THE TESTIMONY OF
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OF THE
INDUSTRIAL ENERGY CONSUMERS OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION
ON
ENERGY POSITION LIMITS AND HEDGE EXEMPTIONS

AUGUST 5, 2009

Chairman Gensler and Commissioners, thank you for the opportunity to testify before you on the subject of energy position limits and hedge exemptions. We are grateful that the Commission is addressing these important issues that directly impact retail consumers, farmers and manufacturers.

Four key points:

1. Protect the integrity of this very special market that is like no other. Speculative transactions should be directly tied to managing the risk of the underlying commodity. Speculative transactions based on other investment objectives like diversification of investment portfolios and a hedge against inflation is not consistent with the managing of risk of the underlying commodity. Funds like the United States Natural Gas Fund undermine price formation.

2. Speculative aggregate position limits are essential. In lieu of aggregated position limits, position limits must be applied to speculative financial transactions.

3. Excessive speculation in the natural gas market is real and must be stopped immediately.

4. The futures markets worked fine prior to the passage of the Commodity Futures Modernization Act.

The Industrial Energy Consumers of America and the importance of natural gas
The Industrial Energy Consumers of America is a nonpartisan association of leading manufacturing companies with over $900 billion in annual sales and with more than 900,000 employees nationwide. It is an organization created to promote the interests of manufacturing companies 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.

Natural gas is a vital fuel and feedstock for the manufacturing sector and its price often determines whether energy intensive industries are globally competitive and whether we create or lose jobs. Supply and demand of the commodity should determine its price – not excessive speculation. We support increased transparency of all markets and exchanges, including the OTC markets. We believe that excessive speculation is a reality that must be addressed through aggregated position limits, limiting speculative transaction exemptions and increased oversight. We are very concerned about the impact ETF volumes are having on price discovery. Lastly, IECA supported increased funding to the CFTC to support increased oversight of these important markets.

Excessive speculation in the natural gas market is real
From January to August of 2008 the price of natural gas more than doubled because of excessive speculation, not supply and demand fundamentals. During the same time period, U.S. production of natural gas rose about 8 percent, national inventories were well within the 5 year average and demand was essentially unchanged from the same period of the previous year. As a result of excessive speculation, consumers paid over $40 billion in higher natural gas costs. The higher price of natural gas also increased the price of electricity because natural gas powered generation sets the marginal price of electricity in a large portion of the country. This means that as natural gas prices rose, so did the price of electricity. We are unable to calculate this impact but believe it rose to a level costing consumers several billion dollars.

The futures market is very unique and its integrity should be protected
The futures market is special and unlike any other. Its creation was not intended to be a substitute for a gambling casino for Wall Street Banks, hedge funds, sovereign funds and index funds. The futures market was created to serve the direct needs of buyers and sellers of commodities and the managing of financial risk associated with these transactions. Financial speculators have an important role but we must keep speculative transactions directly tied to the physical commodity as possible or we will destroy the integrity of this market and price formation.

The Congress and its regulatory agencies must protect the integrity of the futures market because unlike stocks and bonds, what happens to futures prices directly impact each American, each family, farmer and manufacturer. Families do not eat stocks and bonds. The efficient and fair functioning of this market determines what we pay for gasoline, heating and cooling and everything that we eat. For many manufacturers who employ 12,000,000 employees, the futures market can determine our competitiveness and directly impact jobs.

Speculative limit exemptions are of concern and the more the CFTC lets financial speculative trading be less and less associated with the underlying commodity, the more it endangers price formation based on supply and demand. While the volume of natural gas consumed has remained almost unchanged over the last ten years, traded volume has increased multiple times along with volatility.

The futures market was not created to serve speculators whose investment objective is to hedge against inflation or to diversify retail investor’s portfolio. Those objectives are “not” related to the purchase or sale transactions of the commodity. ETF transactions are not related to facilitating transactions or managing the risk to the underlying commodity. The objectives of ETFs and their “passive investors” are detached from the realities of basic supply and demand fundamentals that make this market work and serve each consumer in this country. This detachment from the physical commodity is inconsistent with the futures market.

For most of the last ten years, natural gas volatility has been the highest of any commodity. The volume of trades by producers and consumers is an insignificant portion of the volume while noncommercial speculative volumes have mushroomed. Unfortunately, it appears that speculators are trading with other speculators, betting on the market as if it’s a gambling casino with little regard to the fundamentals of supply and demand of the commodity.

United States Natural Gas Fund

The United States Natural Gas Fund (USNGF) differs in significant ways from the historic functioning of the futures market and how price formation occurs. Their objective is unrelated to financial risk management transactions of buying or selling the underlying commodity. Unlike other players, they “must” roll their positions each month. The combination of their significant volume relative to other players and the size of the physical market - plus everyone knowing when they are going to roll their positions, damages price formation.

Price formation is not “passive”, it is dynamic. It is a combination of reaction and proaction and without a pattern. Price formation is unpredictable, not predictable and reflects changes in supply and demand to the underlying commodity. The USNGF is a “long-only” fund and it does not contribute to the price formation dynamics, it undermines price formation.

