr. Chairman, we absolutely increase our surveillance activity when the markets are volatile, which has been quite often as of late; and NYMEX takes very seriously its role as a self-regulatory organization and as the front-line defense against anti-manipulation, anti-fraud type activity.

Just to point out how seriously we do this not only because of my former role at the CFTC but because of NYMEX's opinion in general, since the markets have become larger, more volatile, we have greatly increased staff presence through our compliance division. We have added compliance staff to the floor that are in the pit every day, monitoring activity of the traders. We have added surveillance cameras to the floor so that we can tape the activities

and use that tape with compliance activities. We have taken numerous steps to make sure that the markets operate in an orderly manner and that trading remains fair and competitive.

The CHAIRMAN. What type of a market anomaly would trigger greater oversight attention?

Mr. NEWSOME. Typically, we look at volatility in the marketplace and how much the price moves. Obviously, we have got lots of tools at hand with regard to increasing margins, position limits, price limits. We have used those tools. In fact, during Hurricane Katrina, when we had some of the biggest price moves in the history of energy markets, we used every tool available to us to make sure that the markets maintained an orderly fashion and we are proud to say that they did.

So, typically, our increased surveillance is based upon volatility or major movements in price.

The CHAIRMAN. Have either of you found any evidence of manipulation in the trading of gasoline or oil contracts?

Mr. NEWSOME. No, sir, we have not.

Mr. LUKKEN. We have not either, sir.

The CHAIRMAN. And, Dr. Newsome, what type of enforcement activity is available to you when you do find such?

Mr. NEWSOME. We have a broad array of enforcement actions. I think probably the strongest tools that we have are the ability to fine, and we have no limitations on our ability to fine market participants. I think probably even beyond the fines, our ability to remove the trading privileges of those on the floor is the strongest tool that we have; and we have used both of those tools. Fortunately, not with regard to manipulation, because we haven't found manipulation, but those are the tools we have available.

We are in constant communication with the CFTC with regard to any type of enforcement activity and actually work very closely with the enforcement staff of the CFTC.

The CHAIRMAN. Mr. Lukken, what tools are available to you and how do you utilize them with regard to the futures trading organizations like NYMEX?

Mr. LUKKEN. Well, we certainly have similar tools to what NYMEX has but enhanced tools as well. Our enforcement authorities allow us to revoke or suspend licenses of traders, to halt prohibited activity, to order restitution, impose civil monetary penalties, and to refer matters to the criminal authorities at the Department of Justice, should it be appropriate. So we, over the years, have a pretty strong track record in this. As I mentioned, we brought 50 cases against individuals and companies levying over \$300 million in civil monetary penalties against those entities.

We have 12 open investigations currently in energy, so we are not sitting idly on our hands in these areas and continue to probe especially during these volatile energy times.

The CHAIRMAN. Finally, let me ask both of you, when was the last time you had to take enforcement action against the possible manipulation of gasoline prices?

Mr. NEWSOME. Mr. Chairman, I will have to look into that. I don't recall us having done so certainly in my tenure. Our compliance group is very active, but we have so many steps in place to

prevent it from ever happening to begin with. I don't recall having to bring an action against actual manipulation.

Mr. LUKKEN. I have just been informed by our head of enforcement that we have not taken any sort of actions of late, but we do have open investigations in which we are studying some of these issues.

The CHAIRMAN. Thank you very much.

The Chair recognizes the gentleman from Minnesota, Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman.

This chart here that is in your testimony—it is figure 3, Delivery Notices, I think. What is this big spike there in November, December 2004 and again in June 2005 on the deliveries there? They are way up. What is going on there that causes there to be such a spike in those months?

Mr. LUKKEN. I think there were certain economic situations at the time. We can get back to you with further details on why the spike is.

But I would note that, overall, compared to open interest, even though these deliveries were high at the time, compared to actual open interests and deliverable supply, this was not an exceedingly large proportion of possible deliveries in this area.

So even though there is a spike there—and we will get you more information as to why this did occur—this did not raise concerns with our economic staff because there were enough supplies available at that time to provide those deliveries.

Mr. PETERSON. So this was a small part of the market, what you have identified here.

Mr. LUKKEN. I think that is correct.

As I noted in my written testimony, deliveries normally occur less than 1 percent across the board in the futures markets; and we are constantly, constantly looking at the amount of deliverable supply compared to those who are seeking delivery and making sure that, as people come down in spec limits in the spot month, that they are able to make and take delivery properly and that the futures markets are properly functioning.

Mr. PETERSON. If you would get back to me and let me know what is going on there.

Mr. LUKKEN. We certainly will.

Mr. PETERSON. The other thing that is coming up at home more and more, we have a good share of the E-85 pumps in the country in my State. A couple of years ago, you could buy E-85 for 70 cents a gallon less than gasoline; and now it is 20, 30 cents. Is that what it is in your area?

So we have people asking questions about what is going on. Because the cost of production of ethanol has actually gone down in those 2 years, not up; and the renewable fuels people tell me that there is no shortage in terms of the amount of ethanol that is available. There might be some distribution issues. As far as I know, there is—I guess there is—Boston, New York, Philadelphia, Washington are going to start substituting ethanol for MTBE, is going on right now, might be an issue.

What is going on there, apparently, about a year ago or maybe a little more, ethanol started to follow gasoline prices where it

didn't necessarily do that before. Is there something going on that fundamentally changed the situation? And was the fact that the futures contract was established on the Board of Trade, did that have something to do with this? I am getting questions from people at home; and I can't really answer why this is occurring. Do you know? Mr. Lukken?

Mr. LUKKEN. The Chicago Board of Trade, as you noted, began listing an ethanol contract last April; and in some ways this is the silver lining. As you talked about earlier, encouraging more ethanol production in the United States and listing a benchmark in this area is going to help resources and capital being devoted to building more ethanol plants and people utilizing ethanol more.

In regard to your question, it is really a retail pump ethanol question. From my understanding of the ethanol markets and our economists who study these markets, there are some difficulties in the transition from MTBE to ethanol that is taking away some supplies in that area.

Also, there is obviously some transportation issues. Ethanol cannot be transported through pipelines, compared to the petroleum-based MTBE that we have utilized over the last few years; and, in addition, ethanol, because of localities, where the plants are located and where it is a lot of the consumers of ethanol may be, that also has been impacting the price of ethanol around the country.

But I will try to drill down with my economic staff to see if we can find more concrete information for you and maybe some of the more fundamentals of why the price differences at the pump.

Mr. PETERSON. Are you following the futures contracts on the Board of Trade? Are you investigating those and studying them the way you are the gasoline?

Mr. LUKKEN. We do. We do. We have an economic staff devoted to that that looks at all participants, receives all the end-user information of who is trading in those markets, what their positions might be, what their positions might be in other energy markets that might affect those markets. So we follow that very closely, and to date we have not found a problem in the ethanol contract.

Mr. PETERSON. Well, if you could look into that and give me a report back on what you think and what you find out, it would be appreciated.

Mr. LUKKEN. We will do that.

Mr. PETERSON. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentleman from Oklahoma, Mr. Lucas, is recognized.

Mr. LUCAS. Thank you, Mr. Chairman.

Commissioner and Doctor, obviously, both of you with your oversight responsibility to monitor all these things closely, whether it is explaining those charts or just for the sake of discussion, would you describe for me how the level of futures contract activities has gone on in recent months? Has there been ups, downs, spikes? Are we seeing substantially more trading of both crude oil contracts and unleaded gasoline contracts than we would have seen in the same, say, 6-month period 2 years ago, 5 years ago, 10 years ago? I assume that part of your oversight is to watch the level of activity in particular areas.

Mr. NEWSOME. Absolutely. And the good bottom line answer is, yes, volumes have increased. We see more activity in the marketplace by both commercials and noncommercials as well; and, as I stated in testimony, those prices have been volatile. We have seen major market moves earlier—or late last year based upon weather-related events. More recently, it has been based upon insecurity in major oil-producing regions; and we are at a point with regard to supply and demand there is no margin to play with.

In the past, if we got into a fundamental crunch, we had Middle Eastern countries who had the capability of pumping more oil. We don't have that luxury now. So because we don't have that luxury, any impact around the globe—and these markets have truly become global markets now—any kind of—whether it is a refinery in Venezuela, political activity in Iran or Iraq, they all have an impact on the market. And because prices have been more volatile, more and more people are coming into the marketplace to try and hedge that price risk.

But, yes, we monitor that every day.

Mr. LUCAS. So are we to the point of what would be described as a frenzy?

A lot of us think back to the early 1980's in the metals markets when there got to be a total frenzy point when the number of contracts in silver and gold went totally ballistic and the volume then of participants drove the market in such a way that it pulled the real commodity prices with it, as opposed to the futures reflecting hard delivery commodity prices was the other way around. Have we seen that level of activity in the futures contracts in crude oil or gasoline yet? Has this volume increased to the point that it has taken a life of its own?

Mr. NEWSOME. I wouldn't characterize it as frenzied activity, but certainly it has been very active activity in the marketplace.

But if you look at the global markets, whether it is North Sea Brent that is traded in Europe versus WTI that is traded at NYMEX, the same pricing patterns continue in all the global markets. So it is not just a U.S. issue. It is a global issue.

In terms of the volume of contracts traded, we see no issues or no problems with the current volume of futures contracts being traded in energy.

Mr. LUCAS. Do we have a record number of crude oil and unleaded gasoline contracts out at this particular moment?

Mr. NEWSOME. Open interest is at the highest levels in recorded history.

Mr. LUCAS. And comparing the next most recent level of activities 2 years ago, 5 years ago, 20 years ago, a factor of a few percentage points more or twice as many? Or give me a guesstimate, gentlemen.

Mr. LUKKEN. I can just note on futures contracts in general—I am not sure about energy contracts, but futures contracts since 2002 have doubled, from a billion contracts traded to 2 billion contracts traded. So some of this is just growth in the industry in general.

Specifically to the futures markets in energy, we certainly have seen a lot of activity, a lot of growth. But our surveillance efforts

have shown that there is enough deliverable supply to meet that need.

As I mentioned in my testimony, volatility brings hedgers to the market, because they want to get rid of the risk that they might see in those markets. So even though there is volatility, even though there are greater volumes, this is a time we need the futures markets the most.

Mr. LUCAS. Thank you, gentlemen.

I yield back, Mr. Chairman.

The CHAIRMAN. Thank the gentleman.

Gentleman from Pennsylvania, Mr. Holden, is recognized.

Mr. HOLDEN. Thank you, Mr. Chairman.

I have a question for both of our witnesses.

What do you regard are the most significant threats to the integrity of the energy derivative markets and what strategies do you use to ward off these threats? And, finally, do you feel that the Commodity Exchange Act is sufficient to ensure the integrity of our Nation's market?

Mr. LUKKEN. I will begin. I think the biggest threat to our markets is the protection of the markets. That is stated in our mission. The integrity of the markets, preventing manipulation, preventing trading abuses and our whole regulatory regime is structured to look for that activity, find it, prevent it, and if it does occur to punish violators that may be involved in that type of activity.

So I think the Commodity Exchange Act has worked exceedingly well, particularly under the guidance that this committee gave us in 2000 with the passage of the Commodity Futures Modernization Act.

Before that Act, as you remember, our laws were very prescriptive, very static. The flexibility provided in that Act allows us, as a regulator, to be more flexible as the markets change, to be able to look around the corners for different trends that might be coming, globalization, the growth of the markets in general, all the things we are seeing in the economy.

So, yes, I think the Act is working well, and it is our job to protect it, and that is its biggest threat.

Mr. NEWSOME. I think when we look at threats to the marketplace I would address it two ways.

One, I think the threat to market integrity that is largest is manipulation; and that is why both the Commission and NYMEX spend millions of dollars to try and prevent that. Can we sit here today and assure you that will never take place? No. But, obviously, we spend lots of time and effort trying to make sure that that is not the case.

I think financial risk is the other greatest threat. The risk that in volatile times the demise of one market participant could have negative impact on other market participants is something that we manage every day, particularly with this volatility through margins.

But I think there is a very, very good system in place, both by the exchanges and by the CFTC. You look at back at the collapse of Enron, which was one of the largest market collapses in history, and the fact that the financial integrity of the exchange stayed in place through the rules and regulations of the CFTC and NYMEX.

Those are the two areas we concentrate on.

Mr. HOLDEN. You believe you have sufficient tools? Is there something else this committee can do to help you?

Mr. NEWSOME. Certainly we believe that we have very sufficient broad tools available to us, and we are not coming before this committee today to ask for anything further. We think it is sufficient.

Mr. LUKKEN. I agree. In regard to these markets, we have provided this committee our recommendations for reauthorization as a Commission; and those were incorporated in your bill. But, beyond that, as far as in particular for the energy markets, we feel we have adequate tools.

Mr. HOLDEN. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Mr. Nebraska, Mr. Osborne, is recognized.

Mr. OSBORNE. Thank you, Mr. Chairman; and thank you for being here this morning.

I would like to pursue Mr. Peterson's line of questioning a little bit further in that we see quite a bit of E-85 production in Nebraska. About the time of the Katrina dislocations, I made a few phone calls to some of our ethanol production facilities and I said I don't understand this. Because gasoline is \$2.80, and we are seeing E-85 at \$3, \$3.25 a gallon, and certainly our ethanol plants were not affected by Katrina. And we don't understand this. I can understand if it if a refinery were shut down on the gulf coast somewhere. And I had trouble getting real clear answers. There was some talk about terminals and having to send it some place to have it blended and those kinds of things. So I wonder if you would be willing to comment on your thoughts on this.

Also, maybe a question that goes a little further, I think in Brazil they burn 100 percent ethanol, which would mean that you might not have to go to a national. You might not have to do blending. Is there really a necessity that we have E-85 instead of E-100? Because then you could really isolate this is what it costs to make a gallon of ethanol and why not go ahead and sell it as it costs. Because, as Mr. Peterson mentioned, E-85 should be 40 to 60 cents a gallon cheaper if you do the math; and here we are seeing it sometimes as high or higher than regular gasoline.

So this may be out of your area of expertise. I would be interested in your comments; and if you can't answer that, I will ask you another question.

Mr. LUKKEN. I would just note that our jurisdiction at the Commission is really overseeing the marketplace and the futures markets and the ethanol contract that is trading at the Board of Trade; and, to date, we have not seen any manipulation problems in regard to that contract in general.

I know that the Federal Trade Commission has been looking at price gouging at the pumps, broadly speaking, for gasoline as well as for ethanol; and we will, as an agency, through our cooperative enforcement efforts try to work with them and if we might have information that might be derived from the futures markets, to have them look at those cases of potential price gouging and help that investigation.

