The Views
Of
American Cotton Shippers Association
On
The ICE No. 2 Contract Informa Report

Presented by
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Agricultural Advisory Committee
Commodity Futures Trading Commission
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Chairman Gensler, and members of the Commission, I am Jordan Lea of Eastern Trading Company of Greenville, South Carolina. I appear today in my capacity as President of the American Cotton Shippers Association (ACSA), whose members market approximately 75 percent of the cotton produced in the U.S. and are the primary commercial users of the ICE No. 2 Upland Cotton Futures and Options Contracts.

At the outset, I wish to inform the Commission that ACSA endorses the recommendations of the Subcommittee of the Cotton Committee of the Intercontinental Exchange (ICE) to delete New Orleans and to add Dallas/Fort Worth as delivery points on the ICE No. 2 Upland Cotton Contract. I want to stress, however, that the adequacy of delivery points has never been an issue for the commercial users of the contract.

As the attached 1997 study conducted for ACSA by Dr. Anne E. Peck[1] and the 2009 memorandum prepared by Neal P. Gillen, ACSA's former Executive Vice President and General Counsel,[2] indicate, the ICE No. 2 Contract is functioning well, there is full convergence, adequate storage capacity, and most importantly it provides accurate price discovery for producers and adequate hedging for its commercial users.

I appear today in response to the Commission's request to provide ACSA's critique of the Informa study and not the recommendations of the previously mentioned ICE Subcommittee. Let me begin by stating that ACSA agrees with one recommendation of the Informa Study – that Memphis be maintained as a delivery point. We respectfully disagree with the other recommendations[3] for the reasons discussed herein.

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[1] Deliveries on the New York Cotton Exchange #2 Cotton Futures Contract: An Analysis of their Location and Amount Over the Period 1970-1997, A Report to the American Cotton Shippers Association by Anne E. Peck, Holbrook Working Professor of Commodity Price Studies, Food Research Institute, Stanford, California, August 1997.

[2] The Adequacy of Delivery Points On the ICE Number 2 Upland Cotton Contract, July 2009, by Neal P. Gillen, Executive Vice President & General Counsel, American Cotton Shippers Association, June 2009.

[3] The principal recommendations of the Informa Delivery Point Study are as follows:

In brief, Informa would add a new location in Texas and discontinue New Orleans, Galveston, and Houston, as well as consider dropping Greenville. It would consider adding Lubbock because it is a primary production area, but not Dallas because it is not in a producing area and may not have sufficient warehouse capacity.

We contend that the contract is functioning properly by providing convergence with the spot and the futures price in the delivery period resulting in accurate price discovery and hedging for commercials. Given that fact, one must ask the question, as Professor Anne E. Peck did in her analysis of delivery points on the No. 2 Contract, "Whether a contract change will have effects on the market and if so, whether those effects will improve the functioning of the market?"

Dr. Peck went on to say that such an assessment "is by definition more speculative, involving judgment of 'what ifs' rather than evaluation of the historical evidence, but, it is nonetheless critical – changes that reduce the utility of the market end by hurting all users."

Not only did the Informa study fail to address this critical, if not dispositive, question, it erroneously presumes that a principle purpose of a futures contract is to provide producers with delivery points at the farm gate. Simply put, it suggests that the

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- ICE retain Memphis as a futures delivery point and that one new location in Texas be added; however, it is recommended that New Orleans, Houston and Galveston be discontinued as delivery locations. Large-scale production of cotton does not take place near New Orleans, and Houston and Galveston are near a second-tier production area. New Orleans is no longer a significant port for cotton, and Houston/Galveston is a second-tier export staging area. Additionally, there is little storage capacity for certified cotton in New Orleans or Houston, and ownership is concentrated among a small number of companies.
- Conditions are not as clear-cut for Greenville. It is recommended that Greenville be discontinued as a futures delivery location but that the ICE monitor cotton sector developments in the region in the coming years, and if production remains strong in southwest Georgia but recedes further in North Carolina, the exchange consider establishing a futures delivery point in Georgia.
- Lubbock should be strongly considered for the new futures delivery location in Texas. West Texas is one of the two areas where cotton production has become concentrated in the last few years, and there is warehouse capacity for 1.6 million bales in Lubbock. Lubbock is a significant origin of cotton shipped by rail; however, container availability is limited, and one merchant reportedly controls a significant share of the shipment of cotton in containers from Lubbock.
- Dallas has a considerably higher availability of containers, and a larger number of merchants reportedly are involved in shipping containerized cotton from Dallas than Lubbock. From a transportation standpoint, Dallas is competitive. However, Dallas is not in the center of a significant cotton production area, and the main drawback is that it does not currently have large-scale cotton storage. Prior to making any decision about the addition of Dallas as the new Texas delivery point, it is highly recommended that the ICE investigate the potential cotton warehouse capacity within Dallas and any obstacles to increasing capacity.

ICE No. 2 Contract would better serve producers by being a cash or a delivery contract, which is contrary to the purposes of a futures contract and is a formula for failure of this vibrant and useful risk management tool. Another erroneous assumption of the Informa study is that a change in delivery points could increase income to producers. The net price to a producer is determined not by the futures price at the time of delivery, but by the market price.[4] Therefore, any reduction in the cost to tender would not result in any change in the price to the farmer. The fact is that the price received by a West Texas producer is the world price in the export market and not the futures price.

