ATA TESTIMONY

Energy Position Limits and Hedge Exemptions

Testimony of Ben Hirst
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on behalf of the
Air Transport Association of America, Inc.
before the
Commodity Futures Trading Commission

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AIR TRANSPORT ASSOCIATION

INTRODUCTION

Good morning Chairman Gensler, Commissioners Chilton, Dunn and Sommers. I am Ben Hirst, General Counsel of Delta Air Lines, and I am appearing today on behalf of the Air Transport Association, which represents the U.S. commercial airline industry, an industry that has been devastated in the past two years by the high price of fuel, and volatility in the oil markets. We, and our employees, are grateful for your commitment to addressing the causes of these conditions, which have destroyed some airlines and deeply damaged the rest.

INDUSTRY CONDITIONS

As an industry, commercial aviation helps drive $1.14 trillion in annual economic activity in the United States, $346 billion per year in personal earnings and 10.2 million jobs. It also contributes $692 billion per year to our nation's gross domestic product – roughly 5.2 percent of GDP.

Unfortunately, U.S. commercial aviation is suffering through a very difficult economic climate. Last month, Merrill Lynch analyst Michael Linenberg was quoted as saying, "We are lowering our 2009…net income forecast [for the airline industry]…from a profit of $1.0 billion to a loss of $2.3 billion. While at the start of the year we were projecting a modest net profit for the industry despite the worst global economic downturn since World War II, our forecast has been stymied by the impact of the H1N1 influenza, creeping energy prices, and a revenue environment that is showing no signs of improvement."

Demand for air travel and air cargo is down sharply in 2009 – approximately 21 percent below the same period last year – and U.S. airlines expect 14 million fewer passengers in the summer of 2009 than we had in 2008. This has forced our industry to do the only thing it can to survive – cut capacity, ground planes, eliminate routes and reduce the number of cities served.

The number of full-time employees at passenger airlines is down 29 percent from our peak employment in May 2001– a total of 154,000 jobs lost in our industry. And airlines continue to cut. In the fourth quarter of this year, domestic seating capacity is expected to decline to levels we last saw in the fourth quarter of 2001, in the immediate aftermath of 9/11. In fact, by the fourth quarter of this year, U.S. carriers will offer almost 1.8 billion fewer available seat miles[1] *every week* than they did in the fourth quarter of 2007. And that figure represents the cuts on domestic routes only. When you add the cuts that have been made to international routes, the numbers are even larger.

Unfortunately, all of these problems are being exacerbated by volatility in fuel markets. In 2008, U.S. airlines spent $16 billion more on fuel than they did the year prior – almost $60 billion in total – despite consuming more than 5 percent fewer gallons of fuel.

We at Delta Air Lines employ over 70,000 people worldwide and offer service to more than 170 million passengers each year to 382 destinations in 69 different countries. We consume approximately four billion gallons of jet fuel annually, making us the second largest consumer of jet fuel in the world, next to the U.S. government. Our business is dramatically impacted by volatility in the oil markets. Each $1 change in the cost of a barrel of oil has an annual impact of $100 million to Delta's bottom line. In 2008, as oil prices and volatility peaked, fuel expense (including the cost of hedging) consumed 40 percent of our total

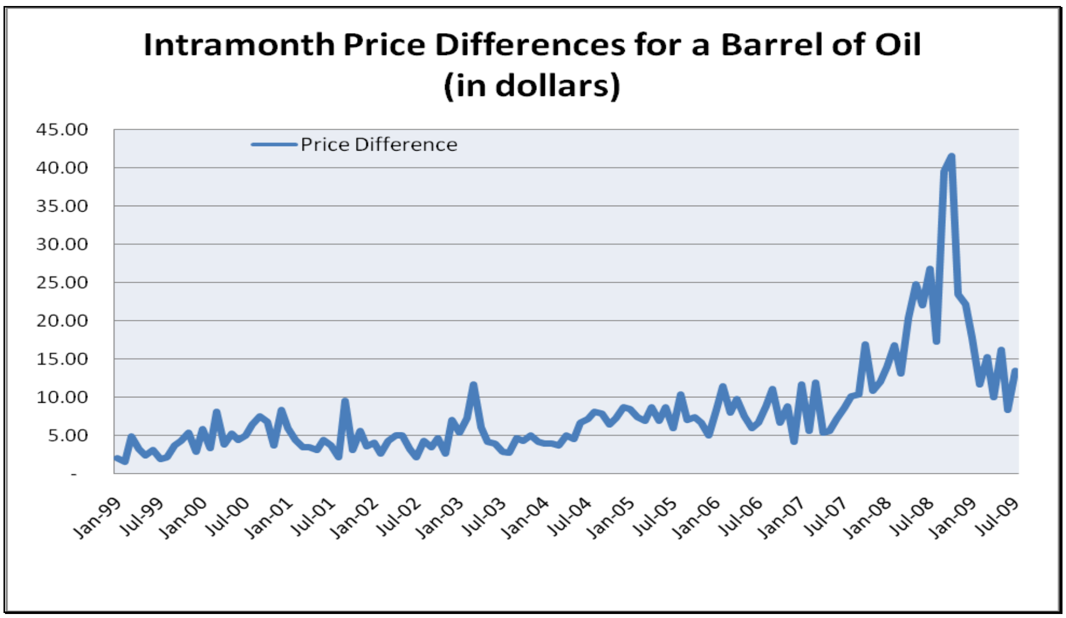
[1] An available seat mile (ASM) is one passenger seat flown one mile and is the standard unit of capacity in the passenger airline sector.