So, unfortunately, it is a little bit outside of my expertise.

We have been closely studying what has been happening in Brazil as a model potentially for the United States. I think it is very exciting what they have done and certainly a model we should study closely as we go forward on ethanol production.

Mr. NEWSOME. Congressman, we don't trade in ethanol contracts at the NYMEX, so my knowledge is limited there.

Mr. OSBORNE. What you guys are saying, it is a bad question. Probably was.

So one other question that may be equally bad is refinery capacity. I am just trying to get at solutions here because, in most manufacturing, they are operating at 80, 85 percent of capacity; and we find refineries are at about 95 percent of capacity. As you mentioned, all it takes is a little hiccup someplace and all of a sudden you are over the top.

We have seen pretty good profits by the oil companies, but it seems like they are very reluctant to reinvest a whole lot of money to remove that deficit of refinery capacity. From your seat, would you say that maybe there should be something done to force some reinvestment to create greater refinery capacity? Because, obviously, it is a problem.

So, again, a very difficult question for you to answer, but I would appreciate if you would take a shot at it.

Mr. NEWSOME. The question is difficult, and I think we can spend a lot of time here today just talking about refinery capacity and why we are in the situation we are in. Obviously, that is somewhat outside of our expertise.

I would just comment by saying that we are in constant contact with refineries because of their activity in the marketplace; and I think some of the difficulty with regard to the refineries has been environmental rules, the difficulty in getting the permits to simply build one, the expense to build new refineries. So I think the effort by the industry in more recent years has been to try to take old refineries, upgrade them and make them more efficient, which is both good and bad, given our situation today.

I know that there is interest by refineries in building more, and I say that simply because they have contacted us to see if the NYMEX would be interested—we currently list our crude oil contracts out 7 years. They are asking if we could extend that time period so that they could actually hedge prices—if they build new refineries and they are in the market, that they could actually hedge out a longer period of time to protect their financial price risk.

From our standpoint, if there is a commercial need to extend the number of contracts that we list, we are more than happy to do so.

Mr. OSBORNE. Thank you, Mr. Chairman. I think my time is up.

The CHAIRMAN. I thank the gentleman.

The gentleman from Georgia, Mr. Marshall, is recognized.

Mr. MARSHALL. Thank you, Mr. Chairman. I am a bit surprised to be called on now with all these senior Members to my left.

Gentlemen, could each of you give your opinions concerning why we are seeing such high gasoline prices and with regard to matters that you supervise or are involved in or other matters, what we as a Congress ought to be doing right now to try to address this problem and whether there is something that we as a Congress could

be doing right now in order to address this problem, or is there no real short-term fix, that it is going to take some time and there are some things we should do but we are not going to have short-term relief?

Could you address that? I am sure you have thought about it.

Mr. LUKKEN. Congressman, obviously, there are a lot of factors that go into what the price of gasoline is at the pump. We do not have jurisdiction over any sort of retail production or oversight over retail gas prices.

I think Jim's testimony provided a pretty good breakout of where the problems lie. A large component of the price of gas, as EIA will tell you, is 45 percent of it is crude oil, and there are a variety of factors why crude oil prices are high: political instability in oil-producing nations and supply-and-demand issues in China and otherwise.

The other reasons that were mentioned by Congressman Osborne, refinery capacity, I think we are currently at 88 percent currently post Katrina and Rita hurricane events, and so we are—EIA is predicting us to be close to 95, 96 percent by June. So I think that is good news that we are going to be up and running almost full capacity, 95, 96 percent. We are never at 100 percent, so that is basically full capacity of refinery by June. So that is also good news and hopefully may help at the pump.

The last issue is, dealing with MTBE ethanol, some of the things are structural, that you are not able to transport ethanol through pipelines, that you have to truck it or ship it or rail it to places; and that provides logistics difficulties we are trying to work through now that may be contributing to the high price of gasoline and ethanol in particular.

Mr. MARSHALL. That does summarize what you described in your written testimony, Mr. Newsome.

Let me ask you this, and again it is a question for both of you, but, Dr. Newsome, perhaps we will start with you.

GAO recently gave testimony before the Senate, and in that testimony identified the exact same things that you just mentioned. And they are kind of long-term problems that we have here. There is not going to be an immediate fix like the ones you just described.

But, in addition, you talked about mergers that occurred in the industry that supplies us gasoline, from the production and all the way through transportation, to wholesale, to delivery, and said that in the 1990's until today there have been about 2,300 mergers, that GAO had studied only 8, and under their econometric models, the majority of those mergers led to 1 to 7 cents per gallon increase in wholesale prices, suggesting that, in fact, mergers have had maybe an anti-competitive effect and maybe an effect that has caused an increase in the overall cost to all of us.

When you see these enormous profits that some of the companies are making right now, ordinary Americans, anyway, and folks like me who don't have a tremendous amount of expertise kind of wonder whether or not there is some price fixing that is going on here, some anti-competitive pressures. Perhaps the FTC has approved too many mergers.

I would like your comment. I understand this is outside your lane, but this is something you have thought about. I would like your comment and perhaps Mr. Lukken as well.

Mr. NEWSOME. Congressman, I think specifically to your second point, the only way that I could comment would be to look at the makeup of the traders in our marketplace; and I would respond that that has changed very little over the last number of years. In fact, today, still 75 percent of the volume held in our gasoline contract is made up of commercial participants. I think that has maybe decreased 1 percent over the last several years. So the commercial component still makes up the vast majority of the open interest in our markets.

We looked specifically last year at the role of hedge funds because it had become a big issue, and less than 3 percent of the volume in crude oil was held by hedge funds.

Mr. MARSHALL. My question is, and it is piggybacking on what GAO has already suggested. It doesn't have to do with whether or not the futures market and futures trading and speculators, et cetera, are causing the problem. It is, do you perceive there is perhaps a problem as a result of these mergers that are occurring, producing an anti-competitive environment that the futures market, frankly, can't solve? Are you suggesting that the futures markets can solve that and it ensures competition that—

Mr. NEWSOME. No, sir. I am not suggesting that we can solve that at all. Nor have I looked at that report and have anything really to add to the comment.

I think I agree there is no short-term solution to higher energy prices. In fact, I would argue that we may be in for a more difficult road ahead. Certainly high prices tend to be the biggest economic driver of responses, and I think conservation is probably our most immediate response with regard to high prices.

My concern is, when you look at the increased usage in China and India, it has been primarily industrial; and that industrial usage has put severe upward pressure on prices. My concern is, as both of those countries develop more of a middle class and that middle class demands cars and air conditioners and the things that we enjoy here, that it is going to put even more upward pressure on global energy prices.

The CHAIRMAN. I thank the gentleman.

The gentleman from Texas, Mr. Conaway, is recognized.

Mr. CONAWAY. Dr. Newsome, you mentioned hedge funds. Could you flush that out a little bit in terms of there has been some speculation that hedge funds had an inordinate impact on certainly the price of crude oil. Do hedge funds trade exclusively on your exchange? Are there other exchanges in which they have availability to trade that happen outside of your jurisdiction? What is your role on hedge funds?

Mr. NEWSOME. The first component, yes, we have active hedge fund participation in our marketplace. As I said, when we looked at it last year, it made up about 3 percent of the volume in our crude oil contracts, a slightly higher percentage in natural gas.

We did not find that they had any impact on price volatility or upward pressure in prices, one, because of their small level of activity in our marketplace.

Secondly, we found, surprisingly, that the hedge funds tended to hold on to their positions longer than normal market participants which argues against adding to volatility.

The second component of the question is NYMEX is but one piece of the pie, that whether you are a hedge fund speculator or a commercial participant, we are but one piece of the pie, that the marketplace has to try and hedge price risk or trade. NYMEX happens to be the only regulated transparent component, and that is a responsibility that we take very seriously.

I think there is the traditional over-the-counter marketplace which the contracts are bilateral, individually negotiated between major commercial participants or banks. The trade in the over-the-counter market is huge. It dwarfs the amount of volume traded at NYMEX.

Then, from an exchange standpoint, there is the Intercontinental Exchange based in Atlanta that trades somewhat in a bilateral marketplace or the over-the-counter marketplace and then also lists futures contracts that are directly competitive to those listed on NYMEX.

The futures contracts are regulated by the U.K. regulator, the FSA, where we are regulated by the CFTC. There is a difference in the regulatory structure of the two organizations, even though they are considered in general to be comparable in nature.

Mr. CONAWAY. You talk about the private market bilateral dwarfing your volumes. Can you tell that those prices, how does that influence or impact prices on your market?

Mr. NEWSOME. You have a lot of the same market participants that are involved in the over-the-counter activity, activity on ICE and activity on NYMEX. But those prices are not transparent, so we do not see that.

Mr. CONAWAY. You just have got the same players?

Mr. NEWSOME. Right.

Mr. CONAWAY. Commissioner, do you have any comments on hedge funds?

Mr. LUKKEN. Just that we follow hedge fund categories very closely. We are able to see them as a class and what they are doing from time to time throughout expiration of a market, and should any type of unusual activity occur by hedge funds we are quick to get on the phone and talk to them about it. Why are they doing it? What is their position? What is the economic justification for it? And then bring enforcement actions against hedge funds and others should they violate our Act. We brought, I think, over 10 cases a year over the last 12 years against hedge funds, so we are very active in overseeing those participants.

Mr. CONAWAY. Speaking to your comments earlier where you said you do not recall either specific actions in relation to gasoline prices or gasoline contracts, you are not seeing hedge funds as being a driver on that that is inappropriate?

Mr. LUKKEN. I think our view so far of the gasoline market as traded on NYMEX is it is kind of an appropriate balance of speculators, hedgers, commercials, noncommercials, hedge funds and others that does not bring any sort of concern for us. Again, we really focus in on the expiration month. But normally hedge funds, as Jim says, act to bring liquidity to the marketplace; and we cer-

tainly encourage those trading activities as long as it is not excess speculation during expiration.

Mr. CONAWAY. Thank you. I yield back.

The CHAIRMAN. Thank you.

The gentleman from North Carolina, Mr. Etheridge, is recognized.

Mr. ETHERIDGE. Mr. Chairman, thank you.

You know, as I sit here this morning listening to our two capable witnesses, I sort of find myself struck by a profound sense of *deja vu*. We have been here before.

First, here we are a month after another summer season is getting ready to start, yet again hearing from my constituents in agricultural and rural areas of this country, I have had telephone calls and e-mails for the last several days wrapping me up.

Since 2000, when the President took office, we have seen spike after spike after spike in gas prices. They come down, but they never come back to where they were, and they just keep going up. They keep spiking. And while it may be good news for the oil companies, I can promise you one thing, the billfolds and pocketbooks of consumers are getting lighter and lighter, while some other folks are getting heavier and heavier. And today and tomorrow we will have record profits by the oil companies, and I promise you they will be bigger and record profits all over again. They continue to get rich, and consumers tend to get poorer.

They have a tough time even getting gasoline to go to work. I stopped by to get gas the other morning before I came to Washington. A lady stopped in front of me and put in \$5 worth, less than 2 gallons of gas, just enough to get to work.

There is a problem out there, and it is a big problem. As a farmer and a small businessman I strongly support a free enterprise system. But the American people deserve to be protected against abuses in this market economy. That is the role of the Federal Government.

I am glad, Mr. Chairman, we are having this hearing today; and I want to thank you for it, because we need to know how the regulators are performing and if they are performing at a level.

The other reason I am experience *deja vu* is because whenever we experience these spikes in gasoline prices or oil prices or natural gas, we never really hear that the fault lies with the people manipulating the futures market to drive the prices up. Now one of the missions of the CFTC is to seek out and stop the market manipulation. These exchanges are likewise charged with maintaining open and competitive markets.

It is hard to imagine there is someone or some group who for the past 6 years have been able to successfully manipulate energy markets, reap tremendous profits and escape detection. But the charge continues to be made, and it is our responsibility to respond and to investigate. So we have the regulators who are here again today.

So I have two questions. I would like to ask, in the interest of time, both of them.

Commissioner Lukken, the figure you cited regarding non-commercial participation in gasoline and oil futures market are limited to those traders falling under the large trader reporting requirements, correct?

Mr. LUKKEN. Correct.

Mr. ETHERIDGE. What mechanisms are in place to protect the consumer or customer from hiding a large position by purchasing contracts with different merchants and remaining below the large trader reporter levels with each merchant, and what prevents people from gaming the system in this way?

My second question is more of a regulatory question. I have been hearing about ICE futures and its chain owned by U.S. companies but regulated under foreign jurisdictions. I have long been concerned about foreign exchange regulations and the competitive advantages that they may have as it relates over our U.S. exchanges.

In the battle for markets and liquidity, I fear exchanges could resort to forum shopping, choosing to operate in a less regulated regime than our own in order to secure a competitive advantage and the consequences of this that it would have on the Commission's ability to seek out and prevent fraud and manipulation. So could one or both of you tell us about the differences in the regulatory regime that the New York Mercantile faces and what ICE reporting requirements are as well in the contract positions limits and also discuss generally whether there is a level of regulatory fee or whether it is level; and if not, why, and what we need to do to fix it?

Mr. LUKKEN. Your first question dealt with how we capture potential people using multiple brokers in order to hide large positions. Our Large Trader Reporting system captures that by aggregation of certain control numbers that goes to the end user. You cannot hide behind a broker or FCM in this situation in order to trade large positions, even though individually they might be small. So we capture that, and we are confident we see all of these positions in the aggregate.

In regard to your second question on ICE futures, as you stated, ICE futures is an exchange located in Britain with a separate board located over there. They are owned by ICE in Atlanta, but under FSA law they are under the highest regulation there, with a separate board of directors running that corporation.

It has been subject to our no-action process since 1999. This was developed to allow foreign boards of trade with comparable regulatory structures to get access to U.S. customers. As long as we did some type of analysis to ensure that we had information-sharing arrangements in place, there was some kind of general comparability between these markets. And this type of arrangement obviously helps our marketplaces, too, that are seeking to go overseas to locate customers that might be interested in trading on the Chicago Board of Trade, the CME or NYMEX, for instance. So we put this no-action process in place in 1999.

Recently, it has been brought to our attention because of the listing of WTI contract in direct competition with NYMEX. I think what has brought concern to us as regulators on this issue is the fact that it is based on the closing price of NYMEX.