Therefore, to place a delivery point in the heart of the largest production area in the world, as the Informa study recommends, would be detrimental to both producers and the contract. The suggestion also ignores the established fact that the U.S. and the international cotton industries have been well-served by the location of delivery points in at either consuming, export, or central marketing locations.

As Dr. Peck said, "The central purpose of a futures market, in so far as it differs from other markets, is to give reflection today to the value of a commodity both today and at specified futures dates. That is, its central purpose is price discovery and price discovery alone, and many of the features unique to futures markets, such as their standardized contract terms, were designed specifically to promote efficient price discovery." Peck notes, and I can tell you from personal experience, that the uniformity of contract terms rarely mirrors the physical transactions between commercials. As a result there are relatively few deliveries because it is cheaper for all parties to offset their futures positions and arrange the physical transfer on more preferred terms.

On the current pattern of export flow, Informa's current data is inaccurate in that it misstates the volume actually shipped from specific ports given that the data was not properly gathered. More importantly, Informa overlooked the evolution underway in the export pattern of shipments impelled by the size of the new ships coming on line, which are restricted to deepwater ports. The new generation of ships, "Pan Max" container vessels, designed to transit the widened Panama Canal in 2014 are already in service and currently calling on Charleston, South Carolina, which increases the importance of Greenville as a delivery point. The lack of containers on the West Coast and the availability of containers on the East Coast has already diverted cotton to Charleston.

I would add that in discrediting Greenville's viability as a delivery point, the Informa study primarily focused on the use of the contract solely from a seller or deliverer's bias or point of view, as opposed to that of a receiver or ultimate user. When you combine the total production in the Southeast along with the total consumption of the

[4] By suggesting that producers have an alternative market, Informa ignores the increased marketing costs incurred in certificating cotton (in addition to penalty fees for prolonged certification) and the likelihood that prices received by a farmer in the futures contract would be lower than those they would have realized in the spot market. Why, because if cotton is going to the contract, it is usually because it is a supply market. Be they loan stocks or cert stocks – such stocks have a price depressing effect. Therefore, to suggest that producers use the contract for delivery in such circumstances subjects them to unnecessary additional costs and lower returns than they would realize in the spot market.

U.S. textile industry, which is based in the Southeast, a delivery point in that location, solely based on the concentration of cotton, is more important than adding one in West Texas.

Further, the diversion of cotton traffic from the West Coast ports will increase considerably when the co-joined ports of Houston and Galveston begin operation of their new container port in time for the opening of the widened Panama Canal. Texas cotton will then move through the new Houston-Galveston container port because of the lower cost to move cotton to shipside and the decreased time of delivering cotton to South East Asia and the Far East. This development could also enhance the establishment of a delivery point in Dallas/Fort Worth. Corpus Christi, however, is lacking as a delivery point for a number of reasons, chief among them being that Pan Max container vessels cannot transit beneath the Harbor Bridge to gain entry to the port; and, the Texas Department of Transportation lacks the estimated $.8 billion necessary to raise the level of the Harbor Bridge to allow such vessels to enter the port.

We would also concede that New Orleans' days as a cotton port have passed. Currently there are no warehouses licensed to store certified cotton in New Orleans; therefore, we believe its deletion is justified.

Further, the Informa report relies heavily on the change in crop production patterns for its delivery point recommendations. The fact of the matter is that crop patterns are continually changing. And, have changed again since the high prices that impelled the switch to corn, other grains and oil seed production in the Mid South and the Southeast have decreased. As a result, cotton production in these areas has increased as farmers are coming home to cotton, the crop they know the best. The latest USDA crop report shows that in the last year U.S. planted acreage has increased by 20 percent and that production will increase by an estimated 50 percent from 12.2 million bales to 18.3 million bales. Therefore, the importance of delivery points in these areas has not diminished, particularly Memphis, which has become the primary transportation, pricing, and marketing center for the U.S. cotton industry.

Most of the increase in production will occur in West Texas due to the most favorable conditions in the last 15-years. By placing a delivery point in that location, as Informa suggests, would ignore the essential purpose of the futures contract and more importantly, as I noted earlier, could jeopardize the price potential for producers.

In conclusion, I would stress the following:

- The events of March 2008 were in no way related to the adequacy of delivery points on the ICE No. 2 Contract.

- The level of trading on the ICE No. 2 Contract reflects a total confidence in the current configuration of delivery points. This fact alone argues for the validity of the current delivery points, which both the commercials and the speculative traders deem to be an adequate balance wherein neither buyer nor seller are penalized or discouraged from using the contract. That belief, by the primary users of the contract, provides it with the essential liquidity necessary to provide cotton producers with adequate price discovery.

- The users of the contract require stability in its terms and conditions. Though ACSA believes that the current delivery structure is adequate, we have agreed to the deletion of New Orleans and the addition of Dallas/Fort Worth.

- ACSA's membership believes that the users of the ICE No. 2 Contract are best served when the contract terms are consistent. Therefore, we urge that once established, the proposed changes in the delivery structure and all other terms and conditions of the contract be maintained.

Thank you.