Discussions with the CFTC

Position Limits

The Goldman Sachs Group, Inc.
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Agenda

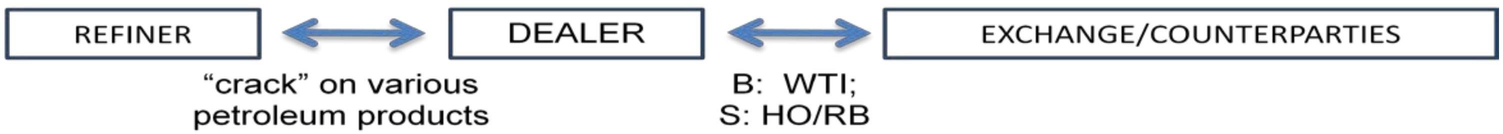
- Dealers’ role in commodities markets
- Existing position limit framework
- Dodd/Frank position limit mandate
- Approach under Dodd/Frank

Managing Risk in the Commodity Markets

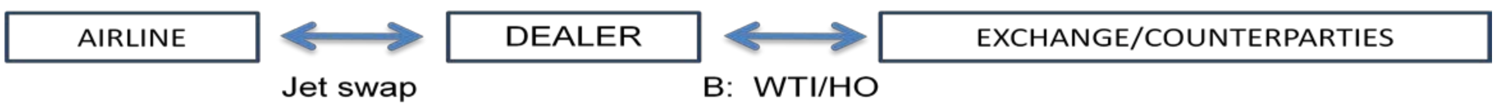
- General motivations:
  - Commodity clients seek to obtain or transfer exposure in relation to different commodities
  - Clients look to dealers to provide customized products and liquidity for various products
    - E.g., Jet fuel in the US Gulf Coast , Diesel in NY Harbor, Iso-butane in Montbelvieu, TX
  - Dealers generally hedge using liquid, standardized contracts (often listed futures on particular commodities)
  - The difference between client- specific underliers and standardized contracts is referred to as basis risk
  - Ultimately, dealers seek to mitigate risk internally by managing diverse client base
- Basis risk includes:
  - Commodity type
  - Tenor and pricing methodology
  - Settlement terms (e.g., single day vs. average of many days settlement)
  - Customized volumes by day, week or month
  - Pricing location
  - Underlying Currency
- Other risks borne by dealers include:
  - Credit
  - Funding
  - Contract terms

Examples of Transactions

- Example 1: Refiner seeks to expand production and takes loan to fund capex. Lenders, seeking to secure borrower's ability to repay, require refiner to hedge feedstock costs and product sales



- Example 2: Airline seeks to hedge exposure to jet fuel prices, for which it pays average of month price



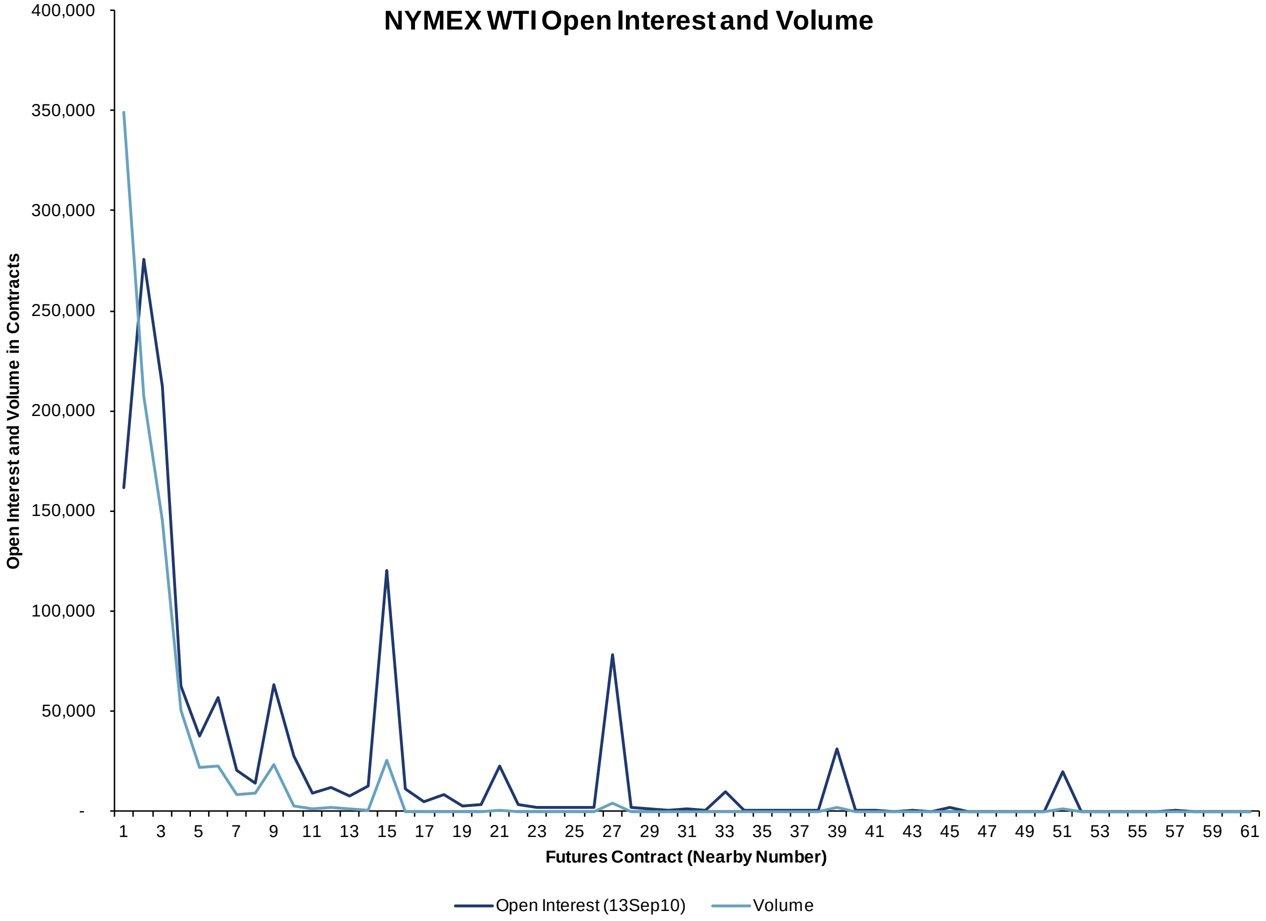
- Dealer's book is a composite of variety positions that are distilled into very focused risks