As far as whether it is in compliance with the no-action process that we did in 1999, yes, it is. But we still want to make sure that, because of this unique situation, we have the right surveillance and information-sharing arrangements in place, and we have been working over the last several weeks since this occurred to ensure

with FSA that we are getting the right information so that both of us are properly surveilling the entire marketplace in this area. I am confident we are.

Over the long run, however, our chairman has noted publicly that we plan to look at this process to make sure that it is addressing the public interest as it should be. As you mention, there may be differences between regulatory structures. I think we need to make sure that the end game that we are after—preventing manipulation, ensuring market integrity—is really the goals that we are after.

I think if you compare the two side by side there are always going to be differences. They do some things differently. It was developed differently than ours. Ours has a long history behind it as well. We want to make sure there is no regulatory arbitrage between the two. There is some comparability, as you mentioned, but also that there is not a race to the bottom among regulators, that markets are able to pick and choose the best of both situations to their advantage. So over the long term this is what we are going to be studying, and hopefully we can address that and report back to Congress on our findings.

Mr. NEWSOME. Congressman, with regard to that same issue, NYMEX has asked the CFDC to review the regulatory structure of ICE, ICE futures, because we believe that there is an unlevel playing field. I was at the CFTC when the no-action letters were created and used, and we believe that those no-action letters remain totally appropriate today. It gives access to U.S. customers, products traded on foreign exchanges.

We believe that the way ICE has evolved, that there is a question as to whether or not they actually remain a foreign exchange. When ICE purchased the International Petroleum Exchange, there obviously was an exchange in London; and it was under that exchange that they asked for the no-action request that was appropriately granted by the CFTC.

The markets evolved, and ICE has evolved. They have since closed that facility in London, and all their trades are conducted electronically through the home headquarters in Atlanta. They trade competing products to the New York Mercantile Exchange. They do so without the same hard-position limits that are required at the New York Mercantile Exchange, and they do so without the regulatory requirement to submit daily large trade reports, as does the New York Mercantile Exchange.

So I think that NYMEX and the Commission are having a very good dialog with regard to what that regulatory role might be, but certainly as the markets have evolved they have changed. Differences in regulation have created a competitive disadvantage in some instances to U.S. exchanges, and it is something that we are concerned about.

The CHAIRMAN. I thank the gentleman.

The gentleman from Michigan, Mr. Schwarz, is recognized.

Mr. SCHWARZ. Dr. Newsome, I am going to ask you to give about a 4½ minute Futures 101, if you do not mind, to initiate the uninitiated, one of those people who was always warned you never get into the commodities market, the futures market, the deriva-

tives market, because it is so arcane and so nuanced beyond apprehension and impenetrable that you just do not want to go there.

So let's say I am a trader, and I have got a few million bucks. Walk me through how I get into the, say, the crude futures market, buy a contract on NYMEX, and how I might either profit from this experience or lose money from this experience.

Mr. NEWSOME. I do not know that I can do that in 4½ minutes, but I will try.

Mr. SCHWARZ. I am not sure you can either, but let's give it a shot.

Mr. NEWSOME. First of all, to participate in the marketplace, to become an actual trader is a rather lengthy process. It is highly regulated. There are a number of registrations both with the CFTC, the National Futures Association, that you have to go through.

A typical customer would enter orders through a banker or brokerage firm who has memberships on the exchange versus trying to become a trader themselves.

It is very different whether you are entering the marketplace from a speculative standpoint or whether or not you have the underlying commodity and you are using the marketplace to hedge or set a floor on that risk. There is no question that, from a hedger's standpoint, the markets do a wonderful job of managing price risk, allowing market participants to protect themselves against risk and price.

The speculators, it is a completely different animal with regard to the hedgers. Typically, speculators will trade a trend. Once they see that a trend has developed, they will start taking positions along that trend line. But it is speculative. And sometimes they guess right, sometimes they guess wrong.

But I think the one thing about futures markets that we have to remember is that, at the end of the day, it is a zero sum game. For every one that wins or guesses right, there is an equal and offsetting loser. So very different from the equity markets where everyone can win or everyone can lose depending upon what is going on in the marketplace.

But from the hedging standpoint, whether a hedger wants to hedge that risk in the open outcry pits that are on the facility in New York, whether they want to use our electronic trading system to manage that risk, they have got multiple opportunities to do so. The function of the exchange I think remains virtually the same as it did when it was created 135 years ago in terms of supplying a very good mechanism and opportunity to manage price risk.

Mr. SCHWARZ. This question has been asked before, but this is for my edification—people still trying to get in and manipulate the market, manipulate prices, windfall profits sort of thing, and is that affecting in any way the price of petroleum or gasoline now? Do you feel basically the market is now on the up and up and what we are seeing literally is the basic economic principle of supply and demand?

Mr. NEWSOME. While, as consumers of energy products, we do not necessarily like the message, but we are confident that the market is operating as intended, that it is following the fundamentals of supply and demand.

Mr. SCHWARZ. Thank you.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. I thank the gentleman.

The gentleman from North Dakota, Mr. Pomeroy, is recognized.

Mr. POMEROY. I thank the Chair; and I want to join comments made by both sides of the aisle, Mr. Chairman, congratulating you for having this hearing.

I believe it is a good start, but I hope that we commit ourselves to much further work on this whole issue of pricing of fuel and then the consequences of higher gasoline and higher input costs to our farmers.

We are involved in a fairly arcane exercise here of trying to understand futures markets. There is something much less arcane that we have to understand, the threat to our farmers posed by higher gas prices. I would like to have a hearing that just focuses on that and what we might do about that. We are looking for whether or not there is some boogey man driving prices in these futures trading areas, all well and good, but let's look at what we can do right now to help farmers facing the most expensive spring planting in the history of U.S. agriculture.

The Senate Committee on Appropriations took action on a bipartisan basis that I find extremely interesting. They put into the supplemental appropriations bill a response for agriculture. It includes assistance for farmers who have had disaster losses in 2005 production. I believe that step should have been taken last year. Better late than never. We ought to do that.

It also acknowledges that, in the face of potentially ruinous costs, they have not been able to get their business plans to pencil out as they sit down with bankers on operating loan negotiations, and there is a 30 percent bump in AMTA payments to assist in dealing with the near term with these high energy prices.

Mr. Chairman, I would really like to have a discussion on the merit of this concept in this committee. I think it could be extremely helpful for producers. It is just not enough for us to go back to our farmers facing the catastrophe of these high gas prices and say, well, we are studying how the future markets work. There is something concrete we can do now, and we need to attend to it.

Now as to the matter of this hearing, Dr. Newsome, it is great to see you again. You have a new hat on since the last time that I believe I have had a chance to inquire of you in this hearing. Is it fair to say that hedgers add liquidity to the markets and speculators add volatility to markets?

Mr. NEWSOME. No, I do not think so. In fact, speculators add the opportunity for the commercials to get in and out of positions when they need to hedge risk. I think the vast amount of liquidity comes from the noncommercial side, the speculative side of the equation, not vice versa.

Mr. POMEROY. The vast amount of liquidity in futures markets is speculative driven? Short-term traders trying to game the timing just right?

Mr. NEWSOME. No. The vast majority of open interests, positions held by the marketplace is held by commercials.

Mr. POMEROY. I heard you exactly wrong then. Most of it speculating money, and some of it is hedging money.

Mr. NEWSOME. Seventy-five percent of the positions in, say, the gasoline market is held by commercial producers, only 25 percent by noncommercial. But I think we were talking about two different things.

The open interests, those who have the contracts, is the 75-25 breakdown that I just commented on. But when you look at the liquidity, the ability to get in and out of a trade everyday in the pit, it is the speculators that help provide that liquidity so that the commercials can take the positions that they want to take. If a commercial participant wants to take a position, whether it is going up or down, someone has to be willing to take the opposite side of that position, and the speculators are the ones willing to do so.

Mr. POMEROY. But is that putting us on a roller coaster that would otherwise be more of a level and predictable pricing environment?

Mr. NEWSOME. No. Because the market is going to move based upon the fundamentals of the marketplace. We do not see that that type of activity adds volatility to the marketplace at all.

Mr. POMEROY. I am hearing with grain futures trading, for example, a volatility now that we have not seen before reflecting the fact that there is more speculative money in. Given your background on CFTC, is it your position that grain markets have not been more volatile?

Mr. NEWSOME. I haven't studied grain markets recently, so I do not know what is happened in volatility, Congressman. But my general perception would be that volatility is not created by additional speculators coming into the marketplace.

Mr. POMEROY. Thank you very much. I yield back my time.

The CHAIRMAN. Thank you.

The gentleman from Kansas, the chairman of the subcommittee, Mr. Moran, is recognized.

Mr. MORAN. Thank you, Mr. Chairman, for your and Mr. Peterson's interest in this topic.

I believe that our subcommittee and its members have reviewed and paid attention, monitored both the activities at the Exchanges as well as the CFTC's regulatory abilities, and we look forward to continuing that as we continue the process of trying to reauthorize the Commodities Futures Trading Commission Act and keep Commissioner Lukken's paycheck continuing.

I appreciate the conversation we have had this morning. This has been interesting and enlightening. I want to ask just a couple of questions. One is very specific, and one is more broad for my understanding.

The specific one is about MTBE and the change to ethanol. Dr. Newsome, you testified—I guess both of you really testified—that there is upward pressure on the price of fuel as a result of that transition; and you put that number, Dr. Newsome, at about 15 cents. Is there any analysis that would predict when the pricing of gasoline futures contracts will no longer include that premium that is there because of the uncertainty of the transition?

Mr. NEWSOME. We have not done that analysis to date, so it would be very difficult for me to give you a specific answer. But we do base that difference on hard numbers.

In October 2005, we started listing a contract that included ethanol to phase out of the MTBE contract that we currently trade toward the ethanol contract. So, currently, we are listing both contracts for trading at NYMEX. We have roughly 125,000 contracts of open interest in the old unleaded contract; and we have roughly 45,000 contracts open interest in the new MTBE contract.

The New York Harbor, where our delivery point is, has pretty much finalized their transition from MTBE to ethanol. So we certainly think that is going to start the process of seeing the two prices come together. But currently in the trading of both we see between that 12 and 15 cents differential at this time.

Mr. MORAN. Would either of you have an opinion as to the suggestion that there is a significant shortage of ethanol? Obviously, your testimony is that so much of what we are dealing with here is related to supply and demand. It is the market forces at work. Ethanol has become in some quarters the scapegoat for high energy prices because of lack of ethanol. Does that allegation have validity?

Mr. NEWSOME. That is not something that I have looked at or could comment specifically about. What we have looked at is how the current supplies are utilized and the differences in transportation and blending and that added cost from that component that the industry is bearing at this point. The fact is there are real differences in how it has to be transported, how it has to be blended. Those methods are more costly than the current methods with MTBE.

Mr. MORAN. Your 15 cent number is based upon those factors, not upon an issue of whether there is adequate supplies of ethanol based upon pricing.

Mr. NEWSOME. That would be my assumption, yes, sir.

Mr. MORAN. Commissioner, anything?

Mr. LUKKEN. We agree with Jim's assessment. The difference between the two futures contracts, the current gasoline product and what is expected after this transition is about 15 cents. As you noted, the futures markets really provide us no information beyond the fall price that you mentioned; and we will be closely following that. But, as these transitional issues resolve themselves, hopefully the expectations of the markets will bring that premium down.

Mr. MORAN. Thank you.

Let me ask a broader question for my edification. A trader is a speculator unless they have a commercial need for underlying product; is that correct?

Mr. NEWSOME. Correct.

Mr. MORAN. My understanding is that if you are not a commercial trader—in other words, you are a speculator—then you will have a spec limit imposed upon your trading activity. And I want you to describe for me how that spec limit is established, what authority there is for that, how that spec limit is arrived at. Are they changed on a regular basis? Would you describe for me the nature of a spec limit?

Mr. LUKKEN. I will start.

The Act, as provided by Congress, says that an exchange shall impose speculative or accountability limits as they deem necessary in order to prevent congestion or manipulation. That is one of the

core principles that each exchange has to abide by. In doing so, most exchanges do on physically delivered products have spec limits that they, based on historical statistical data, find out what the proper levels might be in order to ensure convergence during the time when cash and the spot futures price converge. Again, we work with the exchanges on this, but this is something that our Act delegates to the exchanges to set in the particular amounts.

Mr. NEWSOME. It is an ongoing dialog with the Commission with regard to what those appropriate levels might be.

First of all, there are position limits across the board whether you are a commercial or whether you are a speculator. The speculator position limits are tighter. The commercial participants have the opportunity to get exemptions on those limits if they can prove that they have the ability to either take or make delivery of the underlying commodity. So there is much more flexibility on that side of the equation.

With regard to the speculators, they have general position limits that regard to their positions throughout the curve or the contract. As we start coming toward an expiration the last few days of an expiration, pushing the speculators to get out of the market because they have no ability to take delivery or make delivery, those limits get smaller and smaller and smaller as we move towards expiration.

Mr. MORAN. Dr. Newsome, it is nice to have you have back here in front of our committee in 1300. Commissioner Lukken, we have always appreciated the relationship that our subcommittee and this full committee has had with you and your willingness to come and testify and provide us with information. Thank you both.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The Chair now recognizes the gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman.

I want to thank you, Mr. Chairman, for this hearing. I have a couple of comments and a couple of questions.

Dr. Newsome, you say a more difficult road lies ahead for us presumably about gas prices; and you mention a couple of outstanding factors in your testimony and just a quick note on China in tracking a lot of what takes place there. China's plan is to increase their per capita income from \$1,700 a year per person to \$3,400 per year. That means more folks with China with more money to spend on a variety of things, including the 30,000 or so cars manufactured each month in China as well. So the increase in demand for gas and oil is going to be there as well as in India.

You mention reduced refining capacity. As representative of a district with the four refineries north of California on the west coast, the only four, I can speak to the fact of what happens when they go into maintenance mode and shut down or slow down, as well as their current transition to low sulfur diesel. Those are critical factors. I would agree with your general assessment. There is a more difficult road ahead for us.

Both of you have mentioned that, in your opinion, there is no sign of manipulation in the market. I would agree with you. I would also, though, like to not just necessarily let you off the hook.

I would like for you to describe to us what manipulation looks like. What do you look for when you look for it, so we can be assured when we go back and tell folks, well, they told us there is no manipulation. They will say, how do you know? And we can say, this is what they look for and they are not finding it.

Commissioner Lukken, can you tell us what manipulation presumably would look like, what are you are looking for?

Mr. LUKKEN. Typically, corners or congestions or the typical manipulation case we see involve somebody holding onto a large position at expiration of the contract, when their position is larger than the rest of the marketplace and they are able to exert influence on the prices as those positions have to be potentially delivered upon.