revenues directly resulting in the need to reduce our capacity by more than 10 percent and eliminate nearly 10,000 jobs.

The financial health and security of the airline industry depends, in significant part, on a commodities market structure that is stable, rational and predictable. Today's energy commodities markets, however, do not display these characteristics.

EXCESSIVE SPECULATION DRIVES VOLATILITY

Since 2005 we have seen a significant increase in the volatility of oil prices. The increase has been particularly dramatic in the last two years. From 1999 through 2004, the average annual variance between the high price of a barrel of oil for the year and the low price was about \$16. From 2005 through 2008 the average annual per-barrel variance was about \$52. In 2007 the variance between the high and low prices was \$48 and in 2008 it was \$111. Daily volatility in 2004 was generally under one dollar. In 2008, the price of a barrel of oil rose \$10.75 in a single day (June 6), and daily volatility of \$3 or more became the norm. The average monthly difference in prices in 2008 was over \$19 per barrel.



This increase in volatility has been associated with a massive increase in speculative investment in oil futures. A recent study by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Governmental Affairs noted that over the last six years, financial institutions have aggressively marketed commodity index funds, which are heavily weighted to oil futures, as a way for hedge funds, pension funds, and other investors to diversify portfolios and speculate on rising commodity prices. The study noted that the total value of investment in commodity indexes has increased tenfold since 2003, from an estimated \$15 billion in 2003 to around \$200 billion in mid-2008. During that period, the volumes of oil futures traded on the exchanges quadrupled, despite the fact that, over the same period, global demand for physical barrels of oil remained virtually unchanged.[2] This increase in speculative activity is closely correlated with the increased volatility of oil prices, which has caused so much harm.

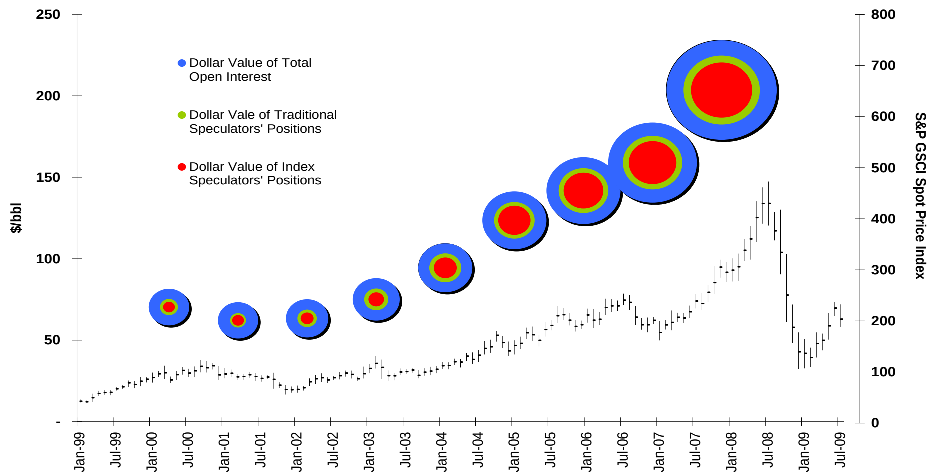
[2] Total world demand for oil from 2005 to 2008 (in million barrels per day):

2005 – 84.00
2006 – 84.98
2007 – 85.90
2008 – 85.33

For an airline, an oil market characterized by high volatility driven by speculation presents a number of serious problems. First, it increases the costs and risks of hedging. Second, in recent years this volatility has pushed prices to levels so high that they have depleted the capital of the firms in our industry. Third, with each spike in oil prices, airlines ground aircraft, reduce air service and eliminate jobs.

