

**Testimony of  
Dr. James Newsome, President and CEO  
New York Mercantile Exchange, Inc.  
before a Joint Hearing of the Senate  
Appropriations Subcommittee on Financial Services and General Government  
and the  
Committee on Agriculture, Nutrition and Forestry**

**June 17, 2008**

Mr. Chairman and participants in this joint hearing, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products, and has been in the business for more than 135 years. NYMEX is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC or Commission) both as a "derivatives clearing organization" (DCO) and as a "designated contract market" (DCM), which is the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

On behalf of the Exchange, its Board of Directors and shareholders, I want to express our appreciation to the Committees for holding today's hearing on the role, responsibilities and resource needs of the CFTC, with particular focus on the oversight of energy markets and oil futures contracts. In the last several years, trading volume on regulated markets has expanded dramatically, yet, according to published reports, the CFTC's current staffing levels fall even below the levels in place when the agency commenced operations over 30 years ago. Like most industry participants, we believe that the Commission is doing a fine job in the face of severe budget, staffing and technology constraints.

We also believe that a compelling case can be made for immediate increases in the size of the CFTC's operating budget. My own views on the need for remedying this mismatch between duties and resources stem in part from my service as Chairman of the CFTC from 2002-2004 during the period when we were continuing to implement the provisions of the landmark Commodity Futures Modernization Act of 2000 (CFMA). As anticipated, that law brought new competition and enhanced innovation in derivatives markets, which contributed to the explosion in trading volume. It is imperative that the CFTC have all of the tools that it needs to carry out fully its obligation to maintain the integrity of U.S. futures markets.

**BACKGROUND**

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 jurisdictions around the globe can submit orders for execution on Globex. 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.

Analysis of the actual market data from the regulated exchange, which is the best evidence available to date, indicates that prices in our markets continue to be determined by fundamental market forces. Specifically, uncertainty about the availability of supply due to political and security factors, uncertainty about the actual levels of continuing growth of demand in developing parts of the world, and uncertainty about currency fluctuations materially weigh into the fundamental analysis.

In addition, the available data indicate that commercials continue to provide the majority of open interest in crude oil futures. Moreover, the extent of non-commercial participation in crude oil as a percent of open interest on NYMEX has actually declined over the last year. There is no evidence to date either that the trading by non-commercials has impaired the price discovery function of our markets.

NYMEX is the benchmark for energy prices around the world. Trading on NYMEX is transparent, open and competitive and highly regulated. 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 or set prices for commodities trading on the exchange. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information.

The public benefits of commodity markets, including increased market efficiencies, price discovery and risk management, are enjoyed by the full range of entities operating in the US economy, whether or not they trade directly in the futures markets. Everyone in our economy is a public beneficiary of vibrant, efficient commodity markets, from the U.S. Treasury, which saves substantially on its debt financing costs, to every food processor or farmer, every consumer and company that uses energy products for their daily transportation, heating and manufacturing needs, and anyone who relies on publicly available futures prices as an accurate benchmark. Legislative proposals intended to decrease overall liquidity and/or speculative participation, such as substantially increasing margin levels, would greatly harm the regulated market and damage the all important hedging and price discovery functions that provide important benefits to consumers and to the economy as a whole.

## **MARKET OVERSIGHT and TRANSPARENCY**

NYMEX has a strong historic and ongoing commitment to its self-regulatory organization responsibilities. The NYMEX regulatory program has a current annual budget of approximately \$6.2 million, which reflects a significant commitment to both staff and technology. Generally NYMEX must comply with a number of broad, performance-based Core Principles applicable to DCMs that are fully subject to the CFTC's regulation and oversight. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. A DCM must monitor trading to prevent

manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability for a listed contract, where necessary or appropriate.

NYMEX has numerous surveillance tools that are used routinely to ensure fair and orderly trading on our markets. The principal tool that is used by DCMs to monitor trading for purposes of market integrity is the large trader reporting system. For energy contracts, the reportable position levels are distinct for each contract listed by the Exchange for trading. The levels are set by NYMEX and are specified by rule amendments that are submitted to the CFTC, following consultation and coordination with the CFTC staff. The reportable level for the NYMEX physically delivered crude oil contract is 350. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing on whether the futures markets prices are converging with the spot physical market as the NYMEX contract nears expiration.

Large trader data are reviewed daily to monitor reportable positions in the market. On a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff.

