



May 16, 2008

IS SPECULATION DRIVING AG & ENERGY MARKETS?

Agriculture and energy market speculation was the subject of a hearing yesterday in the U.S. House Committee on Agriculture. The common question by members of Congress to witnesses representing government regulatory agencies, the agriculture and energy industries, and commodity exchanges concerned the level and effect of the participation of institutional investors in commodity markets. Government and commodity exchange representatives consistently stated that neither the level of participation nor the effect on prices was significant or out of the ordinary. Other witnesses were not so sure.

All of the testimony can be found on the website for the House Agriculture Committee at the link below. Since these issues are affecting your businesses in profound ways you may find this very interesting reading. Some predict long term high prices in all commodities. Others describe a bubble similar to the late 90's technology bubble. Whether you agree or disagree with each witness just reading the debate may be like a book you can't put down since we have not only lived through historic times lately but the story is probably still unfolding.

<http://agriculture.house.gov/hearings/statements.html>

Keep reading – I cut several interesting points from the testimony below.

*Testimony (excerpts) of:
Dr. James Newsome, President and CEO
New York Mercantile Exchange, Inc.*

Prices in our markets are determined by fundamental market forces. However, uncertainty about the availability of supply due to political and security factors, uncertainty about the actual levels of continuing growth of demand in developing parts of the world, and uncertainty about currency fluctuations also materially weigh into the fundamental analysis.

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There is no evidence to date either that the trading by non-commercials has impaired the price discovery function of our markets or that raising margins would have an impact on lowering prices.

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Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are clearly having an impact on the assessment of market fundamentals. One may view such factors as contributing an uncertainty or risk premium to the usual analysis of supply and demand data. Indeed, **such factors now may fairly be viewed as part of the new fundamentals of these commodities.**

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I wish to highlight this finding: growth in consumption has outstripped growth in non-OPEC production by over 1 million barrels per day. That is substantially tighter than a snug fit. Indeed, that may be said to be more akin to a choke hold.

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With projected demand exceeding supply by 1 million barrels per day, the only way a market with highly inelastic demand will equilibrate is through a substantive rise in price. The upward pressure has been there and, according to these projections, will continue to be there.

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While we respect EIA's efforts to project these numbers, we would caution anyone on oversimplifying the challenge of even accurately assessing the demand in these countries, much less projecting it. The only thing we can be certain of is the relentless increase in petroleum demand pushed each year by the millions of people making the transition from less-developed circumstances to the beginnings of middle-class circumstances. Currently, China is putting more than eight million new cars on the road each year. Does anyone doubt that the average driver is increasing his/her amount of driving each year? India, the Middle East and Russia are experiencing similar transitions. We believe the sheer uncertainty around consumption in these economies, in combination with the extremely tight world market conditions, is a strong influence on price volatility in the world oil market.

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Further, the geopolitical risks provide added uncertainty to the oil supply outlook. Moreover, various state-owned oil companies have not been investing adequately in oil production. Venezuela nationalized assets owned by U.S. oil companies and has generally proved to be an unreliable partner. Mexico's major oil field has been depleted, and Mexico will not allow US companies to engage in deep water drilling. Colombian rebels have been blowing up pipelines with some frequency, and are being financially backed by the Venezuelan government. Nigerian rebel forces routinely shut down oil fields - either through strikes, terrorism or sabotage. Russia has suffered a decline in production. Finally, U.S. production has declined dramatically in the past 20 years, and promising new drilling areas are generally not being opened up in this country due to environmental considerations.

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Data analysis conducted by our Research Department indicates that the percentage of open interest in NYMEX Crude Oil futures held by non-commercial participants relative to commercial participants actually decreased over the last year even at the same time that prices were increasing.

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It is widely, yet inaccurately, theorized that speculators can drive prices up. Placing blame on speculators may grab the attention of the media, but does not accurately reflect the realities of how markets work. With hundreds of commercial participants and instantaneous price dissemination, any "speculative" price would be expected to be met with an equally strong "commercial" reaction. If markets move in a direction inconsistent with actual market factors, a vast number of participants, including energy producers, wholesalers, retailers, and

government agencies, have comparable access to information. These participants will respond to ensure that prices rapidly return to where the industry consensus believes they should be.