Example of an End-User Transaction

- Step 1: An airline seeks to hedge its Jet Fuel consumption for 2011. The airline requests a price on an average price swap for 2011 on US Gulf Coast Jet Fuel in the OTC market and receives bids/offers in response
- Step 2: The airline analyzes the prices and decides to buy a swap on US Gulf Coast Jet Fuel from a swap dealer
- Step 3: The swap dealer is short USGC Jet Fuel and needs to hedge
  - Swap dealer buys NOV10 WTI futures (current front month and most actively traded)
  - Swap dealer buys NOV10 HO crack to move length from WTI to HO as a closer proxy to Jet Fuel
  - Swap dealer buys NOV10-DEC10 HO spreads
  - Swap dealer buys DEC10-JUN11 HO spreads on part of position
  - Swap dealer buys DEC10-DEC11 HO spreads on part of position
- Step 4: Swap dealer is left short USGC Jet Fuel pricing over the average of 2011 vs long DEC10 HO, MAY11 HO and DEC11HO

Managing Risks of Longer Tenor Trades

- As shown in the chart below the futures market has liquidity only at specific points mostly concentrated in the front month



Dealer Operations Pre-Dodd/Frank

- Dealer trades swaps with clients, using futures and other products as hedge, relying on hedge exemptions
- Dealer purposefully retains capacity under hedge exemptions to allow for contingencies (e.g., early termination by client)
- Dealer prices efficiently by internalizing risk mitigation through client base (offsetting producers with consumers, also with investors and speculators)

Dodd/Frank Position Limit Mandate

- CEA Section 4a as amended
  - Ability to set limits to prevent/eliminate excessive speculation when burden to commerce
  - Establishment of Position Limits
    - DCM futures on exempt and agricultural commodities
  - Requirements of limits: Each, all and spot months; aggregate, with goal of:
    - Diminishing/preventing excessive speculation
    - Deterring manipulation, squeezes, corners
    - Ensuring sufficient liquidity for hedgers
    - Ensuring price discovery function
  - Definition of Significant Price Discovery Function
  - Commission to treat economically equivalent contracts on equivalent basis, notwithstanding other provisions of section
  - Aggregate limits
  - Exemptive authority for traders; contract types
- 4a(c)(2)(B): Swap dealer exemptions only for swaps with commercials

Rules Under Dodd/Frank

- Aggregate limits
  - — Excessive speculation mandate
  - — Netting of contracts having comparable underlying risk in order to ensure liquidity and price discovery
- Exchange/Contract-Specific
  - — Focus should be on spot month where squeezes, corners are risk
- Swap Dealer Hedge Exemptions:
  - — Reduced reliance on swap hedge exemption in light of reduced scope and manner in which dealers manage operations
- Risks in Rulemaking
  - — More expensive execution for customers
  - — Volatility
  - — Aberrations; movement of open interest
- Other considerations
  - — “Crowding out”
  - — Account controller aggregation

Economically Similar Swaps and Futures

- The same exposures frequently may be expressed in different, but economically equivalent forms
  - Example 1: WTI Average Price Swaps vs. string of listed futures
    - Average price swaps settle against the average settlement price of WTI over the business days in specified period. (ie. Calendar 2011)
    - A string of listed futures over the same time period will have the same economic exposure
  - Example 2: Multiple commodity contract vs the underlying futures
    - Multiple commodity contracts financial settle against the settlement price of the underlying futures
    - Multiple commodity contracts represent the same economic exposure as a corresponding position in the underlying futures

Glossary of Terms

- "Crack": Swap based on difference between price of crude oil and refined products
- WTI: listed futures contract on West Texas Intermediate light sweet crude oil
- HO: listed futures contract on heating oil
- RB: listed futures contract on Reformulated Blendstock for Oxygenate Blending gasoline