We understand that the USNGF currently has 300 million shares and that this represents nearly 30 percent of the prompt month volume, a significant position for one entity. A Wall Street Journal article of July 8, 2009 reports that the USNGF has asked the Security Exchange Commission for a tenfold increase in issued shares to one billion. This is a significant increase and raises market power concerns. The Wall Street Journal reports that assets under management have grown from $727 million in just four months to over $4.5 billion, a 600 percent increase. Is there any doubt that if one player controls 40% of the volume, 50% of the volume or 60 % of the volume, that it does not impact the market price?

Our own analysis of the USNGF shows more existing influence than one thinks. Total open interest in the August natural gas futures contract as of two weeks ago was about 140,000 contracts. The fund maintains that 23% of UNG funds are invested directly into prompt month gas futures and about 34% in Henry Hub swaps.

However, when looking closer at their holding, we estimate that USNGF held 27,203 contracts in August natural gas futures alone. USNGF also held 51,747 in NYMEX

Henry Swaps (quarter size contracts), which converts to 12,937 to full-size futures contracts.

On the Intercontinental Exchange, USNGF held 339,234 in Henry Hub Swap look-a-like contracts, which converts to 84,809 full size contracts. So when everything is converted to full-size NYMEX contracts, it's as if the USNGF maintains around 86% of the entire NYMEX August open interest or roughly 125,000 contracts.

The USNGF has said that there is no empirical data to show the fund's buying or selling of energy futures has resulted in "little or no price disruption even as the overall size of the funds positions have increased dramatically". We do not agree with this assessment and we look forward to empirical data to prove that price has not been impacted. The burden of proof is not on consumers, it is on the USNGF. In the absence of the USNGF volumes, we believe prices would have fallen because of the increasing supply, increased inventories and weak demand relative to the previous year.

IECA is not alone in its thinking. Several market analysts including the Credit Suisse Group estimate the gas fund pushed up prices by 50 cents per million Btu from May through early July. On an annual basis, a 50 cent increase would cost America's consumers about $3.5 billion.

CFTC should pursue why hedge funds are investing in the USNGF versus directly participating in the market.

1. **Applying position limits consistently across all markets and participants, including index traders, managers of Exchange Traded Funds, and issues of Exchange Traded Notes;**
    - All markets and participants, both regulated and unregulated are linked and cannot be separated from price formation. All markets and participants must be included.
    - Of the three choices of speculative position limits, daily trading limits or aggregate position limits, the later is most important. Without aggregate position limits and transparency across all exchanges and players, position limits will not work effectively. Without aggregate position limits, players will move their transactions to dark markets.
    - In lieu of aggregated position limits, IECA supports speculative position limits by month and all months combined.
    - We believe the CFTC should set the position limit for each commodity, not the exchanges. There is an inherent conflict of interest in letting the exchanges set position limits or trading limits.
    - Since Congress, under section 4a. exempted bona fide hedging transactions from limits and statutorily defined a bona fide hedging transaction as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity, this same rationale should apply to speculators. Any speculative transaction must be tied to managing risk of the underlying

commodity. Financial speculators should have position limits and exemptions should be limited and not given unless there is a "direct relationship" to the underlying commodity.
- Speculative position limits serve to decrease the potential for positions to influence the general price level. By limiting the ability of one person or a group of persons to obtain large positions, speculative limits reduce the potential of accentuating price swings if large positions must be liquidated in the event of adverse price changes or for other reasons.
- Transparency is extraordinarily important. Markets work better when all players know the government is monitoring their activity and that illegal actions can be caught and that severe civil and criminal penalties will be applied.
- Responsible position limits do not limit liquidity; they encourage more and diverse players.

2. **The effect of position limits on market function, integrity, and efficiency;**
   - In lieu of aggregated position limits, position limits will help prevent excessive speculation but other factors are important as well such as limiting exemptions.

3. **The effect of position limits on facilitating the risk management of clearinghouses;**
   - We do not believe that position limits would negatively impact risk management transactions.

4. **Whether the CFTC needs additional authority to implement such limits;**
   - We believe the CFTC has the existing authority to implement position limits.

5. **What methodology the Commission should use to determine position limit levels for each market.**
   - For natural gas markets, no player should control more than 10 percent of the physical market volume. The 10 percent represents the combined volumes of prompt and forward positions on all exchanges (regulated and non-regulated) combined and all related products such as futures, options, swaps and index funds.

6. **Should the Commission limit the aggregate positions held by one person across different markets?**
   - Yes. We suggest aggregate position limits for natural gas to not exceed 10 percent of the physical volume of the market.
   - It is important for the CFTC to set aggregate position limits to prevent market participants from moving to the over the counter market or on to foreign exchanges. The CFTC must be able to set aggregate limits on all players trading OTC derivatives that perform or affect a significant price discovery function.

7. **Should exemptions from position limits be permitted for anyone other than bona fide hedgers for the conduct and management of a commercial enterprise?**

- The CFTC should limit speculative position exemptions to purchase or sale transactions closely associated with risk management of the underlying commodity.

Thank you for the opportunity to testify and we look forward to working with Commodity Futures Trading Commission to improve the integrity of the futures market.