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By the nature of their role, speculative traders seek to participate in price trends that are already underway, but because they lack the capacity to make or take delivery, they will never be in a position to hold a market position through to the delivery process. They create virtually no impact on daily settlement prices, the primary benchmark used by the marketplace.

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Some have suggested that the answer to higher crude oil prices is to impose substantially greater margins on energy futures markets regulated by the CFTC. We believe that this approach is misguided. As previously noted, in a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces and imposing more onerous margin levels will not affect price levels. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. dollar, are now market fundamentals. Adjusting margin levels significantly upward will not change the underlying market fundamentals. Furthermore, given the reality of global competition in energy derivatives, increasing crude oil margins on futures markets regulated by the CFTC inevitably will force trading volume away from regulated and transparent U.S. exchanges into the unlit corners of unregulated venues and onto less regulated and more opaque overseas markets.

Testimony (excerpts) of:

Mr. Gerry Ramm

President, Inland Oil Company

On behalf of the Petroleum Marketers Association of America

Excessive speculation on energy trading facilities is the fuel that is driving this runaway train in crude oil prices.

Last month, Mr. Stephen Simon of ExxonMobil Corp. who testified before the House Select Committee for Energy Independence and Global Warming agreed that speculation is part of the problem stating, "When you look at the fundamentals, the price should be \$50-55 a barrel of oil. The weaker dollar, geopolitical risk, and speculation."

Several analysts have estimated that speculative purchases of oil futures have added as much as \$20-25 per barrel to the current price of crude oil, thereby pushing up the price of oil from \$50 to approximately \$70 per barrel.

PMAA has come to the conclusion that excessive speculation on energy commodity markets has driven up the price of crude oil (and, consequently, all refined petroleum products) without the supply and demand fundamentals to justify the recent run-up.

Large purchases of crude oil futures contracts by speculators, have, in consequence, created an additional demand for oil which drives up the prices of oil for future delivery. This has the same effect that additional demand for contracts for the delivery of a physical barrel today drives up the

price for oil on the spot market. Basically, a futures contract bought by a speculator has the same effect on demand for a barrel that results from the purchase of a futures contract by a petroleum marketer.

Congress and the Administration might also consider:

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3. Raising margin requirements (or necessary collateral) for non-commercial entities or so-called "non-physical players," i.e. commodities traders and investors that do not have the ability to take physical possession of the commodity, or otherwise incurs risk (including price risk) associated with the commodity either in connection with their business or that of a client. In other words, anyone who does not meet the definition of "eligible commercial entity" under 7 USC §1a (11). Currently, margin requirements in futures trading are as low as 3 percent for some contracts. To buy U.S. equities, margin requirements are a minimum of 50 percent.
4. Requiring non-commercial traders (e.g. financial institutions, insurance companies, commodity pools) to have the ability to take physical delivery of at least some of the product. (Rep. John Larson (D-CT) is considering such a proposal now).
5. Imposing new transaction fees for non-commercial or "non-physical" traders.
6. Banning from the market any participant that does not have the ability to take direct physical possession of a commodity, is not trading in order to manage risk associated with the commodity, or is not a risk management or hedging service (again, anyone that does not meet the statutory definition of "commercial entity" under 7 USC 1a(11)).

*Testimony (excerpts) of:
 Terrence A. Duffy
 Executive Chairman of CME Group Inc.*

Walter Lukken, the acting Chairman of the CFTC,... said: "These are extraordinary times for our markets with commodity futures prices at unprecedented levels. In the last three months, the agricultural staples of wheat, corn, soybeans, rice and oats have hit all-time highs. We have also witnessed record prices in crude oil, gasoline and other related energy products. Broadly speaking, the falling dollar, strong demand from the emerging world economies, global political unrest, detrimental weather and ethanol mandates have driven up commodity futures prices across-the-board. On top of these trends, the emergence of the sub-prime crisis last summer led investors to increasingly seek portfolio exposure in commodity futures.... **To date, CFTC staff analysis indicates that the current higher futures prices generally are not a result of manipulative forces.**"

The Wall Street Journal surveyed a significant cross section of economists who agreed that: "The global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble"

The U.S. Department of Agriculture's Economic Research Service recently studied the causes of increases in food commodity prices and concluded that, in addition to slower growth in production compared with rapid growth in demand, "...factors that have added to global food commodity price inflation include the declining value of the U.S. dollar, rising energy prices, increasing agricultural costs of production, growing foreign exchange holdings by major food-importing

countries, and policies adopted recently by some exporting and importing countries to mitigate their own food price inflation."