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 restricts the ability of speculators to carry large positions on NYMEX and also restricts the opportunity to engage in possible manipulative activity on NYMEX. Futures markets traditionally list futures and options contracts as a series of calendar contract months. For an expiring contract month in which trading is terminating, NYMEX uses a hard expiration position limit. The hard position limit for the NYMEX physically settled crude oil contract (CL futures) is 3000 contracts. Breaching the position limit can result in disciplinary action being taken by the Exchange.

NYMEX also maintains a program that allows for certain market participants to apply for targeted exemptions from the position limits in place on expiring contracts. Such hedge exemptions are granted on a case-by-case basis following adequate demonstration of bona fide hedging activity involving the underlying physical cash commodity or involving related swap agreements.

For back months of the CL futures contract, NYMEX currently maintains an any-month/accountability level of 10,000 contracts and an all-months-combined position accountability level of 20,000 contracts. When position accountability levels are exceeded, Exchange staff conducts heightened review and possible inquiry into the nature of the position which ultimately may result in NYMEX staff directing the market participant to reduce its positions.

### **RECENT CFTC ANNOUNCEMENT**

The CFTC recently announced several new initiatives to increase the transparency of energy futures markets. NYMEX has advocated for greater transparency of futures activity linked to U.S. exchanges occurring on markets regulated

by foreign regulators. We support the initiatives put forward by the Commission, which can only enhance the CFTC's regulatory mission.

One initiative is intended to expand information-sharing received from the U.K. Financial Services Authority for surveillance of energy commodity contracts with U.S. delivery points, including West Texas Intermediate crude oil futures contracts. The agreement includes implementing expanded information-sharing to provide the CFTC with daily large trader positions in the UK WTI crude oil contracts. NYMEX believes that including large trader reporting is an important market surveillance tool that provides important transparency to the market and to regulators.

NYMEX has advocated similar requirements for certain contracts traded on exempt commercial markets (ECM) and for foreign boards of trade (FBOT) that offer energy commodities with U.S. delivery points, such as the ICE Futures WTI contract. Position accountability levels and large trader reporting requirements, among others, were recently adopted into law for certain contracts traded on ECMs as an amendment to the Farm Bill. We believe that this new law will address the significant regulatory gap identified in the context of the Amaranth collapse.

NYMEX continues to believe that the same requirements should be imposed on FBOTs for contracts that directly affect U.S. consumers and the economy as a whole, such as the ICE WTI futures contract. Two years ago, the CFTC had authority over and could directly see 100% of the futures trading activity in the WTI futures contract. Today they regulate and can only directly see approximately 70% of that market. Thus, NYMEX believes that the "no-action" letter under which ICE Futures lists the WTI contract should be conditioned to require: 1) position accountability levels and/or position limits, as appropriate; and 2) large trader reporting. These requirements should mirror the requirements imposed on U.S. designated contract markets.

As noted above, another fundamental market surveillance and integrity tool is the use of position accountability levels and position limits. We believe strongly requiring FBOTs offering contracts with U.S. delivery points to impose position limits and/or accountability levels would be enormously positive and would strengthen the overall integrity of energy futures markets. This is particularly true when the contract trading on the FBOT has a U.S. delivery point and has a price that is linked to the settlement price of a U.S. regulated contract, such as the ICE WTI futures contract.

Moreover, the CFTC announced its intent to develop a proposal that would routinely require more detailed information from index traders and swaps dealers in the futures markets, and to review whether classification of these types of traders can be improved for regulatory and reporting purposes. Some commentators have recently made sweeping assertions regarding the impact of index traders on the basis of distorted and patently erroneous information. Consequently, the Exchange believes that it will be useful to the development of thoughtful public policy for the CFTC to obtain more precise data so as to better assess the amount and impact of this type of trading in the markets. We look forward to the implementation of this proposal.

Finally, in response to the CFTC's extraordinary step of publicly acknowledging an ongoing investigation into crude oil practices generally, we have reaffirmed our long-standing commitment to provide full assistance to the CFTC on enforcement matters in order to ensure the integrity of U.S. markets.

## **FOREIGN BOARDS OF TRADE**

While much of the focus on Capitol Hill has been on domestically based ECMs, similar issues potentially could arise with regard to U.S.-based products that are listed for trading on foreign boards of trade. As a note, NYMEX has long been a champion of vigorous competition and of greater globalization of services and products. As a rapidly growing global market presence, we have offices in London and Singapore.