OIL PRICES AND VOLATILITY HAVE RISEN AS SPECULATION HAS INCREASED

Volatility Charts



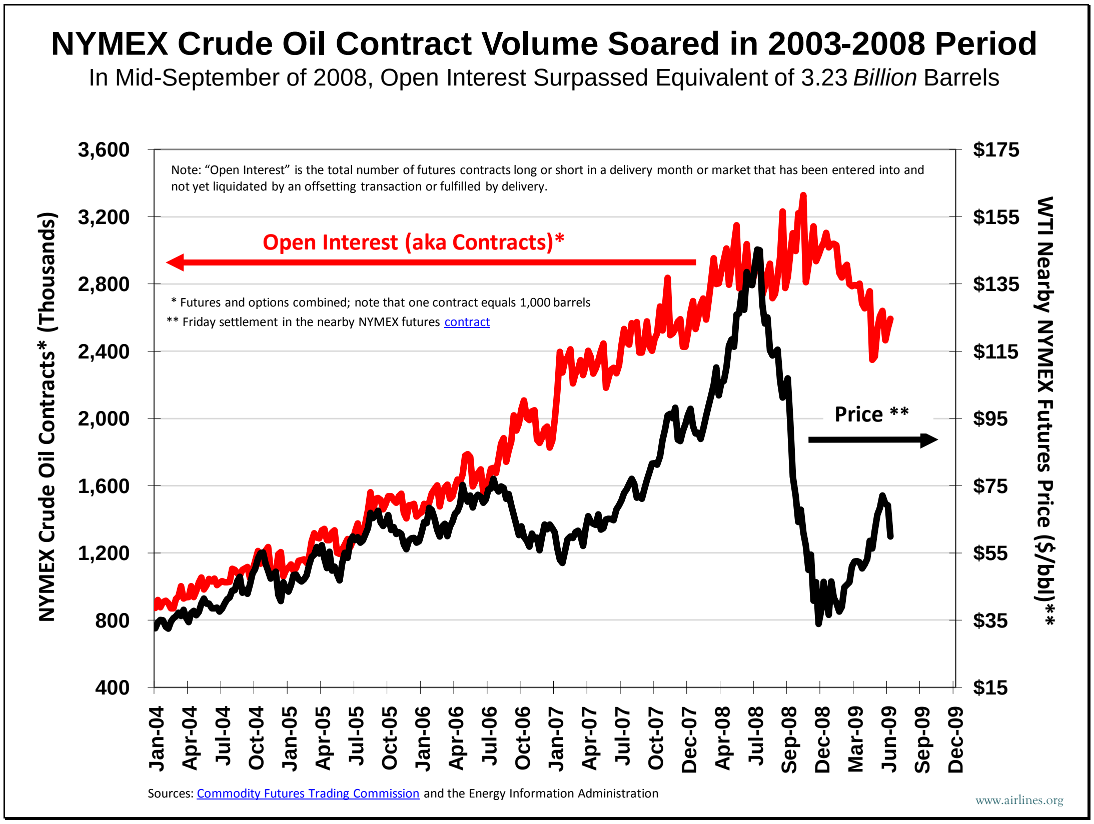
Source: Bloomberg, CFTC Commitments of Traders CIT Supplement, calculations, Testimony of Michael W. Masters before the Senate Committee on Homeland Security and Governmental Affairs on May 20 2008

- In the chart above, the bubbles represent the size, measured in dollars (on the right axis), of the commodities futures market. Over time, not only has the total volume increased, but the amount of Index Speculators relative to the Total Open Interest has risen drastically.
- On the left axis, the high, low, and settled prices for crude oil are displayed by month since 1999 through mid-July 2009. The distance between highs and lows has increased in recent years.
- The two charts together show how the increase in volume has affected the volatility of market prices.

Date	High	Low	Settle	H-L Spread
Jul-99	21.12	19.15	20.04	1.97
Jul-00	32.35	27.35	29.74	5.00
Jul-01	28.29	24.60	26.45	3.69
Jul-02	27.95	25.73	26.90	2.22
Jul-03	32.05	29.17	30.62	2.88
Jul-04	43.85	36.69	40.68	7.16
Jul-05	62.10	56.10	58.93	6.00
Jul-06	78.40	71.65	74.53	6.75
Jul-07	78.28	69.57	73.91	8.71
Jul-08	147.27	120.42	133.87	26.85
Jul-09	71.85	58.32	62.86	13.53

We estimate that the speculative oil price bubble that began in mid-2007, peaked in mid-2008, and then plummeted abruptly, cost Delta $8.4 billion, compared with what we would have spent on jet fuel if the price of oil had remained at $60 a barrel. This includes $1.7 billion in hedge losses and premiums. At least we're still in business. Other airlines without our financial reserves have not been so fortunate. Since December 2007, eight airlines have ceased operations.