So we have closely followed—and again we talked about spec limits and other ways that we sort of step down as these contracts expire to ensure that the prices with cash and futures converge. So we are constantly—it is mainly a control issue of large traders and expiration month that we look for.

But there are a variety of other ways that we have in the over-the-counter markets looked at false reporting are different indexes around and taken aggressive enforcement actions against that type of manipulation that might be broadcast out into the public marketplace outside of the futures market but that influence the futures markets. So those are the cases that we closely follow.

Mr. NEWSOME. I would just add to that. I think certainly Walt is correct. We look at historical trends, price differences between different products. We look at that every day to make sure that stays at least at a historical or traditional balance.

The reality is if a price attempts to get out of line, we hear it from the marketplace and we hear very, very quickly that something is awry. You guys need to look or you need to talk to specific market participants.

Mr. LARSEN. I am sorry, when you say you hear from the marketplace, does that mean you are monitoring a price or literally somebody tells you?

Mr. NEWSOME. Somebody tells us. Snitching. We hear loud and clear.

The reality of the way the markets work itself protects against manipulation because a number of you have been to exchanges and you have seen the pit and they are very competitive. You have got several hundred people in the pit doing business either with each other or against each other. And if somebody tries to take a price in a direction that the fundamentals do not support, there is somebody standing next to them or across the ring ready to take advantage of them at great economic detriment to the person trying to move in an unnatural manner. So I would say that the structure of the marketplace itself is the first offense.

And then, second, we have a number of ways that we monitor both humans—the cameras that I talked about. But I think, more importantly, we have very sophisticated computer systems that look at trading patterns, who they are doing business with, and we monitor those every day to study for anomalies and look for anything out of the ordinary.

So, like I said earlier, I cannot give you 100 percent assurance, other than to say that we do everything we can to make sure that the market operates fairly.

Mr. LARSEN. Specifically to your market and your role at CFTC that helps me then say more than "I know because they told me." it helps me understand exactly what you are looking for and helps me to explain to folks. I appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Minnesota, Mr. Gutknecht, is recognized.

Mr. GUTKNECHT. Thank you, Mr. Chairman.

Let me, first of all, say that I am a believer in markets. I am an auctioneer, and what you do every day is really an ongoing auction. I have described this to my constituents before that here in Washington we change laws and we amend laws but there is one law that is really hard for us to change and that is called the law of supply and demand. So I do understand that and I admire much of what you have said and I think you do the best you can every day to make sure there is not a manipulation of markets, at least that falls under your purview.

Let me clarify a couple of things. First of all, I know that was not your intent and it is a follow-up to what my colleague from Kansas talked about, and that is there has been a tendency by some of the people in the oil industry to blame ethanol for what is happening today. I just want to make it very clear that we have doubled the production of ethanol in the last 5 years. If we had not done that, I do not believe that oil prices would be cheaper. I honestly believe they would be higher. We have doubled the production, and we will double it again.

Then we hear from the oil companies, well, the problem is refining capacity. Let me remind everyone here that in the last 5 years we have built 53 new refineries. They are called ethanol plants. We are currently building 39 more, and there are 40 of them on the planning stages. So I really believe that renewable fuel long term is actually helping.

Right now, I will admit—and, frankly, we probably should have had someone from the Energy Information Office who could give better information about right now what is the bottleneck and what is the problem relative to ethanol. But I think we have to be careful to say that ethanol is the problem. I think ethanol long term is part of the solution. It is part of the solution today.

I want to clarify something else, because we are hearing this from the oil industry, that you cannot put ethanol in the pipelines. That is simply not true. They pipe ethanol in Brazil, and Brazilians are not smarter than we are. The problem is the technology they use to plug one commodity to the next. In other words, if they have been shipping diesel fuel, they use a water plug to differentiate between the diesel and the gasoline. Well, that water plug does not work with ethanol because it will mix with the alcohol. But that, it seems to me, is a relatively simple technological problem if the oil industry wants to solve that problem. I do not think they do.

I think there is a difference of opinion in terms of the oil industry. I just want to be very careful, though, because we hear this from some of the folks on the Intelligence Committee. It is a simple

statement, but I think it applies to what we are talking about here today. They say that absence of evidence does not necessarily prove evidence of absence, and what that means is just because you do not have evidence that there is manipulation of markets does not necessarily mean that it is not happening.

I think there are three terms we should be concerned with in this committee and what you do every day. One of them is speculation. And I think one of you said something to the effect, and I don't want to misquote you, but you said that speculators play an important role. Well, that is a little hard for a lot of our folks back home to really understand and perhaps even to swallow, but I do understand speculation. It happens every day in all kind of markets, and I think we can deal with a certain amount of that. But the second term is manipulation, and that is what we are really concerned about. But the third term we have not talked about today that I think is extremely important, and that is concentration.

Let me ask you, you said that 75 percent of the contracts at NYMEX, for example, are contracts that are initiated by producers. How many producers are there?

Mr. NEWSOME. Hundreds, and they represent all the segments of the business, from production companies to refineries to wholesalers, groups of retailers. It is numerous.

Mr. GUTKNECHT. Let me go back one step. How many big oil companies are there today?

One of the things we seen—and I must admit I am more of a Teddy Roosevelt Republican and we have allowed too much concentration in my opinion. You took two great big companies, Exxon and Mobil, and put them together. What the consumer got out of that transaction I do not know. But we now have a very small handful of megacompanies who control the production. They are not interested in lower prices in oil. They have a vested interest in driving oil prices higher. Would you not agree?

Mr. NEWSOME. I certainly cannot speak for the oil companies, but, yes, there is no doubt that there has been a decrease in the number of the major oil companies. All of those except ExxonMobil trade on our exchange. ExxonMobil does not trade in the futures market to hedge risk.

Then there are numerous middle-tier energy companies around the world that use the markets as well.

Mr. GUTKNECHT. I want to make it clear to the members that I believe that renewable energy is not part of the problem. I think it is part of the answer.

I also believe that we need to be very careful when we look at concentration right now, when you have very large companies that control large amounts of the overall production; and it strikes me that they have shown little interest in expanding their production or their refining capacity. While we see in the renewable fuel industry we are building hundreds of plants and they are all independent and they all compete with each other. So we do not have the concentration problem in renewable fuel. So I think, particularly for benefit of this committee and the folks who sit on this committee, we ought to make it very clear that we think that renewable fuel, while it may in the short term be causing some problems out there, in the long term, if the oil companies will work

with us, they will be a very important part in keeping our energy prices down.

I yield back.

The CHAIRMAN. I thank the gentleman for his observations.

The gentleman from Tennessee, Mr. Davis, is recognized.

Mr. DAVIS. Mr. Chairman and Mr. Peterson, I too, appreciate the opportunity to be here today in the hearing that is being held.

So often, a lot of the folks that I represent really feel that there has been a lack of oversight on many of the issues in this Congress. I tend to have to agree with them. Sometimes, as a sophomore in my second term, I, too, am disappointed in the lack of oversight. And, quite frankly hearings, not investigations and not special prosecutors but actually a hearing such as this on many of the issues that obviously we are talking now, about the markets and whether they are being manipulated by those who have deep pockets, and there obviously must be that concern.

I have traveled through my district, 19 of the 24 counties. When I look at the automobiles that many of the folks are driving and the factories that pay \$7 an hour or \$7.50 an hour and I see one or two really pretty cars, I realize who owns those; and I also realize those who are driving the other automobiles that they are lucky to spend \$7 or \$8 that morning to buy the gasoline that is required for them to go to work. For some reason, I just have a conscience that really makes grieve as a result of that.

But I also know that in this country we are capable of solving any problem, and I believe we will solve this one. It probably will be painful. It probably will continue to be painful for many of the workers who have low earnings in much of rural or urban or metropolitan America, and those folks we really need to have some concern for and certainly hope that this Congress will address the issue.

Perhaps if we go back to the mid to late 1970's after the wars in the Middle East and the battling of the OPEC nations that had some control of the amount of production that we have had—I can recall in the 1970's that a service station would open at 8 o'clock and close at 4 o'clock and their allocation had already been sold. I also know there were times that, even though I may have needed more than the 10 gallons of gasoline, that is all that the service station, even though he was my dear friend, would allow me to purchase.

So I realize back in those days, even though it may have been created, there was a shortage of gasoline for automobile consumption and for workers to use to get to and from work. I know today that the only thing there is a shortage in is the hip lettuce, that is, money in the pockets of working people, the green cash that is used to pay for gasoline.

Because when you drive up to a service station, it is open 24 hours a day now, in many cases, and there are several pumps and people waiting in line to buy the expensive gasoline to get to and from work. I know without the markets we might be paying more. Quite frankly, I applaud the opportunity for us to have markets that we cannot necessarily invest in but certainly the dollars that are made available to where it will continue to keep energy available for working men and women.

But I want to mention several things.

I watch the debate on the floor, and I hear Democrats blame Republicans, and Republicans blame Democrats, and that seems to be a good thing to do. My folks back home are saying, I do not care whose fault it is. Can't you all get together and do like the folks in Brazil? Aren't we any smarter than the folk that live in Brazil? What is wrong with America?

I remember Jimmy Carter during those days in the 1970's propose a comprehensive energy price. And because gasoline or oil prices dropped back to about 7 or \$8 a barrel, which means about 20 or 25 cents a gallon for raw crude, now it is costing us a dollar and a half plus. I realize that we probably converted back to buying fossil fuels because it was cheaper on us. We have reached a new level in this country where we have got to use our ingenuity, where we have got to use our intellect and the technology we have in conservation, alternatives and other areas.

I defy those who say that the environmentalists are causing this because it is the lack of refineries in this country. We have passed all kinds and joined all kinds of trade agreements that I think in many cases are unfair, and there is not a level playing field for American producers and workers. But if in fact we are able to do production with corporate America in other areas of the world, I am dumbfounded as to why we are not able to build a refinery where there will be no environmental issues in Mexico just south of us. Because over 50 percent of what we use in crude oil today comes from this hemisphere. And it boggles my mind to think that there is anyone, Democrat or Republican, that would say the refineries capacity is what is creating the situation or environmentalists are.

I know you can go just south of the Padre Island in Mexico, labor is cheap, no environmental issues. You go just south of San Diego and Tijuana, labor is cheap, no environmental issues. I just believe that there is a larger problem that we are facing today than just trying to pick out one or two issues and blame someone else for it.

For me, to the oil companies who had a hundred some billion dollars in profit last year, just please invest \$4 billion in about four different refineries in Mexico where some folks maybe can go back and get a good-paying job that they are getting here in this country, and that will cost you \$6 billion of the \$113 billion that you earned last year, and America could be happy again. That is the real problem. Then we solve that problem.

The question I want to ask you—but I guess I do not have time because that light is flashing red at me. When I stop someplace and ask for directions, I want a destination, I know the destination I am going to and I ask for the way because I am lost and I am looking to get there. I guess what I am asking you, Commissioner, are there any areas of enforcement or regulations that you feel could help reduce the cost of fuels for the average working families in this country?

Mr. LUKKEN. Well, again, we closely supervise one of the factors that are involved in the price of gasoline, so our efforts to prevent any type of manipulation through our surveillance, deterrence efforts, speculative limits, in my view, make sure that the markets work properly; and if they were not working properly there may be

artificial prices that may contribute to the price of gas. So I do believe our efforts have helped make sure that markets are working legitimately.

Those forces of supply and demand, as you mentioned, are there to bring price discovery to that marketplace. Certainly if all else fails we have our enforcement arm ready to police those actions and bring civil penalties against anyone who wants to manipulate the wholesale price of gasoline, and we are ready to take action.

Mr. DAVIS. I thank the gentleman.

The CHAIRMAN. The gentleman from Louisiana, Mr. Boustany, is recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman.

Gentlemen, thank you for your testimony. I really appreciate it. It has been very informative.

Coming from Louisiana, I have some understanding of the complexity of the energy markets. I have somewhat of a specific question that I want to address. We have sort of talked around it some today. Commissioner Lukken, for instance, in your written testimony I read, managed money traders, including hedge funds, are treated as noncommercial traders. And you state, as a group, they are a significant but a minority portion of the noncommercial positions in both gasoline and also crude oil futures.

Is there sufficient transparency in this arena for you to ascertain that there is no commercial interest and do you need some additional tools here? What challenges do you face as you approach this group?

Mr. LUKKEN. Well, when somebody comes into our marketplace as a trader, they have to fill out a series of forms to let us know more information, more transparency about what the trader is trying to do.

Again, we can categorize these folks as commercials, those that are in the business or they are trying to hedge their positions, non-commercials, those that are involved with speculating. We have some that are swap dealers that are doing some of this business over the counter and then bringing their net risk positions to the market. So we learn as these participants come to the markets quite a bit of information about who is participating in these markets.

As you said, the largest participants in our markets are the commercials. Those that are actually involved in production agriculture in the grain markets or maybe in the supply chain of energy markets, in the energy futures markets, that is the biggest percentage; and these are the folks that normally are the ones hedging their position. They have risk and price exposure and have price fluctuations in the market, and they want to hedge that.

So everybody else goes into this sort of miscellaneous speculation category. But we as an agency are able to refine that even further into hedge funds very specific data so that we can closely follow that type of information.

Mr. BOUSTANY. So you have historical data, you have statistical data, and, of course, all the information technology at your disposal to monitor this group.

Mr. LUKKEN. When I say transparent, it is transparent to us as a regulator. It is not transparent necessarily to the markets. Too

much transparency could allow traders to discover other traders' positions, and then they would be fleeing these price discovery markets, and we do not want that. As regulators, we want to be able to see the entire marketplace, who the participants are; and I think NYMEX in its SRO function does the same thing.

Mr. BOUSTANY. That was the point of my question, was to determine what is that balance. Because certainly these are the tools you need to look for market manipulation.

Dr. Newsome, do you have anything you want to add to that question?

Mr. NEWSOME. I think Commissioner Lukken did a good job of explaining it. Certainly when you look at the regulated markets such as NYMEX, they are completely transparent. Prices are transparent on a real-time basis for the whole world to see what is going on in the market. Obviously, those who are behind those positions are transparent to us, transparent to the CFTC so that they can monitor and protect against anti-manipulation.

But, as I said earlier, we are but one piece of the whole pie. We are the regulate-transparent component of that pie, and there are other segments of the trading community of which we do not have that same kind of transparency. So I think those are some issues that the committee may wish to take a closer look at as time goes on.

Mr. BOUSTANY. I appreciate your answer.

