

**Testimony of**

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**Senate Permanent Subcommittee on Investigations**

**“Commodity Futures Trading Commission Proposal to  
Implement Speculation Position Limits for Futures”**

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**Washington, DC**

Chairman Levin, Ranking Member Coburn and Subcommittee Members, thank you for the opportunity to testify before you.

My name is Paul Cicio and I am the President of the Industrial Energy Consumers of America (IECA) a non-profit non-partisan association of leading manufacturing companies with \$700 billion in annual sales and with more than 750,000 employees nationwide. It is an organization created to promote the interests of manufacturing companies through advocacy, and collaboration for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA membership represents a diverse set of industries including: plastics, cement, paper, food processing, brick, chemicals, fertilizer, insulation, steel, glass, industrial gases, pharmaceutical, aluminum and brewing.

IECA has been a long time supporter of setting responsible speculative position limits. Levels of speculation and volatility have increased at an alarming rate in the commodities futures markets over the last eleven years.

For illustration, in 1998, physical hedgers represented 77 percent of the market, traditional speculators were 16 percent and index speculators were 7 percent. In 2008, physical hedgers were only 31 percent, while traditional speculators rose to 28 percent and index speculators rose to 41 percent of the total.

The futures market is special and unlike any other. It was created to serve the needs of buyers and sellers of consumable commodities and the managing of financial risk associated with these transactions.

Prior to year 2000, these markets worked well with prices reflecting the underlying supply versus demand of the physical commodity. Since then, the volume traded by speculators, especially passive speculators, has increased so significantly that it negatively impacts price discovery and has transformed this market from a “commodity” to an “asset” class investment. Unfortunately, the dollar inflows of these investments is now estimated at about \$300 billion and growing.

As an asset class investment, the retail investor doesn't really care about the supply or demand of the underlying commodity. Their priority is that they have made an investment in an area that diversifies their investment assets. And, when they invest in these passive index funds, the fund rolls the current month position to the next month without any regard to the price of the commodity. They are completely insensitive to price.

The distinction could not be greater. A well functioning market whose price reflects the supply and demand of the commodity is critical. Consumers like ourselves “must” buy

and depend upon this market to competitively produce the products that our customers require.

We need speculative position limits in all consumable commodity derivatives markets that will significantly reduce speculator dominance.

### **Questions Posed by the Subcommittee:**

**1. Please describe the extent to which excessive speculation has affected the price of oil and other commodities and the extent to which price increases or volatility have harmed members of your association, and provide specific examples where possible.**

As manufacturers who compete globally, the cost of energy commodities that are used as a fuel or feedstock are very important to maintaining competitiveness and jobs. Some of our companies also purchase and hedge agricultural commodity products. IECA began to get concerned about the commodities markets in the 2002-2003 time period when our energy managers noticed that the natural gas market was changing rapidly, becoming more volatile.

What we found is ever increasing levels of non-commercial trading. As a reminder to the Subcommittee, physical hedgers are not traders. Physical hedgers consume the equivalent product that they hedge or more. So, when there is increasing non-commercial volumes and there is no commercial physical hedgers to trade with, speculators end up trading with other speculators.

Volumes of trades continue to increase even though volumes of natural gas consumption remain relatively low. For example, natural gas open interest in 1995 averaged about 169,000 contracts per month and in 2011 increased to about 997,000 contracts per month, a 590 percent increase even though U.S. consumption increased during that same time period by about only 6.5 percent.

Small speculative trading volumes are not a problem. Large volumes can be a problem because they can move the market price and increase volatility. For example, chart 1 on page 7 illustrates how only four traders controlled about 50 percent of the open interest in natural gas. That means that only a handful of companies can have an incredibly big role in what we pay for that commodity. Saying it another way, if these four companies decide to go long (herding) and prices rise, a handful of companies could be richly rewarded at the expense of every consumer of natural gas in the country. That is a lot of market power in the hands of few.

**2. Please provide specific examples of how price volatility in the oil and other commodity markets has adversely impacted any of your members from hedging their risk in the futures market.**

Speculative trading volume that outsize's the underlying commodity volume can create price volatility because traders end up trading with traders, not physical hedgers. This type of trading has little to do with the serving the function of hedging by producers and consumers of the commodity - which is the reason we have a commodity futures market. Speculators want volatility because it provides greater opportunities to profit. It is for that reason that banks and traders oppose speculative position limits.

High volatility increases costs:

For example, high volatility will increase the price of an option. There is a direct relationship between volatility and the option price premium. The higher the volatility - the higher the option premium. The higher premium increases the cost of hedging which may be a reason that fewer companies are hedging. Higher volatility also increases the bid-ask spread in the forward market. Because of the increased uncertainty, physical hedgers pay higher prices.

The more movement in price, the more volume trades occur on both sides of the transaction. The banks/funds sit in the middle and make the bid/ask spread. Because they sit in the middle and by holding such large positions, they can create volatility and increase profits.

