SUPPLEMENTAL QUESTION FOR THE RECORD
from
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to
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President
Industrial Energy Consumers of America

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Hearing on
"Excessive Speculation and Compliance with Dodd-Frank Act"
November 3, 2011

Please provide the responses to the following question by December 23, 2011:

1. **Your testimony states that "in 1998, physical hedgers represented 77 percent of the market, "but that today it is closer to 31 percent-essentially flipping from 2/3 to 1/3. This statistic is widely used, but where did you get it?**

   a. *Do you have any evidence that the statistic is accurate?*

      The specific numbers have been used for some time by a lot of the industry. We did not generate this data. However, what we can say is that the IECA Board of Directors is largely the people in charge of buying energy for their companies, including natural gas. It is their direct observation that these numbers are about right.

   b. *How do you define your terms? Is it possible to completely separate bona-fide hedgers from speculators? If so, what is the precise difference?*

      Bona-fide hedgers either consume or produce the physical commodity. Speculators do not.

   c. *Even if it's accurate, what does this say about the impact of speculation in commodity markets?*

      The answer starts with the fundamental fact of what makes the futures market different than other markets. The futures market was created to serve one function and one function only – to determine price discover based on the "supply and demand" of the underlying physical commodity and allow those that consume or produce the physical product to complete their transactions. The volume of physical product consumed each month is finite. The speculator is needed to provide liquidity for transactions to occur to service that volume. When the finite commodity volume of deals is serviced, most of the other transactions are simply trading to make bets – to gamble on the market that can move the price up or down and cause price volatility. Their trades are to simply make a profit by creating volatility and we end up paying for it. Volatility increases our transaction costs and can drive the price either up or down – often, irrespective of supply and demand.

2. Do you believe that federal regulatory costs are a factor in commodity prices?

a. For example, do you believe that Federal and State regulations about blending impact the price of gasoline?

Yes, there are additional costs to physically blend, store and ship multiple blends of fuels that would not otherwise exist without blending regulations.

b. Do you believe the price of corn was affected by federal policies on ethanol?

Yes. Mandates for ethanol demand in fuels and subsidies drive additional demand for corn based ethanol above what would otherwise have occurred putting upward pressure on the price of corn.

c. How do these factors compare with impact of speculation?

Price movement because of speculation is driven purely by profit motive while price movement due to regulation is driven by policy with a purpose. They cannot be compared.

3. What would you say to the concern that banning commodity index funds will encourage investors seeking commodity exposure to go into the physical market?

It is not clear what is meant by "physical market" (i.e.) encourage them to purchase physical product (or) trading futures directly versus through an ETF.

Banning commodity index funds will not force the majority of investors to trade futures on their own (trade futures for their own account). It will encourage them to buy the "companies" who produce the commodities. In the energy product area, banning energy ETFs will result in retail investors owning shares of Exxon, Chesapeake, and Devon Energy etc. The typical ETF investor will not buy the physical product. Only large banks and trading houses have the capacity to buy/sell and or store the physical product.

Isn't that even more likely to increase volatility for consumers?

No. It would reduce volatility.

4. **You said position limits are essential to combating excessive speculation. How do you respond to the fact that many of the nine commodities with position limits saw repeated record prices recently?**

   We do not monitor commodities other than natural gas so I cannot comment directly. However, common sense says that record prices could have been caused by the underlying demand exceeding supply. In that case, the relative price should go up irrespective of speculative position limits.

   Importantly, the concept of position limits is not to reduce the price movements due to fundamental changes to the supply or demand of the commodity. If there is more demand than supply of the commodity, the price should go up. The case for setting speculative position limits is to ensure that the price movements are not caused by aggressive speculation.

   It is also possible that the position limits were too large and did not reduce or limit the impact of excessive speculator volumes.

5. **You testimony talks about the direct implication of commodity prices to real people who need to feed their families and heat their homes. In your analysis, did you consider worldwide demand for these commodities, and its impact on these prices?**

   My testimony addressed natural gas. Natural gas is not exported and the price is “not” set or influenced by international demand.

   a. *Between 2005 and 2007 China’s oil consumption went up 5.1 percent annually, according to the Federal Reserve Bank of Dallas. Do you believe this has an impact on the price of oil in the United States?*

      Underlying growing demand for the physical product relative to supply puts upward pressure on price.

   b. *Are you concerned that U. S. market participants will choose to leave the U. S. because of the position limits being imposed by the CFTC?*

      No. Bona-fide hedgers would not leave. As for speculators, there are inherent advantages of operating from the U.S. This is not to say that some would choose to leave.

6. **In your testimony you express concerns about speculators trading with other speculators. Can you first define what exactly you mean by “non-commercial” trading?**

Noncommercial entities are not commercial consumers and producers of the underlying commodity.

7. You say that because in the last four years index funds held long position 83% of the time that this " confirms that index funds put upward pressure on prices. " How is this so?

No matter what entity you are, if you consistently are long, that is, always buying versus selling – puts upward pressure on price. Remember, we are dealing with a commodity that has a finite volume. If only ten apples are available in the market and ETFs keep placing orders to buy apples, then the price will rise.

An ETF like UNG, the United States Natural Gas Fund always buy. The only time they sell is to sell the current month only to go "long" in the next month. The only time there is an actual "sell" of futures positions is when a customer liquidates their shares of the ETF.

Do you think that the balance should instead by 50-50?

Banning ETFs is the only solution.

Remember, the problem with ETFs is that their goal is to satisfy a retail investor's strategy of "asset diversification." This goal is completely inconsistent with the fundamentals as to why the futures market was created. The futures market was not set up to satisfy asset allocation for retail consumers! It was created to serve consumers and producers of a commodity and determine the price of the commodity. Those who participate in an ETF for asset allocation buy the commodity through an ETF and do not care what the underlying supply or demand is - nor the price they pay for the commodity. This is contrary to the futures market and how it works. Consumers and producers of the commodity "do" care about price determination that reflects supply and demand.

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