I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

The gentleman from Hawaii, Mr. Case, is recognized.

Mr. CASE. Thank you, Mr. Chairman.

Obviously, what we are trying to do is to figure out why prices have spiked up again and again. There is no hurricane this time. Oil refineries have had this perceived shortage for a long time. The Middle East has been insecure for a long time. The question of ethanol is uncertain in my mind, using the reasons that you raised, Dr. Newsome.

I think, focusing on what we are trying to accomplish right in this hearing, one of the potential suspects that we are trying to get to the bottom of here is the question of whether the energy futures and options markets are reflecting market conditions or causing market conditions. We want it to reflect market conditions, not cause them. That is the issue of manipulation in which you, Mr. Commissioner, have said is essentially where we are. We are focusing on manipulation. You have testified not that you do not believe that manipulation is taking place but that the mechanisms that you have for controlling manipulation are effective for keeping it to a dull roar, if I can put it that way.

One of the things in your testimony that I was just curious about was that you testified since December 2002 you had filed 32 enforcement actions charging 27 companies and 23 individuals in cases involving natural gas and assessed \$300 million in fines. But did I hear correctly that, in terms of cases that involved crude oil or unleaded gas, what would be the comparable record in that area? Did you testify there has been no enforcement action then? I guess the question is, OK, you talked about natural gas, but let's talk about oil.

Mr. LUKKEN. In the natural gas markets, a lot of the activity was over the counter and a lot of those cases that we brought in the 3 years since then have been us using our anti-manipulation authority which extends to over-the-counter transactions. Those cases in particular were dealing with false reporting where transactions were being done over the counter and they were reported to a price index for publication to the public. So our section 9 anti-manipulation authority applies those transactions.

With crude oil, we are obviously exploring its volatility. I mentioned in my testimony that we have 12 open cases currently involving energy cases. Some of those are crude oil. Some of those are gasoline. So we are constantly trying to find out whether there has been any type of price aberrations or anti-manipulation activity in this area.

Mr. CASE. Have there been actual fines imposed for manipulation in the crude oil, unleaded gas markets during that same period.

Mr. LUKKEN. There may have been fines imposed by the futures markets because that is where the primary market is, and I will defer to Dr. Newsome on this, but as far as what we have seen in the over-the-counter space that we typically use our anti-manipulation authority over, we have not seen anything to date. However, as I said, we certainly are investigating those areas right now.

Mr. CASE. I guess what I am trying to figure out from a layman's perspective is what is so different about the natural gas market that lends itself apparently to a little bit more potential manipulation or enforcement versus the market that we are trying to get into right now? Am I missing something there? Is there a ready explanation?

Mr. LUKKEN. I think the natural gas markets had certain index pricing mechanisms that Platts and other organizations had organized for the over-the-counter products that were outside the futures space. I think crude oil and the gasoline are more of centralized futures markets. There is some over-the-counter business obviously that we can talk about, but primarily, I think that is what brought our attention in 2000. And one investigation lead to another, lead to another, but certainly we are not closing our eyes to crude oil or to gasoline and will continue to police those areas.

Mr. CASE. Now one of the areas that somebody that is not familiar with what you do, believes, judging from my layman's e-mails and my layman's communications is information manipulation. You talked about congestion and corners and that kind of stuff. But most people that are concerned in this area believe that there is the purposeful introduction into the markets of false information designed to cause a market response that they can be prepared for and take advantage of. Have you seen that in terms of the investigations that you are conducting.

Mr. LUKKEN. Historically, we have seen people who have brought false information into the marketplace and taken action against them. A lot of the information comes from the public. USDA, Federal Reserve, BLS and other organizations that provide information to the public have certain regulations administered by those organizations that regulate when that information is released to the public. And we have certainly investigated potential leaks of those cases in the past.

Mr. CASE. But that would be manipulation from your perspective in terms of investigation.

Mr. LUKKEN. If it brought an artificial price, certainly.

Mr. CASE. Final question, one of my colleagues, our colleagues, is circulating a Dear Colleague for some proposed legislation. The point that he makes is that the problem is not what we are regulating, but what we are not regulating. The specific point he makes is that 75 percent of the futures markets in energy is in fact occurring off-market unregulated. And he believes we should expand your authority to incorporate the regulation of off-market trading.

What is your reaction to that? First of all, is he accurate factually?

Mr. LUKKEN. I believe that may be an accurate number. I will have to check on that. Our authority primarily is focused on this centralized marketplace where price discovery is happening. A lot of the markets that he was referring to are bilateral transactions that are happening off the marketplace. No one in the public is really relying on the pricing that coming from those transactions.

If we see a situation that arises in the futures markets that we may want to discover more information from the over-the-counter space, we have the ability through special call and other mechanisms to get to that information—to find out what the positions may be in the over-the-counter market that might be effecting positions on the futures exchanges.

So we currently, we do look at that, and certainly on the enforcement front, our powers are not limited to the futures markets. But anything that may effect interstate commerce.

So we have used that authority as it effects futures markets to ensure that prices are not being manipulated.

Mr. CASE. But there are clearly transactions occurring outside of the normal markets that are not specifically regulated by your jurisdiction; is that correct?

Mr. LUKKEN. That is correct.

Mr. CASE. Do you think that is a problem that could be leading to some offline manipulation, if I could put it that way?

Mr. LUKKEN. Well, we certainly have the ability to go after it if we find it. I think, in 2000, when Congress passed the Commodity Futures Modernization Act, it made the determination that most of these markets were institutional financial markets not deserving of the CFTC's attention and regulation.

A lot of them, a lot of those products also are being run through regulated companies, through banks, through SEC-registered entities. So I think that the thinking of the President's Working Group in 1999 when they made that determination was that those were sufficiently regulated for their views.

Mr. CASE. Thank you.

The CHAIRMAN. I thank the gentleman. The gentleman from Texas, Mr. Cuellar is recognized.

Mr. CUELLAR. Mr. Chairman, thank you very much, and thank you, Mr. Chairman, for having this important meeting and of course, Dr. Newsome, and Commissioner, thank you very much for being here with us.

I represent several rural counties in Texas. And as you know, since 2002, the farm field prices have more than doubled up to 113

percent. Since 2002, fertilizer prices are up about 70 percent. That is a price increase of 10 to 20 percent each year.

Fuel and fertilizer prices and cost for corn run an estimated \$124 per acre, for cotton about \$70 per acre, the rice about 99 percent per acre. The impact of rapidly rising energy costs for Texas producers is bad right now. I think this impact will be worse in the fall when many of these producers use up the fertilizer and fuel that they locked in last year.

Of course, I am concerned about high energy costs not only for the urban areas but for the rural areas, like members of this committee, especially when the impact it will have on the productivity of our farmers and ranchers as they continue to provide America, Americans with a safe, abundant and affordable food supply.

Yesterday in the Washington Post, the business writer, Steve Pearlstein asserted that at least \$15 of a barrel of crude oil was due to increased speculation by pension funds and other non-industry investors, as one of the other Members was mentioning a few minutes ago.

Pearlstein said that, 2 years ago, this group had about \$20 billion in the market. Today they have about \$150 billion in the market.

Yet, Dr. Newsome, in your testimony, I think your quote was, "It was widely yet inaccurate to theorize that speculators can drive up the market." And I will be the first one to say I believe in the law of demand and supply.

But still, how would you square your statement, Dr. Newsome, given our knowledge, and speculative bubbles do occur—let's witness the crash of the dot coms, and I guess my question to you, and, commissioner if you want to just add upon this, how are we going to make sure that we are not seeing any unusual speculative activity in crude oil and gasoline prices?

And I know what your testimony was a few minutes ago that the rules are there. The policies are there. You are doing everything possible. The transparency on behalf of the speculators. But again, there are certain facts out there, how do we square that together, and how do we know that there is not something unusual, believing like we all do, in the law of supply and demand? But how do we know that there is not some unusual activity going on at this time?

Mr. NEWSOME. I would say a couple of things, Congressman. One, I don't know where that \$15 comes from. I would like to look at an analysis of how they come up with that, because personally, with my experience in the markets, I would find that certainly not to be the case.

Secondly, with regard to blaming that on speculators, because speculators do not have the ability to make or take delivery, they don't trade to the settlement price. And the settlement price is what is used by the marketplace as the pricing benchmark. And speculators are not active in the market at that point.

So it is impossible for the speculators to have the kind of impact on a price that this article would seem to indicate.

Mr. CUELLAR. So, how do we get to that point? If the speculators are not at that point, is it like Congressman Case said a few min-

utes ago, that we need to expand a little bit more? Or what do we do?

Mr. NEWSOME. I think, again, when you look at NYMEX, the markets that the CFTC oversees, I have a great comfort in not only the current levels of regulation but in terms of the oversight capabilities of both the exchanges and the commission.

But that is but one piece of the overall energy component. You have multiple components, the cash market of which is the 800 pound gorilla; the volatility in markets actually occurs in the cash market. The futures market makes that volatility transparent for everyone to see through benchmark pricing.

A huge component of the market is the over-the-counter market. And there have been various arguments since I was at the commission over whether or not that should be regulated.

I continue to believe now as I did then, that that component of the market does not need direct oversight regulation because you have got bilateral activity between very large commercial companies, between commercial companies and banks, the price is individually negotiated between the two that shift risks from one to another. That system works very, very well.

And but then, as the markets evolve, you see other things that come up. The ICE, the intercontinental exchange was mentioned earlier. That is an area that we have asked the commission to take a closer look at in terms of that regulatory structure, whether it should be regulated as a futures market because of the activity that they are involved in.

So I think the Congress and the commission made the right choices in the year 2000, but we do have to admit to ourselves that this market is changing and evolving, and because of that, the work of this committee and the commission is very, very important.

Mr. CUELLAR. And I know I think every Member has said, every time we go back to our districts, besides immigration reform, this is the other issue that has come up. And I know sometimes people want a simple answer. They want a magical, this is the cause. But there are so many factors involved from the supply of crude oil to distribution and everything, so, any suggestions that both of you all can give the committee, we would really appreciate it. Because we know there is no magical solution out there, but anything you could give us we would people it. We thank you.

Mr. MORAN [presiding]. The gentleman's time has expired.
The gentleman from Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman. I want to ask my question relative to a direction which I believe we need to go which much emphasize has not been placed upon and that is this: 2 years ago, John Thompson of ExxonMobil made the statement that we are dealing with a very serious resource of diminishing returns.

He said 3 years ago that, each year, we are losing 6 percent of our capacity of producing oil. With that, knowing that, we are losing that capacity, knowing that we are dealing with a diminishing resource. He also said that, within 15 years, two-thirds of the known oil reserves would be in the Middle East, a very volatile, very dangerous section.

My point is this, that given the fact that we are dealing with a diminishing resource, given the fact that everything on the horizon where we can look says the wrong thing for us to continue to do is to base our future energy needs on oil—and a recent report on CNN reported that Brazil is moving in more of the right direction with ethanol, that in fact, they are very successful and fueling their economy, fueling their automobiles, with a very renewable product that they can continue to grow and grow, and that is sugarcane. But yet here in the United States, there is this tug of war; there is this schizophrenic attitude towards what we can do.

And I just want to hear from you two gentlemen because all the other questions I wanted to ask have already been asked. So I would like to get from you, why are we in this schizophrenic attitude involving ethanol, and particularly given the fact that our plentiful production of corn, which could be the most basic element of it, especially in light of what Brazil is doing?

Why can't we do what they are doing? And why are we not putting more emphasis on getting alternative fuel needs as opposed to continuing down this road of pursuit of oil which is a diminishing resource at best?

Mr. NEWSOME. Congressman, I would simply say that prices are the best drivers of economic direction. And I think the prices that we are currently experiencing are going to push us exactly in the direction that you are suggesting.

Alternative fuels, as you can tell, my accent didn't come from living in New York very long. So I am sensitive to the issues raised by this committee, because my Dad is a farmer and is experiencing the difficulties that all of us have talked about.

But I think the price pressure that we currently see is going to move us exactly in the direction you suggest with regard to more conservation, alternative fuels and the utilization of new technology.

For example, one of the largest known but relatively untapped crude supplies in the world is in Canada with the capability of producing 10 million barrels a day, which is as much as we get currently from Saudi Arabia. But it is intertwined in sand and minerals, and it is very difficult to refine and to get the usable crude out. The cost of doing so today is 20 bucks a barrel just to refine it to a component that is useful.

So without prices today, nobody had the pressure or the desire to try and develop that technology. But that technology is currently being worked on. So I think we are going to see a number of areas pushed by the current economics.

Mr. SCOTT. Do you see, either you or your regulatory agency, but do you see where more regulation will be or can be a factor in reducing the price of oil?

Mr. LUKKEN. I think as far as regulators, we have to be tailored in our approach. The appropriate amount of regulation, smart regulation, if we see a problem that needs to be addressed, we need to try to administer the right amount of medicine for that problem. And that has really been the approach that we have adopted since the CFMA's passage in this committee in 2000.

So I couldn't say, as a general rule, regulation will drive down gas prices. But we are certainly there when needed, when the risks to the public occur.

Mr. SCOTT. Could over-regulation drive it up as well? For example, one immediate issue is the Intercontinental Exchange.

That is being bandied about now. There is some concern that it needs to be regulated by United States regulation.

My feeling is that might be a particular case where we ought not to regulate, intercontinental, that it is being regulated enough already by the European regulation. I think the British are regulating it.

Where do you come down on that, particularly in view of the fact that there appears to be some sentiment in the Senate to regulate ICE?

Mr. NEWSOME. Let me say up front that my viewpoint is probably a little bit biased towards that answer.

The way we look at it, the reason we have asked the CFTC to review this is that when ICE took advantage of the foreign no-action letter, we thought it was completely legitimate and there was—the argument is, are they still foreign exchange? And, closing the floor, moving all the trading mechanisms to Atlanta and operating them under a different regulatory scheme does create competitive issues.

For example, we have hard position limits required by the CFTC, ICE doesn't have those hard position limits. So in terms of the speculative trade, we have numerous market participants who bump up against those limits on NYMEX and then are forced to quit trading or to move to the Intercontinental Exchange which has no hard limits.

So it creates competitive issues. We are simply asking the commission—and they are responding—to look at whether or not ICE is, in fact, a foreign exchange or a domestic exchange. And I think the answer to that question will then drive the appropriate regulatory response.

Mr. SCOTT. But don't you think it would place a tremendous unnecessary burden on ICE?

Mr. NEWSOME. I think if they are trading futures contracts that are the same contracts that we trade at the New York Mercantile exchange, for all the reasons that we are regulated to protect the marketplace and customers, I think it seems they should operate on a level playing field with us.