Source: Energy Information Administration



In 2008 alone, some 28,000 pilots, flight attendants, mechanics, ramp workers, gate agents, reservation sales and service representatives, and office workers lost their jobs due to cutbacks in our industry, and air service was reduced at countless communities across the country. Further capacity reductions, layoffs, bankruptcies and liquidations will occur if oil price volatility is not reduced to more manageable levels.

SOLUTIONS

A key responsibility of the CFTC is to ensure that prices on the futures market reflect the laws of supply and demand rather than manipulative practices or excessive speculation. Section 4(a) of the Commodities Exchange Act provides the Commission with the authority to fix limits on the amounts of trading which may be done or positions which may be held by any person, in order to prevent excessive speculation from causing sudden or unreasonable changes or unwarranted fluctuations in commodity prices.

The Air Transport Association strongly supports reforms to energy market oversight that will promote price stability, market integrity and accurate price discovery. This is because the fundamentals of supply and demand alone, while certainly influencing the price of commodities, cannot explain the destructive volatility that we have seen in oil markets over the past 16 months. The dramatic and devastating run-up in oil prices that we experienced last summer – and the almost-as-devastating price crash last fall – was largely caused by a massive influx of speculative investment into commodity markets generally and energy markets in particular. The Commission has a responsibility to prevent a recurrence of these devastating conditions by using its authority to the fullest extent to regulate speculation in these markets.

And to be clear, we are talking about a phenomenon separate and distinct from fraud and intentional market manipulation – although combating those is obviously a paramount responsibility for the Commission as well. Investors with lawful motives, such as wealthy endowments, can drive speculative price bubbles like the one we saw last year. Broader implementation of position limits and stricter control over hedge exemptions are needed to address this problem.

To temper the devastating effects that excessive speculation has on oil markets, Delta Air Lines and the U.S. commercial aviation industry strongly support reforms to the framework of commodity market regulation that (a) impose aggregate position limits consistently on all speculative traders across all markets and (b) strictly limit noncommercial traders' access to hedge exemptions. These are among the most important policy changes that the CFTC can make to ensure our commodity markets function effectively, efficiently and with integrity.

Aggregate Position Limits

The CFTC should impose federal position limits on designated contract markets such as NYMEX, exempt commercial markets such as ICE, and foreign boards of trade such as ICE Europe that trade energy futures, options or swaps (including natural gas, crude oil and gasoline). For exempt commercial markets, the government-imposed limits should cover all contract markets that perform a significant price discovery function as determined by the CFTC pursuant to section 2(h)(7) of the Commodity Exchange Act. For foreign boards of trade, it should cover all energy contracts that are offered to U.S. persons in the U.S. pursuant to Part 30 relief, and should be a condition of receiving that relief.

Section 4a of the Commodity Exchange Act gives the CFTC the authority to set position limits for designated contract markets to prevent excessive speculation. Section 2(h)(7) provides the authority for setting position limits for exempt commercial markets and position limits may be imposed on foreign exchanges as a condition of receiving no action relief from the requirements of Part 30 for foreign futures traded in the United States.

When establishing a formula for position limits, the limits should cover spot-month, individual-month and all-month-combined levels. They should be set to ensure that no individual trader holds, in the spot month, an unduly large percentage of the spot-month deliverable supply. They should also ensure that no individual trader holds a disproportionately high percentage of the average futures and delta-adjusted option month-end open interest. In addition, they should ensure that positions held in aggregate by speculative traders do not exceed the percentage that had been historically held by speculative traders in that contract market, prior to the recent dramatic increase in speculative positions.

For the purposes of applying position limits, the positions of all accounts that are under common ownership or control should be aggregated. In addition, the futures equivalent positions in that same energy commodity that are held in the OTC market should be aggregated with the exchange futures and options positions.

The CFTC should also be given the authority to impose federal position limits on the OTC energy swaps market. The limits should be set to ensure that speculative traders do not take unduly large positions (either individually or in aggregate) relative to the size of the total energy market and do not use the OTC market to evade exchange-based position limits.