We also note that there have been substantial advances in technology since the former era of closed end proprietary trading systems. New exchanges have emerged that operate on a solely electronic basis, and products have now been listed under the CFTC staff no-action process that are parallel (if not identical) to other products listed by existing U.S. exchanges that are subject to full CFTC regulation.

NYMEX believes that it would be prudent from time to time for the Commission or Commission staff to conduct a thorough review of foreign markets operating in the U.S. under existing staff no-action letters. A primary goal should be a “regulatory gap” analysis that can identify significant regulatory differences in the foreign board of trade’s program that may raise significant market oversight and transparency concerns for U.S. regulators. The Commission should adopt a measured approach that will protect the regulatory and public policy objectives that have been tried and proven over the years, and that will further enhance the strong relationships developed with other international regulators.

In our recent experience, “regulatory arbitrage” is not a hypothetical concern but is actually already underway for certain of our listed products. This process could actually harm markets because of the distortion of market efficiency occurring when customers make choices among the same or similar products on the basis of differences in regulatory treatment among providers rather than on the basis of intrinsic distinctions in the products themselves or in related services. In addition, regulatory arbitrage potentially diminishes the breadth and depth of the CFTC’s regulatory authority and, consequently, reduces much needed market transparency.

## **MARKET ANALYSIS OF THE CFTC-REGULATED ENERGY EXCHANGE**

NYMEX staff monitors the supply and demand fundamentals in the underlying cash market to ensure that NYMEX futures prices generally are consistent with ongoing, cash market price movements and that there are no price distortions. In a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are clearly having an impact on the assessment of market fundamentals. One may view such factors as contributing an uncertainty or risk premium to the usual analysis of supply and demand data. Indeed, such factors now may fairly be viewed as part of the new fundamentals of these commodities.

Before turning to analysis of specific market factors, we note an article that appeared last month in the Wall Street Journal (WSJ). The WSJ conducted a survey from May 2-6, 2008 of 53 economists. According to that survey, the majority of economists have concluded that “the global surge in food and energy prices is being

driven primarily by fundamental market conditions, rather than an investment bubble.” “Bubble is not Big Factor in Inflation,” May 9, 2008, page A-2. Fifty-one percent of those respondents said that demand from India and China was the prime factor in soaring energy prices, and 41% said that demand was the chief contributor to rising food costs. Constraint in supply was cited second most often; 20% blamed supply problems for higher food prices, and 15% for increasing energy prices. One economist noted that it was a combination of demand and supply issues.

The demand and supply fundamentals in the oil markets continue to be the driving factors in high oil prices. In a recent Energy Information Administration (EIA) *Short-Term Energy Outlook*, published on May 6, 2008, the demand and supply situation is summarized as follows:

“The oil supply system continues to operate at near capacity and remains vulnerable to both actual and perceived supply disruptions. The supply and demand balance for the remainder of the year is tighter than in last month’s Outlook. World oil markets are particularly tight during the first half of 2008, with year-over-year growth in world oil consumption outstripping growth in non-Organization of the Petroleum Exporting Countries (OPEC) production by over 1 million barrels per day. The combination of rising global demand, fairly normal seasonal inventory patterns, slow gains in non-OPEC supply, and low levels of available surplus production capacity is providing firm support for prices.”

I wish to highlight this finding: growth in consumption has outstripped growth in non-OPEC production by over 1 million barrels per day. That is substantially tighter than a snug fit. Indeed, that may be said to be more akin to a choke hold. Conventional wisdom, borne out by substantial experience from over seas as well as here in North America, is that the short-run worldwide demand for petroleum products such as gasoline-- especially retail demand-- is highly inelastic: consumption does not decrease by much in the face of significant price rises. With projected demand exceeding supply by 1 million barrels per day, the only way a market with highly inelastic demand will equilibrate is through a substantive rise in price. The upward pressure has been there and, according to these projections, will continue to be there.

## **DEMAND**

At NYMEX, we understand the difficulty of assembling accurate and timely information on non-OECD petroleum consumption and the corresponding challenge in projecting non-OECD consumption. However, the latest EIA *Short-Term Energy Outlook* projections provide important insight into the current state of global demand. EIA projects that world oil demand will grow by 1.2 million barrels per day in 2008, up a healthy 1.4%, with China accounting for 35% of this demand growth. The EIA predicts China’s oil consumption will rise by 0.4 million barrels per day in 2008, up 5.6% from its record-high levels achieved in 2007. Almost all of the oil growth in 2008 is projected to come from the non-OECD countries, led by China, India, Middle Eastern countries, and Russia. U.S. oil demand is actually projected to decline slightly by 0.9% in 2008.