David Hightower, author of the "Hightower Report," summed up the supply/demand situation in corn last year as follows: "We have experienced three consecutive years of record corn production... and three consecutive years of declining ending reserves. Supply has put its best team on the field and demand keeps winning."

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We have identified eight of the most significant factors that are influencing the supply and demand for grains and oilseeds. Each is important and deserves attention.

- 1) Biofuels
- 2) Limited Farmland
- 3) Weak Dollar
- 4) Slower Growth in Production vs. Rapid Growth in Demand
- 5) Additional Meat Needs More Grain
- 6) Drought
- 7) Export Curb
- 8) Inventories

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None of these factors seems to make the least impression on those commentators who demand an easy solution, which they claim can be mandated without cost or consequence. This vocal group, which does not include any competent agriculture economists, insists that driving speculators from the markets will bring prices back to a level that is more acceptable to these critics and better for the market. Worse still, the plan is to drive speculators from futures markets by government mandated increases in margins.

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The proponents of this plan do not understand the role of speculation. They do not understand that there are speculators on both sides of the market. They fail to grasp that increasing margins to artificial levels is just as likely to drive prices to artificial levels. And they are oblivious to the fact that efforts to mandate price by direct price control, or by indirect actions, distort future production and cause costly misallocation of resources of production.

*Testimony (excerpts) of:
Jeffrey Harris, Chief Economist
Commodity Futures Trading Commission (CFTC)*

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Clearly, the commodity futures markets are experiencing robust growth across commodities, particularly with the recent influx of institutional investors. There is no question that investors and consumers are diversifying their portfolios and seeking exposure to the commodity markets.

.... The arrival of these newer participants has, in some instances, coincided with observed price increases. Perhaps naturally, some have concluded that a portion of the high prices in agricultural and energy futures markets is related to the impact of financial trading in futures

markets. Because these allegations come, in many cases, from experienced participants we do take them seriously and are examining this issue very carefully. ...

.... data used by Commission staff show that price changes are largely unrelated to fund trading. In fact, record agriculture prices have occurred in commodities for which there is no futures contract (durum wheat and hay, for example) and in markets with little or no index trading.... rice (with relatively modest levels of index trading) has recently set new, all-time high prices.

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In the agriculture commodities, wide basis relationships (cash-futures differentials), where they exist, are largely explained by historically high diesel prices.all major modes of grain transportation (truck, rail, and barge) rely on diesel fuel,grain is located further from those points and incurs higher transportation costs. barge freight....is more than twice as high as it was last year.

CFTC staff...., have not seen diminished aggregate short hedging in forward futures months.CFTC continues to analyze this data and its implications - in hopes of finding ways to encourage more forward contracting by market participants.

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Some observers have suggested that higher crude oil and agriculture commodity futures prices are being driven by speculators in the financial markets, and have suggested steps to reduce or limit their actions in the markets.

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All the data modeling and analysis we have done to date indicates there is little economic evidence to demonstrate that prices are being systematically driven by speculators in these markets. Generally, the data shows that:

- Prices have risen sharply for many commodities that have neither developed futures markets (e.g. durum wheat, steel, iron ore, coal, etc.) nor institutional fund investments (Minneapolis wheat and Chicago rice).
- Markets where index trading is greatest as a percentage of total open interest (live cattle and hog futures) have actually suffered from falling prices during the past year.
- **The level of speculation in the agriculture commodity and the crude oil markets has remained relatively constant in percentage terms as prices have risen.**
- **Our studies in agriculture and crude oil markets have found that speculators tend to follow trends in prices rather than set them.**
- Speculators such as managed money traders are both buyers and sellers in these markets. For example, data shows that there are almost as many bearish funds in wheat and crude oil as bullish funds.

Testimony (excerpts) of:

Bob Stallman

President, American Farm Bureau Federation

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Lack of Convergence Between the Futures and Cash Prices

Convergence is the idea that futures prices by the close of the contract eventually equate to what is occurring in the cash market. It varies by commodity and geography, but historically the relationship between the cash and futures markets has been fairly constant with predictable seasonal variation. Certainly local market conditions might move the basis level around a few cents on any given day, but the underlying basis figures – predicated on the futures and cash markets coming together at the end of the contract – allowed all involved to function in a well-informed manner.