Because Section 2(g) of the Commodity Exchange Act limits regulation of swaps, it is likely that this proposal would require congressional action, either by imposing position limits by statute, authorizing the CFTC to do so, or repealing the swaps exemption in the CEA.

By imposing consistent position limits on all noncommercial traders across all markets, traders will continue to have the opportunity to invest in energy commodities, but only up to the level necessary to ensure adequate liquidity in the market. This would prevent a recurrence of excessive speculative activity that created the 2008 commodity bubble while ensuring that the markets continue to enjoy adequate liquidity to function efficiently.

The Air Transport Association strongly supports taking these steps and, except as noted above, believes that the Commodity Exchange Act, which charges the CFTC with ensuring the integrity of commodity markets, provides you with the authority needed to take these steps. To the extent legislation is needed to implement any of the measures described above, the Air Transport Association supports legislation.

You have requested views on the methodology for determining appropriate position limits for energy markets. The CFTC should draw on its experience in setting position limits for agricultural commodities to determine appropriate position limits for all crude oil contracts. The factors that CFTC should consider when setting these limits include normal trading volumes for that commodity, open interest, price volatility, the risk of price manipulation or market “cornering,” the size of the spot market, the supplies of the underlying commodity, and other measures routinely used by the Commission to set position limits on agricultural commodities.

The objective should be to allow sufficient speculation to provide sufficient liquidity to enable the market to function efficiently, and no more. While it may not be possible to determine this limit with scientific precision, a reasonable surrogate might be the level of speculative activity on the regulated exchanges 10 or more years ago, before the recent explosion of speculation in commodities. The focus should be on restoring the proper and historical balance between speculators and commercial hedgers. However it is derived, the formula used should ensure both that an individual's position does not represent an unduly large percentage of the deliverable supply or an unduly large percentage of the open interest outside the delivery month and that speculative traders, in aggregate, don't hold an unduly large percentage of the total open interest.

Regarding the merits of setting these limits on a percentage-based approach versus setting them based on a fixed number of allowed contracts, the Air Transport Association Air does not have a view on that question. If the CFTC chooses to put a hard limit on the number of contracts allowed, it should do so with an eye toward ensuring that the ratio of speculators to commercial traders remains close to proven historical averages.

Finally, we feel that index funds should be required to report the level of investment of each individual investor or entity that has invested in a fund. This will ensure that no single investor has exceeded his or her speculative position limits through investments in large index funds. As with agricultural commodities, swap dealers should be subject to standards applied to the aggregate positions of the swap dealer and his or her commercial and noncommercial interests, so as to prevent distorting of the market, which would undermine its economic purpose.

Hedge Exemptions

Hedge exemptions from speculative position limits generally should only be available to persons who produce, process, merchandise, manufacture or consume a commodity. The general assumption here is that the management of financial risk alone should not qualify a trader for a hedge exemption from speculative position limits. Thus, index traders, exchange-traded funds and issuers of exchange-traded notes should not qualify for hedge exemptions. Commercial hedgers receiving hedge exemptions should be required to report their positions and be subject to audits to ensure the legitimacy of their claim for hedge exemptions.

Conflicts of Interest

I would be remiss if I failed to call your attention to another factor driving the destructive volatility in oil markets. Some financial firms trade extensively for their own proprietary accounts in the oil futures market while at the same time:

- Occupying a central position in the OTC market as swaps dealers, which provides them with information as to transactions which may influence market movements;
- Selling commodity investments to clients, including index funds, which may influence the direction of the market;
- Advising corporate clients on hedging strategies; and
- Publishing analysts' reports on the market, including predictions of market movements, which can significantly impact the market.

These activities, and the possible conflicts of interest to which they give rise, deserve to be investigated. In recent years, commodities have come to be viewed as an investment class by the investment community. Unfortunately, commodity markets do not have the same kinds of protections against fraud and manipulation that govern the function of the stock market. We strongly support the administration's efforts to harmonize the legal and regulatory structures governing the commodity and the stock markets, and to harmonize the authority of the SEC and the CFTC.

CONCLUSION

Again, thank you for the opportunity to testify before the Commission on these vital issues. Fuel has become airlines' single largest expense. The extreme volatility we have seen in these markets in recent months has made it impossible to undertake necessary corporate planning and has been devastating to our industry and the employees and communities that depend on us. You have the opportunity to take significant steps to reform these markets and we in the airline industry, on behalf of our employees and the communities we serve, commend you for the leadership that you are exercising on this critical issue.

I look forward to answering any questions you may have.