**Example of How Volatility Increases Costs**

Using the closing Henry Hub Index price of natural gas on Friday, October 28, 2011 of \$4.04 per mm Btu, a call option for 100,000 MM Btus with a six month expiration of May 2012 at the money would cost \$36,498.50. The information below shows the increase in cost of that option (leaving all other parameters fixed) if the implied volatility increases.

<b>Increases in Implied Volatility</b>	<b>Percent Increase in Premium</b>
+5%	15%
+10%	31%
+15%	46%
+20%	61%

Higher margin requirement:

Volatility could result in a manufacturer's receiving a margin call on their hedged position and require the company to post higher levels of capital. This reduces working capital needed to operate the business.

Hedged price does not reflect fundamentals of supply and demand:

What makes the futures market different than all other markets is that the price of the underlying commodity should reflect the supply versus demand of the commodity. High levels of speculative volume results in traders speculating with other traders. When that happens, physical hedgers end up locking in prices that may not necessarily represent the underlying supply and demand. As a result, they could pay more for their product.

**3. Please provide your views on the CFTC's proposed rule and any final rule issued prior to the hearing to establish position limits for certain commodity futures and option contracts, and equivalent commodity swaps.**

The CFTC's recently released rule sets a speculative position limit at 25 percent of the estimated deliverable supply. It is too large and will do little to reduce excessive speculation. The CFTC rule also set a time frame for review or change in the level of the speculative position limits at every two years. This is not frequent enough and should be evaluated yearly. The CFTC should also have the ability to act anytime there is unusual volatility that is impacting the price of a commodity to the detriment of consumers.

The commodity futures market is different and special than any other market. It is a market created by producers and consumers to hedge price risk or purchase or sell the commodity. Unlike stocks and bonds, commodities are physical products that homeowners rely upon to feed their families, provide gasoline for their cars and heat and cool their homes. Manufacturers rely upon commodity futures for fuels, feedstock and a host of other commodities that we consume. We do not trade commodities.

The point is, what happens to the price of commodities has direct implications to real people in direct terms, not in theoretical terms. It is essential that policy makers place a high priority on ensuring that the futures commodity market works effectively and to the benefit of the producers and consumers of the underlying commodity – and not speculators.

Speculators play an important role of providing liquidity. However, the speculator's sole goal is to make money – lots of it – from commodity trading. Their fiduciary responsibility is to company profits and they do not care what impact their actions have on the price of food or fuel for U.S. citizens or manufacturing competitiveness.

The futures markets were not created to serve the interests of traders, banks, hedge funds, sovereign funds, index funds, pension funds and retail investors. It is for all of these reasons that without responsible restraints, speculators can and will take unfair advantage of everyone that consumes commodities.

The speculative position limit allows each speculator to control as much as 25 percent of the deliverable supply of the commodity, this is too large and will do nothing to reduce excessive speculation.

### **Illustration of Implication of 25 Percent Speculative Limit**

*Let's put in perspective what setting speculative position limits at 25 percent mean by looking at natural gas. Annual consumption in 2010 per month was 1,843,735 mm cubic feet. Twenty five percent would equal 460,933 mm cubic feet. There is an estimated 350 to 450 traders who report from time to time to the CFTC Large Trader Report. For purposes of simplicity, we will assume that only 100 traders will trade the limit. If so, traders/speculators will control 46,093,300 mm cubic feet or 25 times U.S. monthly demand. Two hundred traders would control 50 times the U.S. monthly demand. Three hundred traders would control 75 times the U.S. monthly demand and so on. All the while, the volume of producer and consumer volume traded will not change much at all and be dwarfed by speculative volume and potential volatility.*

For example, if the physical market has plenty of supply versus demand, prices should remain in a relatively narrow trading range. Today's natural gas market is a good example. This narrow trading range is not as attractive for speculators as compared to other commodities because it is harder for them to make a profit.

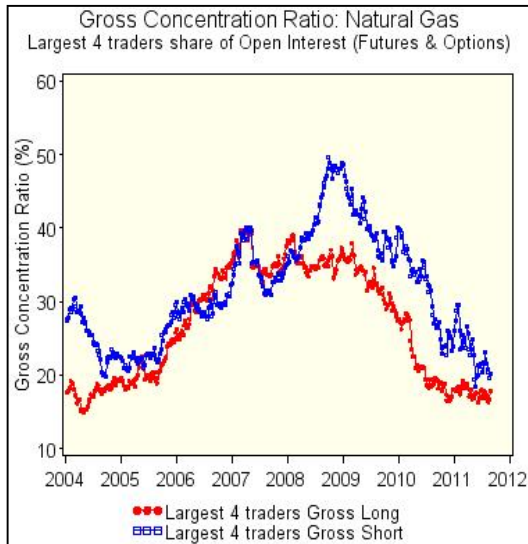
The reverse is true if the physical market is in balance or if there is a perceived potential shortage. It is under these conditions that the high speculative position limits become lethal for consumers but not producers of the product. If prices rise, producers of the commodity benefit. Without exception, when there is a perceived short fall, speculative volumes and volatility increase. The number of speculative trades increases as do the number of traders. Combined, all of these factors drive up consumer commodity prices. It is under these conditions that tight speculative limits are needed.