Mr. MORAN. The gentleman's time has expired. The very anxious gentleman from California is recognized.

Mr. BACA. Yes, I have been anxious, and I think there are 30 other people who asked the question, but I still think it is very important. First of all, I want to thank the chairman for having this and our ranking minority member, Collin Peterson, for having this important hearing, especially as it pertains to alternative fuels as well as many of our constituents in other areas are very much concerned with where it is going, and they are asking us, what is it you are doing about the gas prices? It has escalated to a point where they feel that Congress has got to do something. And it has impacted all of us.

So I thank the chairman, and of course, the minority member for having this hearing.

My first question pertains to Mr. Lukken. In your testimony, you described that 3 million-some penalties have been imposed, but yet when we look at these penalties that have been imposed on many of these companies right now, my question is, when you look at, and this is what the consumers and others are very much concerned, when you look at the report by the Washington Post, it has ExxonMobil reporting \$8.8 billion in profit this quarter. That is the fifth highest quarterly profit reported in the history. And it is very appalling to consumers and others to say, how is it that our gas prices are going up? How is it that these reports of quarterly reports such as Exxon has made \$8.8 billion? Yet when you look at the penalties of only \$3 million in penalties towards everyone? It seems it is a small amount of dollars.

What can be done in reference to these particular fines? Can we increase the fines to have equal value of the profit? Maybe that is something we have to do to really get these individuals to enforce what needs to be done and really address the problem.

Mr. LUKKEN. Well, our penalties, as you reference, are set by statute, where we have some limitations. I think it is actually \$130,000 per violation currently. And so we are somewhat limited by statute of what we can do.

Mr. BACA. Does that mean we have to change the statute?

Mr. LUKKEN. I think there has been some discussion in Congress about amending our penalties.

Mr. BACA. Maybe that is the direction we have to do. Our consumers are saying, do something, so if we change the statute then maybe some of these companies will look at what they are doing right now, and how they are gouging a lot of our consumers.

Mr. LUKKEN. I think that has been, in order to recognize the weight of manipulation and how harmful that might be to the public there have been some discussions among this committee and others about changing penalties.

Mr. BACA. You have indicated you have 12 open cases right now especially as it pertains to crude oil or gasoline.

When do you think these cases are going to be closed? Because that has an impact in terms of any action in terms of what is going on right now and what our consumers are asking for is immediate action so this way we don't continue to escalate the gas prices, and can we do it if they are being investigated?

Is there a possibility of putting a freeze in terms of increasing the prices until these cases are even heard?

Mr. LUKKEN. Again, this is dealing not at the retail pump level of gasoline but those involved in the futures markets' trading of gasoline or similar derivatives.

I can commit to you that we are working as fast as we can to bring these cases to fruition, to bring them to court or to settle if that is appropriate. So we will try to keep this committee apprised of the investigations and how those are going.

Mr. BACA. It would be nice if we had a freeze on them, so this way at least our consumers wouldn't be effected.

Mr. Newsome, what would happen if NYMEX were to suspect any improper activities in the market?

Mr. NEWSOME. Well, if we suspect it we would immediately start an investigation. Based upon the results of that investigation, we could fine, remove the person from the marketplace, any level of numerous sanctions against either the company or the individual.

Mr. BACA. That is why, again, I asked the questions some of them don't mind the fines because the fines are smaller than the profit margin. So I think we have to look at the statute of increasing it to make it equivalent to where it would be painful so this way our consumers aren't effected.

Mr. BACA. How rare is it to find market manipulation in this setting?

Mr. NEWSOME. I think it is very rare because of the protections we have in place, it typically doesn't get to the point that the market actually becomes manipulated. We have surveillance mechanisms, both physical and electronic that are utilized, and at the earliest sense of any aberration in the market, it becomes detected and stopped at that point.

Mr. BACA. Mr. Lukken, does over-the-counter gasoline markets operate in a similar manner to natural gas market, question No. 1? And has CFTC brought similar enforcement actions against OTC gasoline markets?

Mr. LUKKEN. I can't speak to the particulars of the over-the-counter gasoline markets, and structurally, how it is in comparison to natural gas. However, I would say that we continue to look at the situation that we learned from the natural gas market and applying to these other energy over-the-counter transactions. If we see similar types of false reporting or manipulation, we will bring action and the penalties will be severe.

Mr. BACA. Regarding the special call for position data, do you generally limit them to participants who show up in the large trader reports, which is question No. 1 and what signs would trigger a special call on a participant who is not a large trader?

Mr. LUKKEN. Normally, the special call authority is focused on participants in the futures markets, the positions that we see them, that may cause concern, and our surveillance economists may need more information. So we are able to, through the special call authority, ask for other positions in the cash market or over-the-counter positions that may be the motive of why they may be trying to manipulate the futures markets. And it has proven successful in the past.

Mr. BACA. When CFTC staff contacts large long- and short-sighted traders to obtain information about their intentions, delivery capabilities and et cetera, what ensures that traders are honest and upfront about their answers? And are there penalties for lying or providing misleading information to CFTC market surveillance staff in this manner, as well?

Mr. LUKKEN. I think most of the people that we contact are known entities in the markets. Certainly, we have close relationships with the exchange's SRO functions, and they know their market participants as well and who has the ability to receive and provide delivery.

So it is a dialog that we have not only with the exchanges but also the end users to determine, and if we need to, we will send people out to see the facilities that they claim to have. But nor-

mally, these are known entities, and we work with exchanges on making sure that that occurs.

Mr. BACA. I know that my time has run out, but since I am the last one here, I guess I can keep asking the questions until I get the gavel hit.

Mr. MORAN. Briefly you can.

Mr. BACA. You mentioned that, as required in the energy bill, the CFTC and the Federal Energy Regulation Commission has executed a memorandum of understanding with regard to information on special market participants.

Are the CFTC at first cooperating at this time regarding your prospective activities in the energy markets?

Mr. LUKKEN. Yes, we are. And not only on the enforcement side, but also on the surveillance side, they often come to our surveillance briefings on Fridays to get an update on what we are doing in the futures markets and provide us an update on what is happening in the cash markets.

Mr. BACA. Thank you very much.

Mr. MORAN. You are very welcome. Let me ask just a follow up question. One of the things that happened in the 2000 Modernization Act was to give legal certainty to transactions in exempt commodities which include energy contracts traded between eligible contract participants, and I think it was Mr. Case and maybe you, Mr. Lukken, had a discussion about those contracts.

Mr. Newsome, has NYMEX analysis shown any artificial increase in price, in oil contract trading since that legal certainty was granted in these off-exchange contracts?

Mr. NEWSOME. We don't have an ability to monitor the off-exchange contracts. So it would be very difficult for me to answer that, Mr. Chairman.

Mr. MORAN. Mr. Lukken?

Mr. LUKKEN. We have not seen any type of problem from the 2(h)(3) markets, the exempt market. And let me just be clear because I think there has been some confusion. The exempt marketplace, which is based in Atlanta, also owns as a subsidiary the ICE Futures regulated market space, which is based in London and separately run by a board of directors, compliance staff based in London as well.

That is where the crude oil is being traded currently.

The exempt market is primarily natural gas and has no gasoline and very limited crude oil if at all. So as far as our topic of today, really the 2(h)(3) markets don't have any direct impact on crude oil prices or gasoline prices.

Mr. MORAN. Thank you for that clarification.

Let me ask either one of you, Commissioner Lukken or Dr. Newsome, do you have anything that you would like to add on the testimony you previously made, particularly in response to any questions? Let me give you that opportunity.

Mr. LUKKEN. I think what I said speaks for itself, thank you.

Mr. MORAN. Doctor Newsome?

Mr. NEWSOME. Just appreciate the opportunity to be here, Mr. Chairman, and to continue our productive dialog.

Mr. MORAN. You are very kind. I appreciate the opportunity to hear what you have to say. And this committee will then conclude its work for the morning.

Without objection, the record of today's hearing will remain open for 10 days to receive additional testimony and supplementary written responses in regard to any witness for any question proposed by any member of this panel.

Mr. MORAN. This hearing of the Committee on Agriculture is now adjourned.

[Whereupon, at 12:30 p.m., the committee was adjourned.]

[Material submitted for the record follows:]

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

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

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

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

A. The Commodity Futures Trading Commission's Core Mission

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

counter (OTC) markets look to futures markets to discover prices that accurately reflect information on supply, demand, and other factors. Both functions would be harmed by manipulation of prices.

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

B The CFTC's Market Oversight Program

To the full extent of our congressionally conferred legal authority, the CFTC attempts to proactively identify and mitigate the potential for price manipulation. When any new futures or options contract is listed for trading on a futures exchange, the CFTC staff reviews the terms and conditions of the contract to determine if it is readily susceptible to manipulation. For example, although most futures contracts are ultimately financially-settled (meaning participants offset their positions through the exchange by paying or receiving money rather than by making or taking delivery of the actual commodity), the CFTC carefully examines those contracts that permit physical delivery (as do key energy contracts on the New York Mercantile Exchange, or NYMEX) to ensure that the deliverable supply of the commodity is sufficient to facilitate orderly deliveries and liquidations at contract expiration dates, and to prevent any would-be manipulator from cornering or squeezing the market.

Every trading day, CFTC staff closely monitors trading activities on the exchanges to detect unusual activity or price aberrations that may indicate actual or attempted manipulation. The cornerstone of the CFTC's market surveillance program is the Large Trader Reporting

System. The Large Trader Reporting System requires clearing members, futures commission merchants, and foreign brokers to file daily reports with the CFTC concerning their own and their customers' positions in a particular contract. This reporting requirement is triggered when a trader holds a position at an exchange that is at or above specific reporting levels set by CFTC's regulations. Through Large Trader Reports, the CFTC becomes aware of concentrated and coordinated positions that might be used by one or more traders to attempt manipulation.

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

Market surveillance is not conducted exclusively by the CFTC. Each futures exchange is required under the CEA to affirmatively and effectively supervise trading, prices, and positions. The CFTC examines the exchanges to ensure that they have devoted appropriate resources and attention to fulfilling this important responsibility. The CFTC staff's findings from these rule enforcement reviews are reported to the Commission, and are publicly posted on the CFTC Web site (www.cftc.gov). Furthermore, exchanges must impose position limits, where appropriate, to guard against manipulation. For example, NYMEX imposes spot month speculative limits on its energy futures contracts.

When the CFTC's surveillance staff identifies a potentially problematic situation, the CFTC engages in an escalating series of communications to work to resolve the situation. Typically, the CFTC's staff consults and coordinates its activities with exchange staff. CFTC staff contacts the largest long- and short-side traders to obtain information on, among other things, their delivery intentions and capability, and their price objectives in liquidating trades.

The traders are advised of the CFTC's concern regarding the orderly expiration of the futures contract, and reminded that they are expected to trade in a responsible manner. This targeted regulatory oversight by CFTC staff and the exchanges is quite effective in resolving most potential problems. When, however, staff is not satisfied that it has been successful, a more formal written warning will be issued to notify the trader of the CFTC's concern about the possibility of manipulation.

Given the CFTC's statutory role as an oversight regulator, and the exchanges' statutory responsibility to monitor trading to prevent manipulation, the law requires that the exchanges take the lead in resolving problems in their markets, either informally or through emergency action. If an exchange fails to take actions that the CFTC deems necessary, the CFTC has broad emergency powers to direct the exchange to take such action, which, in the CFTC's judgment, is necessary to maintain or restore orderly trading in, or liquidation of, any futures contract. Such actions could include limiting trading to liquidating transactions, imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period, or in extraordinary circumstances, closing a market. Fortunately, most issues are resolved without the need for the CFTC's emergency powers. The fact that the CFTC has had to take emergency action only four times in its history demonstrates its commitment not to intervene directly in markets unless all other efforts have been unsuccessful.

C The CFTC's Enforcement Program

The CFTC aggressively pursues any individual or entity that intentionally seeks to disrupt or undermine the integrity of markets for trading commodity futures and options contracts. The CFTC's Division of Enforcement investigates and, as appropriate, prosecutes individuals and entities for violations of the CEA or CFTC regulations, including manipulation and false

reporting, as well as trade practice abuses (*e.g.*, wash sales and accommodation trading) involving trading on markets subject to CFTC oversight. The proposed sanctions sought in the CFTC's enforcement actions serve the dual purposes of obtaining redress for the charged violations and acting as a deterrent for would-be violators by sending a clear message that improper conduct will not be tolerated.

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

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

If warranted at the conclusion of its investigation, the Division of Enforcement will recommend that the CFTC initiate a civil injunctive action in Federal district court or an administrative proceeding. The CFTC may seek temporary statutory restraining orders and preliminary and permanent injunctions in federal courts to halt ongoing violations, as well as civil monetary penalties, appointment of a receiver, the freezing of assets, restitution to customers, and disgorgement of unlawfully acquired benefits. Administrative sanctions may include orders suspending, denying, revoking, or restricting registration; prohibiting trading; and imposing civil monetary penalties, cease and desist orders, and orders of restitution.

The CFTC is a member of the President's Corporate Fraud Task Force, which is chaired by the Department of Justice. The CFTC may refer an enforcement matter to the Department of Justice and criminal activity involving commodity-related instruments can result in prosecution for criminal violations of the CEA and for violations of federal criminal statutes, such as mail fraud or wire fraud.

In recent years, the CFTC's Enforcement program has conducted an extensive investigation of alleged abuses in energy-related markets. This investigation has focused on energy trading firms that allegedly have engaged in: 1) reporting false, misleading or knowingly inaccurate market information (including price and volume information) to natural gas reporting firms which affects or tends to affect the market price of energy commodities, including futures prices as traded on NYMEX; and 2) manipulation or attempted manipulation which could affect prices of NYMEX energy futures contracts. The CFTC's enforcement actions in the energy sector reflect an approach to market oversight that emphasizes tough enforcement actions against proven wrongdoers. As a result of its efforts in investigating wrongdoing in the energy markets, the CFTC has filed 32 enforcement actions charging 27 companies and 23 individuals in cases

involving natural gas since December 2002. These enforcement actions have thus far resulted in civil monetary penalties totaling nearly \$300 million, among other sanctions.

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

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

1. Participation Rates of Non-Commercial Traders

Data from the CFTC’s Large Trader Reporting System help answer questions about the role of non-commercial traders in futures markets for crude oil and unleaded gasoline. A weekly summary, called the Commitments of Traders (COT) Report, is based on information gathered through the Large Trader Reporting System. The CFTC publicly releases the COT Report every Friday afternoon via its Web site (www.cftc.gov).