As a practical consideration, the most accurate data on energy consumption applies to the U.S., followed by the OECD. However, the strongest source of projected energy demand is from the far-less visible reaches of developing countries such as

China, India and the Middle East. While we respect EIA's efforts to project these numbers, we would caution anyone on oversimplifying the challenge of accurately assessing the demand in these countries, much less projecting it. The only thing we can be certain of is the relentless increase in petroleum demand pushed each year by the millions of people making the transition from less-developed circumstances to the beginnings of middle-class circumstances.

Currently, China is putting more than eight million new cars on the road each year. Does anyone doubt that the average driver is increasing his/her amount of driving each year? India, the Middle East and Russia are experiencing similar transitions. We believe the sheer uncertainty around consumption in these economies, in combination with the extremely tight world market conditions, is a strong influence on price volatility in the world oil market. In concert with the tight market conditions and inelastic demand for petroleum products we highlighted above, that volatility is oscillating around ever increasing prices.

It is key to realize that the market tightness and the market's struggle to discern actual demand in growing and developing economies are both fundamental influences in the world oil market. The most visible signs of these conditions are the transparent market mechanisms that reside in the world today, such as NYMEX's futures and options markets, where prices are discovered and risk is managed. These mechanisms operate immediately. Compare that to fundamental market information, such as the consumption data referred to above. Consumption data, even for the most advanced economies that have been collecting these data and refining the process for collecting these data for decades (by the International Energy Agency), are provided on a preliminary basis six weeks after the fact. The data are then further refined four weeks later and again four weeks after that; all of this for a monthly statistic, which at the time of the final revision is 14 weeks after the month.

When you add onto that process the fact that the most dynamic component of consumption emanates not from those economies but from others where data collection is materially less advanced and the quality of the data much less certain, then the importance of immediate price discovery and transparency becomes even more evident. In a tightly supplied market where demand is highly inelastic, the only check on rising prices is competition and the price transparency and market liquidity that provide the support for it. Anything that reduces price transparency and liquidity under these market conditions will result in shifting price discovery to the collection of uncoordinated, opaque and, at times, esoteric mechanisms that comprise the cash market that provides limited transparency; a market not informed by the immediate discovery of value but by the relatively untimely release of fundamental information that is of uncertain quality and that provides limited transparency.

## **SUPPLY**

On the supply side, global production of crude oil was relatively flat in 2007, despite rising demand and rising prices. It is important to note that this rising demand did not provoke a significant supply response. The EIA *Short-Term Energy Outlook* points to the slow growth in non-OPEC oil supplies, along with the OPEC quota constraints, which have given "firm support for prices."

Further, the geopolitical risks provide added uncertainty to the oil supply outlook. Moreover, various state-owned oil companies have not been investing adequately in oil production. Venezuela nationalized assets owned by U.S. oil companies and has generally proved to be an unreliable partner. Mexico's major oil field has been depleted, and Mexico will not allow US companies to engage in deep water drilling. Colombian rebels have been blowing up pipelines with some frequency, and are being financially backed by the Venezuelan government. Nigerian rebel forces routinely shut down oil fields - either through strikes, terrorism or sabotage. Russia has suffered a decline in production. Finally, U.S. production has declined dramatically in the past 20 years, and promising new drilling areas are generally not being opened up in this country due to environmental considerations.

In addition, the price for crude in Euros has risen, but much more modestly. For instance, the last time the Dollar and Euro were exchanged at par was during December 2002 when the spot price of oil was about \$27 per barrel. By the end of April 2008, the price of oil in Dollars had risen 340% while the price in Euros had risen 180%, a substantial difference. Attached is a chart showing the price of oil in Dollars and Euros since 2000. So, while supply and demand fundamentals are the major determinants of price, at the margin, as the value of the dollar goes down, it may be providing some upward pressure on the price of oil in dollars so that it stays constant in value with the value of crude in Euros.

In the face of these market factors, NYMEX provides a level of economic stability to the market by offering a reliable and well-regulated price discovery and risk management mechanism. Our highly transparent, open and competitive market continues to work according to design.