Wall Street argues that speculative limits reduce liquidity. There has never been a case where a physical hedger had difficulty finding a speculator to take the other side of their position. What Wall Street is really saying is that speculative limits impact their trading and could potentially limit their profit generation.

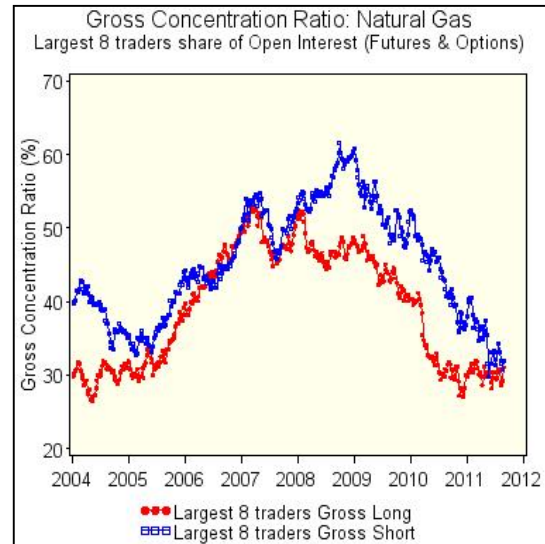
Both of the CFTC charts below illustrates why speculative position limits at lower levels are needed. Chart 1 shows that the four largest traders controlled 50 percent of the short and 40 percent of the long futures and option open interest for natural gas during

2008 when commodity prices spiked. Chart 2 shows that the eight largest traders controlled 60 percent of the short and over 50 percent of the long futures and option open interest for natural gas.

**Chart 1**



**Chart 2**



**4. Please provide your views concerning the CFTC’s justification in postponing the establishment of positions limits for single month limits and all-months-combined limits until after a significant period of data analysis on physical commodity swaps.**

We do not see a justification for not setting speculative position limits for single months and all-months combined – especially at the large speculative limit of 25% of deliverable supply.

**5. Please describe the impact of commodity index funds and commodity-related exchange traded funds (ETFs) on commodity prices, and whether position limits ought to apply to swap dealers and ETF managers attempting to hedge their positions in the futures, options, or commodity swap markets.**

Passive speculators should be banned from the futures market. At minimum, they should be subjected to individual speculative position limits. The next best action is to set speculative position limits on all commodity related ETFs and index funds. Swap dealers and ETF managers should be subject to speculative position limits except for hedges associated with transactions with producers and consumers of the commodity.

CFTC began reporting index investment data for natural gas on December 31, 2007. The data shows that index funds held a “long” position 82.6% of the time and only held “short” positions 17.4% of the time which confirms that index funds put upward pressure

on prices. The relationship between longs and shorts has remained relatively steady but the volumes continue to increase. Total open interest in December of 2007 was 194,000 contracts and in September of 2011 contracts increased to 571,000, a 294 percent increase.

Active traditional speculators add beneficial liquidity to the market by selling and buying with the objective of creating a profit. This is constructive until they control substantial volumes that damage price discovery and increase volatility. Passive speculators reduce liquidity by buying and then holding larger and larger quantities of futures contracts. They act as consumers who never take delivery of the commodity so the volumes continue to pile up. Their volumes are moved forward to the next month, every month, getting theoretically larger and larger. This is inconsistent with the functioning of a futures market that serves “consumable” commodities that have a prompt month that expires.

The objective of the passive investor is also inconsistent with a consumable futures product. We use it for price determination which impacts our profitability and our viability; they use it to diversify an asset class portfolio.

They do not care what the price of the underlying commodity is, we do. They buy regardless of whatever the price is. If the price goes up, they buy. If the price goes down, they buy. This means that their growing volumes of commodity purchases, without regard to supply and demand will impact the price that “we” and every homeowner and farmer will pay. If the American public fully understood how these passive speculative funds impact the cost of heating and cooling their homes, driving their cars and feeding their families, they would be outraged.

Passive commodity funds also publically communicate when they will roll their positions from the current month to the following month. Funds like the United States Natural Gas Fund (UNG), post the days that they will roll their positions from one month to another on their website. This is something that no producer, consumer or traditional speculator would do. Again, that is not how the futures market was created to work and damages price discovery.

Because passive index funds that include a basket of commodities and or single commodity passive funds like the United States Natural Gas Fund (USG) all predictably roll their futures positions forward in the exact same manner each month, should be subject to the position limit of a single person. Collectively, these funds outsize all other market participants, and as a result, can have market power.

The Commodity Exchange Act (CEA) says that “such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the



position were held by, or the trading were done by, a single person.” It appears to us that this CEA provision applies to passive funds. These funds all have written publically available documentation that describes the fund’s methodology.

The CFTC appears to already have the authority to take action to prevent a single speculator or class of speculators from damaging these markets.

Thank-you.