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

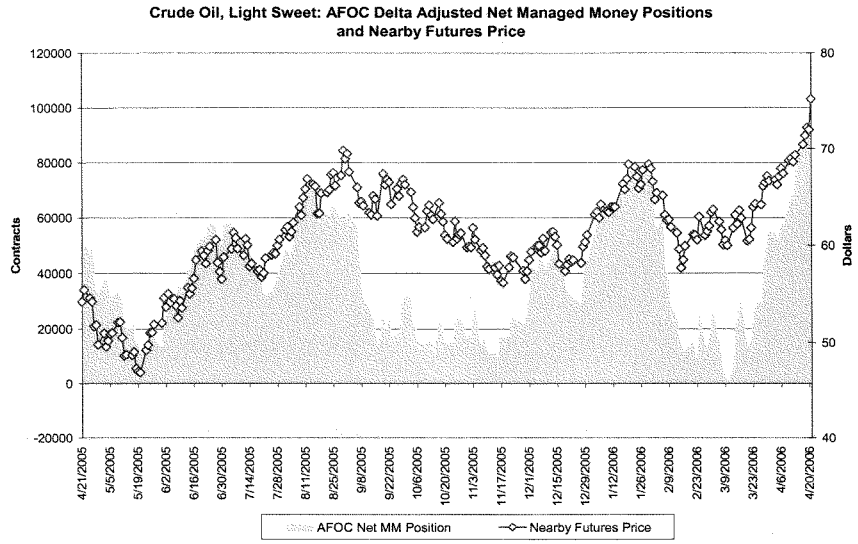
short positions. In unleaded gasoline, non-commercial traders hold approximately 21.8 percent of the open long positions and 7.0 percent of the open short positions.

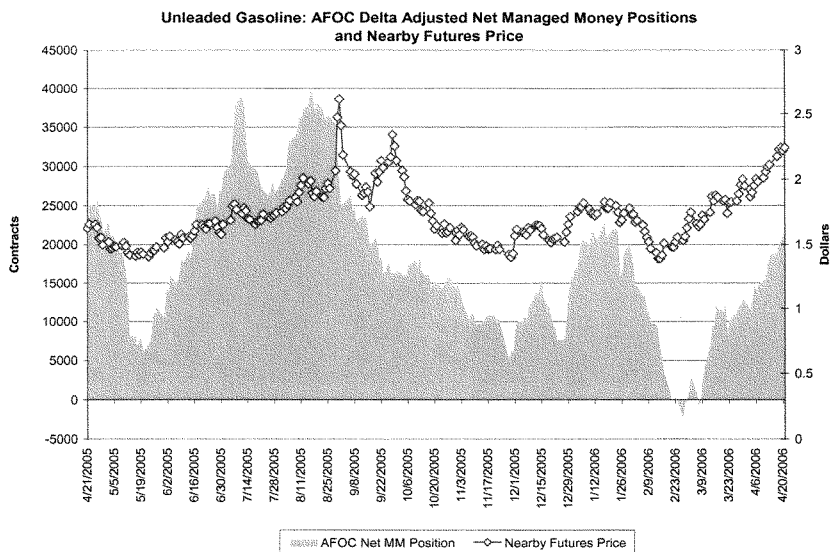
Positions in both crude oil and unleaded gasoline futures markets are held predominately by commercial traders – that is, producers, refiners, and retailers, who are commonly known as hedgers. In the crude oil futures market, approximately 55.6 percent of outright long positions (*i.e.*, positions that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

Managed money traders, including those called “hedge funds,” fall into the category of non-commercial traders because they do not have a commercial interest in the product upon which the futures contract is written. As a group, managed money traders represent a significant – but minority – portion of the relatively small percentage of non-commercial positions in both crude oil and unleaded gasoline futures markets. On average, managed money traders make up approximately 47 percent of the non-commercial long positions and 26 percent of the non-commercial short positions in the unleaded gasoline futures markets. In the crude oil futures market, managed money traders make up 44 percent of the non-commercial long positions and 36 percent of the non-commercial short positions.

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

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





The role of non-commercial traders in futures markets has been studied extensively, both by the CFTC's economists and others. One lesson from these studies is that non-commercial traders are necessary in order for futures markets to fulfill the needs of hedgers. An "all hedgers" market simply can not work. In order for hedgers to reduce the risk that they face in their day-to-day commercial activities, they need to trade with someone willing to accept the risk the hedger is trying to shed. Therefore, both hedgers and speculators are necessary for the futures markets to perform their vital role of transferring risk to those who are willing to accept it for a price.

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

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

2. *A Snapshot of Current Futures Market Prices*

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

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

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

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

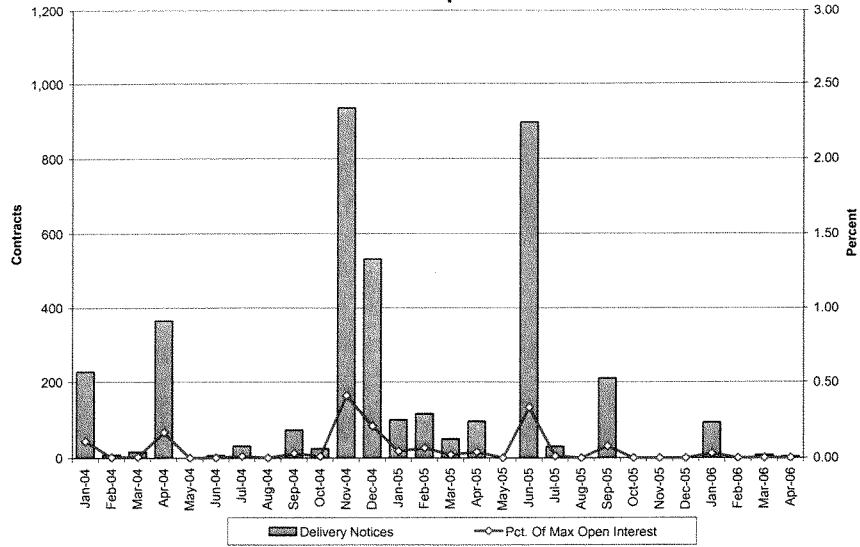
In recent years, with increased economic growth in China and elsewhere, demand for petroleum products has risen faster than have supplies of these commodities. This has created very tight demand/supply balances in these markets. In economists' jargon, both supply and demand for crude oil and unleaded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

3. *Recent Delivery Experience*

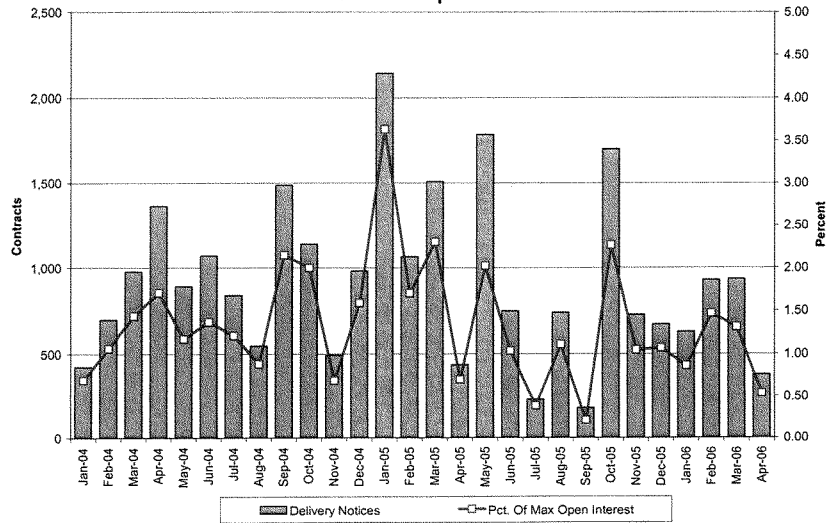
Figures 3 and 4 below show deliveries for crude oil and unleaded gasoline contracts since January 2004. The vertical columns depict the number of contracts delivered. The number of contracts corresponds with numbers displayed on the left-hand axis of the figures. The continuous line, corresponding to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

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

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



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

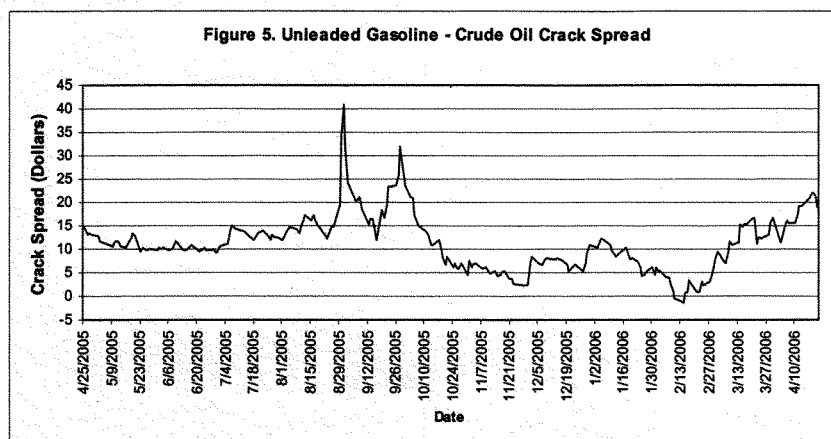


4. *The Relationship between Crude Oil Futures Prices and Unleaded Gasoline*

Futures Prices

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

blending, or "RBOB," to which ethanol will be added.



E. Conclusion

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

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

STATEMENT OF JAMES E. NEWSOME

Mr. Chairman and members of the committee, my name is Jim Newsome and I am the CEO of the New York Mercantile Exchange (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products. We have been in the business for 135 years and are a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC) both as a contract market and as a clearing organization. On behalf of the Exchange, its Board of Directors and shareholders, I thank you and the members of the Committee for the opportunity to participate in today's hearing on the futures market and gasoline prices.

NYMEX provides an important economic benefit to the public by facilitating competitive price discovery and hedging. As the benchmark for energy prices around the world, trading on NYMEX is transparent, open and competitive and heavily regulated. Contrary to some beliefs, NYMEX does not set prices for commodities trading on the exchange. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts and, being price neutral, does not influence price movement. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information.

There is a strong beneficial and interdependent relationship between the futures and the underlying physical commodity or "cash" markets. The primary motivation for using the futures market is to hedge against price risk in the cash market. Price volatility drives many into the futures markets. Many prudent business managers rely on the futures market to protect their business against price swings in the cash market.

Futures markets provide a reference point for use in executing off-exchange trades at competitively determined prices. An understanding of the NYMEX market, its pricing mechanism and the relationship between the futures price and the cash price will provide useful instruction and clarity to what is often perceived as an esoteric area of the broader financial marketplace.

OVERVIEW

Futures markets fulfill two primary functions: (1) they permit hedging, giving market participants the ability to shift price risk to others who have inverse risk profiles or who are willing to assume that risk for potential profit; and (2) they facilitate price discovery and market transparency. Transparency involves many factors, including: (1) continuous price reporting during the trading session that is disseminated on a real-time basis worldwide by various market data vendors; (2) daily reporting of trading volume and open interest; and (3) monthly reporting of deliveries against the futures contract.

Currently, NYMEX's core energy futures contracts trade by open outcry on the Exchange floor during the day and during the evening on NYMEX ACCESS[®], our after-hours electronic trading platform. Soon, NYMEX will offer side-by-side floor trading and electronic trading so that market participants will have the choice during the trading day between executing their orders on the trading floor or on the electronic screen. Open outcry transactions are executed in a transparent and competitive environment between NYMEX members who are registered futures industry professionals.

NYMEX's futures and options contracts are listed and traded by calendar month. For energy contracts, trading terminates in the month preceding the month of actual delivery of the underlying commodity (if positions are not offset and held through the termination of trading for that contract month). Consequently, the front or spot month listed for much of this month has been the May 2006 contract month. The daily settlement price for each contract month of a listed contract is calculated pursuant to Exchange rules. The rules governing the calculation of our settlement price reflect the business judgments exercised by Exchange officials.

By listing contracts that are traded in contract months listed out into the future, a common convention in the futures industry, our prices at all times reflect the collective consensus of the marketplace as to the future direction of commodity prices. By contrast, many cash markets of the underlying commodities for our products, such as for gasoline, are quoted and traded in the cash market as day-ahead products. Consequently, there can be at times significant differences between prices in our markets and prices in the day-ahead cash market.

NYMEX energy futures markets are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the

energy marketplace. Customers from around the globe can place buy and sell orders through brokers on the NYMEX trading floor. On behalf of the customers, buyers announce their bids and sellers announce offers. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices.

Price signals are the most efficient transmitters of economic information, telling us when supplies are short or in surplus, when demand is robust or wanting, or when we should take notice of longer-term trends. NYMEX futures markets are the messengers carrying this information from the energy industry to the public. The wide dissemination of futures prices generates competition in the establishment of current cash values for commodities.

GASOLINE

Gasoline is the largest refined product by volume sold in the United States and accounts for almost half of the national oil consumption. It is a highly diverse market, with hundreds of wholesale distributors and thousands of retail outlets, often making it subject to intense competition and price volatility.

NYMEX trades, among other things, New York Harbor leaded and unleaded regular gasoline futures contracts. The New York Harbor gasoline futures contract trades in units of 42,000 gallons (1,000 barrels). It is based on delivery of petroleum products to terminals in the New York harbor, the major east coast trading center for imports and domestic shipments, from refineries in the New York Harbor area or from the Gulf Coast refining centers.

Average daily trading volume in these contracts has hit record levels in recent months and prices have been volatile. These market conditions reflect the basic market fundamentals where there is an imbalance of supply and demand. Tight gasoline supplies due to lack of refinery capacity, compounded by the lingering impact of Hurricane Katrina, concerns about Middle East insecurity, and more recently the transition from methyl tertiary butyl ether (MTBE) to ethanol have driven prices upward dramatically in the cash and futures market.

NYMEX closely monitors the gasoline futures market and increases surveillance during periods of price volatility. To date, we have found that our markets are behaving rationally and that the market participants acted responsibly in their futures and options trading. More specifically, we have seen no evidence to date to suggest that the recent price rises in gasoline futures being traded on our markets are attributable to violative activity.

MARKET ANALYSIS

NYMEX staff monitors the supply and demand fundamentals in the underlying cash market to ensure that NYMEX futures prices are consistent with broad, ongoing, cash market price movements and that there are no price distortions. Our analysis of the gasoline market has identified three key factors that are contributing to higher gasoline prices in the cash and futures market: (1) high crude oil prices; (2) MTBE phase-out; and (3) reduced refinery capacity.