Today neither the convergence of futures to cash nor reasonable expectations of basis levels applies for a number of contracts. This is significantly increasing the risk faced by producers and will likely induce major structural change in the grain/oilseed/fiber handling sector over the next few months.

These developments challenge producers' abilities to develop and implement risk management programs for marketing their products. The problem is compounded by the fact that many producers are being asked to make firm price commitments for inputs. In some instances, they are even being asked to pre-pay for inputs they will not utilize until next crop year. This results in the uncomfortable position of producers locking in future input costs without similar opportunities in future crop prices.

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...grain storage.

Some possible solutions to the convergence problem may be:

1. We encourage the CFTC to require additional delivery points to prevent potential market manipulation and assure an adequate delivery system. We note the Kansas City Board of Trade is currently in the process of increasing its wheat contract delivery points from two to four. We would encourage other exchanges to consider similar changes.
2. End the certificate of delivery and return to the notice process originally used for delivery against the futures contract. This should not cause any major disruption to futures trading. Once the change is made and traders realize delivery means actual physical acceptance of the commodity or that there will be some monetary penalty for re-tender, then we should see the orderly liquidation of open interest going into a contract delivery period. As we move toward contract expiration, we should see more orderly convergence.
3. An option which merits examination is cash settlement. There are cash-settled grain and oilseed contracts today; however, the volume for those contracts is probably too small to test this in practice. Moving to cash settlement should not be undertaken lightly, but it should be studied as a way to improve convergence.

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.....Market analysts report a continued, massive inflow of capital into the grain pits, much of it by long-only, passively managed index funds that buy futures and roll them forward according to a set schedule.

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Trading activity by funds is certainly one of the contributing factors generating high futures prices for commodities. Ordinarily, this would appear to be positive for agriculture. But if the futures markets do not converge with cash markets, there is little information on what real price levels should be either for producers or consumers of the commodity in question. With convergence, even if futures market prices fall precipitously in the delivery month, there are still economic signals being sent to which producers can respond.

*Testimony (excerpts) of:
Garry Niemeyer
National Corn Growers Association*

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First, to address the current lack of convergence in between Cash and Futures markets: Simply to fix convergence in the market, we must fix delivery. The problem, there are no easy solutions to this task. Here are a few recommendations; we put forward to the CME Group.

1) Investigate the development of a method to allow farmers or small elevators that have taken a short position to actually deliver against that futures contract. Currently farmers cannot make delivery against these positions. Farmers can only sell futures and deliver against shipping certificates, provided the owner of that certificate plans to make delivery and go to load out. If the delivery stations realized that a farmer or an elevator could call a clearinghouse and set up delivery, it would cause the commercials to drive the futures down at contract expiration to the cash price. A possible hybrid would be to restrict farmer delivery to only a few points with a 1 or 2 day delivery option.

2) Investigate implementing a forced Load Out plan whereby some set percentage of contracts has to go to delivery. During the investigation, consideration must be given to how these Load Outs would be distributed, and what impact this may have on liquidity if the non-commercials are prematurely driven out of the market prior to contract expiration.

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Second and more importantly, we must find a way to head off the development of a commodity bubble or if it has already occurred, stop it from bursting. Several possible solutions are:

1) Redefine hedgers vs. speculators. NCGA recognizes the valuable role all parties play in providing liquidity in a market. It is NCGA's view that the large Funds are having a disproportionate influence in the futures markets and are "non-commercial" traders. While we do not want to drive the index and hedge funds or swap traders from the market, they should be treated as "speculators". Counter to several CFTC decisions, we believe to truly be classified as a "hedger"; an entity must have a cash commodity position.

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If in fact a “Commodity Bubble” is developing and that bubble was to pop, the entire grain sector would be devastated. Similar to the increase in grain prices, other input costs have risen dramatically, including for seed, fertilizer, fuel, or land rents. Farmers are now carrying significantly higher financial risk to plant their crops. A rapid deflation in grain prices would result in tremendous financial losses to farmers, especially in light of our recent inability for growers to contract grain at these current prices. If a disconnect between futures prices and cash (fundamentals) exists as alluded to earlier, the impact of the bubble bursting would be all the more dire. For this reason, it is imperative that the CFTC review recent decisions concerning the market power some of the major players wield and take into consideration the potential impact pending decisions have from the perspective of inflating a commodity bubble.

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