### **ANALYSIS OF PARTICIPATION IN NYMEX'S CRUDE OIL FUTURES CONTRACT**

Data analysis conducted by our Research Department indicates that the percentage of open interest in NYMEX Crude Oil futures held by non-commercial participants relative to commercial participants actually decreased over the last year even at the same time that prices were increasing. NYMEX staff reviewed the percentage of open interest in the NYMEX Crude Oil futures contract held by non-commercial longs and shorts relative to that held by commercial longs and shorts. The review period commenced at the beginning of 2006 and continues through to the present. During the last year, commercial longs and shorts consistently have comprised between 60 and 70% of all open interest.

On the other hand, non-commercial longs and shorts consistently have been in the range of 25-30% of the open interest. Thus, non-commercials holding long or buy positions have not been participating in the market to the extent that they could have a significant impact on market price. Moreover, as noted, the extent of non-commercial participation in the crude oil energy futures contract has actually declined since the levels observed last summer. It should also be noted that the percentage of non-commercial longs (as a percentage of all long or buy open positions) is generally within just a few percentage points of the percentage of non-commercial shorts (as a percentage of all short or sell positions). In other words, non-commercial participants are not providing disproportionate pressure on the long or buy side of the crude oil futures market. Instead, non-commercials are relatively balanced between buy and sell open positions for NYMEX crude oil futures. In addition, "hedge funds" identified in

analysis conducted by NYMEX staff only accounted for approximately 5% of the total volume in the NYMEX Light Sweet Crude Oil contract in 2007.

## **MARGINS**

In futures markets, margins function as financial performance bonds and are employed to manage financial risk and to ensure financial integrity. A futures margin deposit has the economic function of ensuring the smooth and efficient functioning of futures markets and the financial integrity of transactions cleared by a futures clearinghouse. Margin levels are routinely adjusted in response to market volatility. At NYMEX, margin generally is collected to cover a 99 percent probability of a likely one-day price move, based on an analysis of historical and implied data.

Some have suggested that the answer to higher crude oil prices is to impose substantially greater margins on energy futures markets regulated by the CFTC. We believe that this approach is misguided. As previously noted, in a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces and imposing more onerous margin levels will not affect price levels. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are now market fundamentals. Adjusting margin levels significantly upward will not change the underlying market fundamentals. Furthermore, given the reality of global competition in energy derivatives, increasing crude oil margins on futures markets regulated by the CFTC inevitably will force trading volume away from regulated and transparent U.S. exchanges into the unlit corners of unregulated venues and onto less regulated and more opaque overseas markets.

Finally, Exchange staff has examined trends in margin levels at the Exchange going back to early 2000. The data clearly indicate that higher margin levels lead rather than follow increases in the price of crude oil futures products. In other words, when Exchange staff, in exercising their independent and neutral business judgment, determined to increase margin levels in response to changes in crude oil volatility levels, the higher margin levels were followed not by lower prices but instead by yet higher crude prices.

## **CONCLUSION**

At all times during periods of volatility in the market, NYMEX has been the source for transparent prices in the energy markets as well as the principal vehicle by which market participants achieve stability. Futures markets provide the means by which to achieve price certainty and lock-in prices. 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. The market uncertainty and mayhem and further devastation to consumers that would unfold is clear if NYMEX were unable to perform its duty and prices were determined behind closed doors. Policies that would inevitably result in reducing transparency and liquidity would only succeed in conferring market power unto those who would benefit from price increases in the crude oil market, a market that is so prominently characterized by the inflexible demand of its end-users. Transparency and liquidity are the foundation that supports competition in the oil market.

Over the last several years, NYMEX has worked closely with Congressional leaders providing information and other assistance on legislative initiatives that would add greater transparency to unregulated derivatives venues. We believe that these measures reflect a consensus regarding the need for greater transparency and oversight for certain specified products now trading in unregulated over-the-counter electronic trading markets.

We also hope that Congress does not misinterpret the lessons of the recent past by moving to impose new arbitrary and onerous burdens on futures exchanges, which are the most highly regulated and transparent segment of U.S. derivatives markets. Such steps would shift trading from regulated and transparent markets to unregulated and nontransparent markets and, thus, would constitute a significant step backward in transparency and market integrity. As markets continue to evolve, there is a regulatory and public interest rationale for increasing transparency in other venues in order to ensure that the CFTC has the data it needs to properly carry out its statutory duties.

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 that any Members of the Committees may have.