HIGH CRUDE OIL PRICES

Crude oil is the main feedstock for gasoline production. Indeed, according to the Energy Information Administration, 59 percent of the price of the gasoline is attributable to the price of crude. Consequently, the strength in crude oil prices has led to higher gasoline prices. Last week, crude oil futures prices reached an all-time high of over \$75.00 due to continued concerns about Middle East security and rising global oil demand. Chart A (attached) reflects global crude oil prices using the front month NYMEX Light Sweet Crude Oil (WTI) futures and Brent Crude Oil futures prices.

MTBE PHASE-OUT

The gasoline market is currently in a difficult transition period due to the phase-out of MTBE, and the related transition to ethanol. As companies eliminate the use of MTBE and replace it with ethanol, gasoline refiners and importers must adjust their practices and systems. Ethanol, which is chemically different than MTBE, contains more volatile compounds than MTBE and, therefore, is harder to use in reformulated gasoline in the summertime. In addition, ethanol cannot be carried in the Nation's pipeline system, and must be segregated from the wholesale distribution

system until its addition at the truck rack. Finally, ethanol presents new demand and supply implications, which must be factored into the pricing of gasoline.

There is a level of uncertainty involved in this transition process as the marketplace adjusts to the new supply situation. This uncertainty typically leads to higher gasoline prices in the short term. Buyers and sellers have concerns about demand and supply fundamentals, and the higher costs are then passed on to consumers.

This transition process is now well underway but not yet completed, as the gasoline market begins to phase out MTBE-blended gasoline. Commencing after May 5, refiners will no longer be required by law to add oxygen to gasoline products.— In addition, one price survey service, which collects and distributes surveys of prices of transactions in cash markets, will begin on May 1 to use Reformulated Gasoline blendstock (RBOB) as the anchor or reference point for gasoline transactions involving a delivery point other than the New York Harbor. Consequently, most energy firms likely will continue to draw down and use up their reformulated gasoline inventory during the remainder of the month of May. Most market observers continue to believe that sometime this summer the RBOB product will largely replace reformulated gasoline as the predominant gasoline product in the cash market.

Chart B (attached) shows the wholesale price of ethanol and MTBE in the New York Harbor area. As you can see, ethanol prices are currently \$1 per gallon higher than MTBE. This large price differential indicates the strength of ethanol demand as compared to MTBE. The ethanol is then added to RBOB, to make finished gasoline. NYMEX first listed RBOB gasoline futures for trading last October in anticipation of the phase-out of MTBE from the gasoline pool. Chart C (attached) shows prices for finished RFG (with MTBE included) and RBOB (before the addition of ethanol). The RBOB price is about 10 cents per gallon higher than finished RFG (with MTBE), and when the ethanol is added (at a 10 percent blend by volume) the finished ethanol-blended gasoline is priced even higher, at 15 cents higher than RFG with MTBE. This accounts for some of the recent price rise in gasoline.

REDUCED REFINERY CAPACITY

Even though no new gasoline refineries have been built in the US in several decades, this imbalance has been mitigated to some extent by higher efficiencies from existing plants, which have generally operated at a high rate of utilization in recent years. However, such a high utilization rate also means that when utilization rates are reduced for any reason, there will be an immediate impact on the availability of new supplies.

This year, the gasoline supplies have been constrained by lower refinery utilization rates due to heavy refinery maintenance. Some refineries reportedly had delayed maintenance work in the aftermath of Hurricane Katrina to ensure adequate gasoline supplies. Furthermore, additional refinery work is needed this year to comply with new low-sulfur requirements in diesel and gasoline. The end result is tighter gasoline supplies in the short-term until the higher refinery utilization rates can be restored.

In the face of these market factors, the NYMEX system continues to work according to design. As intended, NYMEX's highly transparent, open and competitive market place adds a level of economic stability to the situation by providing a reliable and well-regulated price discovery and risk management forum.

SURVEILLANCE

NYMEX has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing on whether the futures markets are converging with the spot physical market as the NYMEX contract nears expiration. Large trader data are reviewed daily to monitor customer positions in the market. At the end of every trading day, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels. These data, among other things, are used to identify position concentrations requiring further review and focus by Exchange staff. Any questionable market activity results in an inquiry or formal investigation. By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on our markets.

NYMEX maintains a comprehensive audit trail of all transactions executed on the Exchange. The audit trail includes such data as trade time, executing broker, and the account number for the beneficial owner of the trade and other data, which can be used to reconstruct trading activity for investigative purposes.

In addition to the Exchange's self-regulatory program, the CFTC conducts ongoing surveillance of our markets, including monitoring positions of large traders, deliverable supplies and contract expirations. The CFTC also conducts routine rule enforcement reviews of our regulatory programs. NYMEX consistently has been deemed by the CFTC to maintain adequate regulatory programs and oversight, in compliance with its self-regulatory obligations under the Commodity Exchange Act.

SPECULATORS

It is widely, yet inaccurately, theorized that speculators can drive prices up. Placing blame on speculators may grab the attention of the media, but does not accurately reflect the realities of how markets work. With hundreds of commercial participants and instantaneous price dissemination, any "speculative" price would be met with an equally strong "commercial" reaction. If markets move in a direction inconsistent with actual market factors, a vast number of participants including energy producers, wholesalers, retailers, and government agencies have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be.

Speculators do exist and they actually play a valuable, even necessary role in the market. They add liquidity to the market and enable commercial traders to get in and out of the market when necessary. By the nature of their role, speculative traders seek to participate in price trends that are already underway, but because they lack the capacity to make or take delivery, they will never be in a position to hold a market position through to the delivery process. They create virtually no impact on daily settlement prices, the primary benchmark used by the marketplace.

The speculative participation in the NYMEX New York Harbor Gasoline Futures Contract continues to be relatively modest and essentially unchanged from levels observed a year ago. Our latest data from year-end 2005 (see chart D, attached) show that speculators held 24 percent of the total open futures positions, up from 22 percent in the previous year. Meanwhile, commercial companies, which are actively hedging their physical gasoline transactions, account for the majority of the futures market participation with 76 percent of the total open interest. Open interest represents the total number of futures contracts that are currently held by buyers and sellers, and this measure of market participation is monitored by the Exchange and reported to the CFTC on a daily basis.

CONCLUSION

At all times during periods of extreme uncertainty in the market, NYMEX has been the source for transparent prices in the energy markets. Our price reporting systems, which provide information to the world's vendors, have worked flawlessly and without delay.

The NYMEX marketplace continues to perform its responsibility to provide regulated forums that ensure open, competitive and transparent energy pricing. We can only imagine the market uncertainty and further devastation to consumers if NYMEX were unable to perform its duty and prices were determined behind closed doors.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions members of the committee may have.

Chart A: NYMEX WTI and Brent Crude Oil

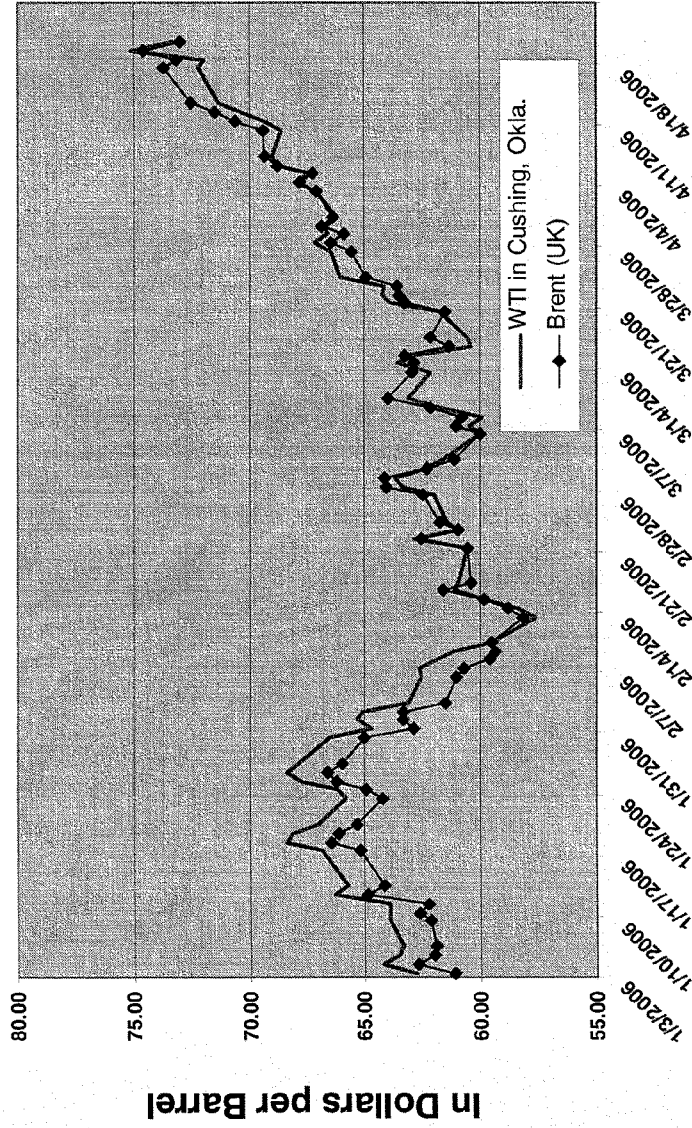


Chart B: Ethanol vs. MTBE (NY Harbor)

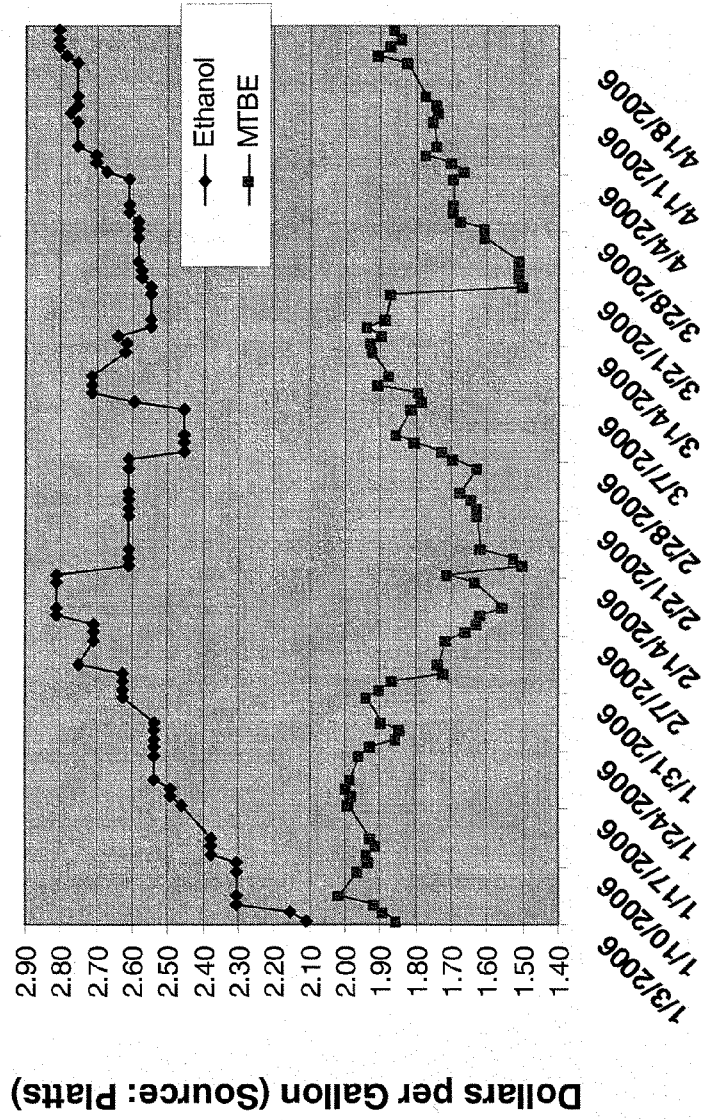


Chart C: NYMEX Reformulated Gas with MTBE vs. NYMEX RBOB Gas Blendstock w/o Ethanol

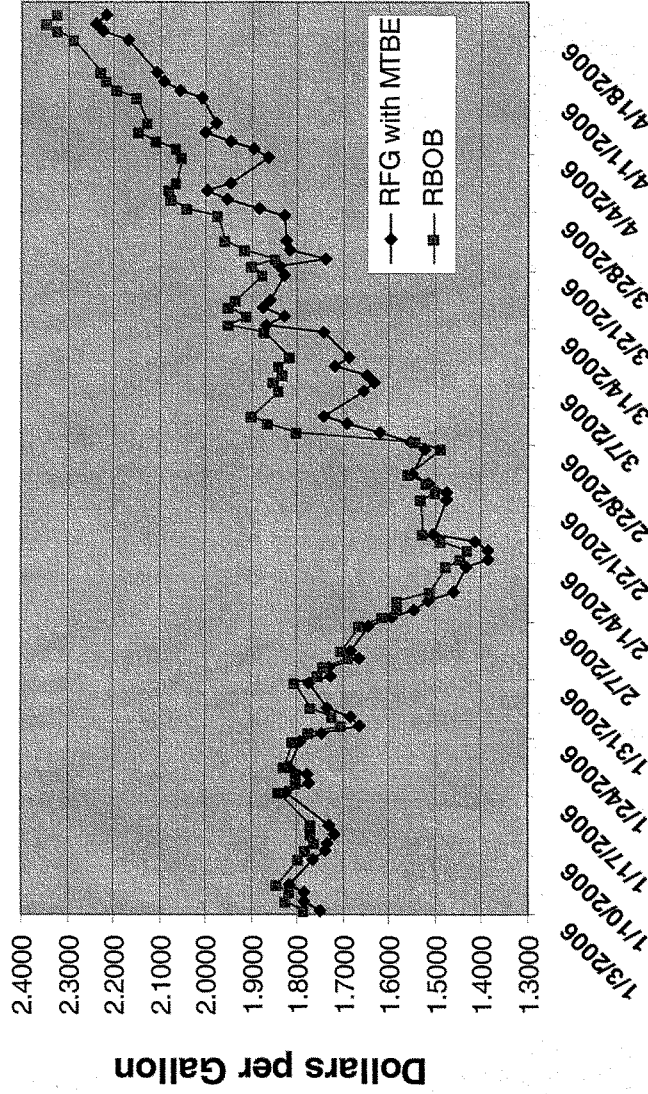


CHART D: NYMEX GASOLINE FUTURES
MARKET PARTICIPATION BY OCCUPATION
OPEN INTEREST

