ISDA®

International Swaps and Derivatives Association, Inc.(EU Office)
Square de Meeus 38/40
1000 Bruxelles
Belgium
Telephone: 32 (2) 4018760
Facsimile: 32 (2) 4018762
email: isdaeurope@isda.org
website: www.isda.org

President Jose Manuel Barroso
The European Commission
200 Rue de la Loi
B-1049 Brussels

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Dear President Barroso,

ISDA view on Rising Commodities Prices (also responding to EC Communication on Rising Food Prices)

ISDA © (International Swaps and Derivatives Association) represents participants in the privately negotiated derivatives industry. ISDA was chartered in 1985 and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, including commodity derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities.

ISDA is pleased to submit a response following the European Commission's recent Communication on rising food prices (20 May 2008). For the purposes of this letter we also address the causes of rising oil prices.

ISDA believes that increases in food and energy prices in the near term have been driven by a shift in fundamentals, specifically a rise in demand relative to supply. We support the headline measure of the European Commission's Communication, which calls for proposed reforms of the CAP in order to increase EU production and reduce tariff barriers. We also agree with the Commission's analysis of the numerous macro-economic factors underpinning price increases in food and energy. However, ISDA queries the assertion made in the Communication which suggests that the activities of 'speculators' in commodity related financial markets 'lead to increased price movements and volatility on futures and spot commodity markets and have amplified the underlying price movements[1].'

[1] http://ec.europa.eu/commission_barroso/president/pdf/20080521_document_en.pdf

On the contrary, we believe that the presence of a wide set of participants in the commodity markets (including financial institutions) limits volatility in these markets. We should note that the emergence of the futures markets over three hundred years ago was due to the need for commodity producers to limit risks particular to their activities, such as weather. Commodity derivatives trading, has limited price volatility in these markets, thus achieving this goal. This core function of risk mitigation remains vital in the present day.

Additionally, it is well known that commodities can act as a useful hedge in an inflationary environment (while other asset classes, such as equities, may fall in value, commodities are likely to increase in value). Commodities also provide a useful opportunity to prudently diversify portfolio risks. This is investment that is *responding* to market conditions however, with, a very limited impact in terms of 'amplification' of price.

There is a wealth of evidence that there has been a shift in fundamental supply and demand in commodities markets. While the emotion generated by rising fuel and food prices is understandable, we believe that reactions focusing on the supposed ill-deeds of 'speculators' (for the purposes of the rest of this paper we will use the term 'non-commercial investors') are driven by emotion – and not by evidence.

The key reasons for recent commodity price rises

ISDA believes that the recent increases in food and oil prices reflect a fundamental shift in the balance between supply and demand in both cases.

1. Increased demand from developing countries

As noted in the Commission Communication, there has been a huge increase in demand from developing economies for food and energy, most prominently in China, India and Brazil. Rapid economic growth, accompanied by industrialization and urbanization has seen a continued increase in demand for oil and other raw materials, while the resultant rise in living standards has seen a greater demand for food, as well as changes in dietary patterns.

Demand is further enhanced by subsidization of the costs of some commodities by both developed and developing countries.

The recent (1 July) Medium Term Oil Market report of the IEA[2] estimates that even while demand for oil from developed countries will decrease slightly over the 2008-2013 period, demand will increase by 3.7% annually over that period in developing countries, particularly in Asia, Latin America and the Middle East.

The nature and extent of the increased demand for food is very well documented in the European Commission's Communication.

[2] http://www.iea.org/textbase/speech/2008/eagles_mtomr2008.pdf

2. Supply constraints

Global supply of oil and food has not been able to keep pace with the growth of demand.

Supply constraints on the oil side relate primarily to barriers and disincentives to invest in new oil production. These include

- Uncertainty created by global climate change policy;
- Uncertainty caused by political instability or legal uncertainty (e.g. due to State intervention) in major oil-producing regions (e.g. the Middle East, Russia, South America);
- Greater regulatory barriers to accessing oil, for environmental, planning and other socio-economic reasons;
- In some countries, a reluctance to tap oil sources, in order to save it for future generations.

The Medium Term Oil Market report from the IEA (which confirms the view that oil price rises are due to supply and demand fundamentals and not 'speculation'), for example, suggests that investment costs have doubled, and that current oil drilling projects have fallen 12-15 months behind schedule on average.

A similar pattern is evident in food commodities. Supply constraints in this context include

- Bad weather in 2006 and 2007, leading to poor harvests;
- Policy responses to food shortages, which, while making sense at national level, have helped to drive up global prices e.g. restriction of rice exports from India and of wheat exports from Russia, Ukraine, and Argentina. This distorts the usual supply and demand interaction at global level.
- 'Closed' or artificially supported markets. Regardless of the justifications of the Common Agricultural Policy, or of US farm policy, price supports and subsidies unquestionably distort food prices;
- A slowdown in productivity growth and inadequate investment in research.

We would also mention that supply in the food sector lags demand, as growers cannot respond to increased demand immediately (planting, growth, and harvesting, which take time, is required).

Further to the aforementioned supply constraints, government policies favouring biofuels production, as a means to both address energy self-sufficiency (in the face of climate change and an increasing awareness of resource scarcity) have indirectly led to reduced food supply, as land previously used for food cultivation and production is being used.

The European Commission points out that EU biofuel production has little impact on global food prices, as biofuels use less than 1% of EU cereal production, but we should note that the impact of policies of other trade partners have a significant impact on global commodity prices: the US Energy Independence and Security Act, for example, requires fuel producers to produce 5 times as much biofuel as in 2007, by 2022. The US is backing this policy with major subsidies.

Participants in commodity derivatives markets

ISDA would classify the main participants in commodity derivative markets as follows:

Commercial risk managers:

- Commodity producers – farmers, miners, upstream, oil;
- Intermediaries – Refiners, traders, utilities;
- Consumers – Transportation fuel, building trade, food processors, jewelry.

These participants seek to hedge commercial risks through derivatives. Examples in this regard could include power companies investing in weather derivatives (to hedge against lower demand) or food processors seeking to hedge against rises in physical food prices.

Non-Commercial participants

- Global macro hedge funds;
- Commodity trading advisors (often system trading);
- Large pension and other index-tracking funds;
- Capital-guaranteed investment products.

Much attention has been focused on the role of pension funds in 'long' investing in commodities. This is largely done in investment in commodity index-linked funds. It is worth underlining, in this context, that this type of investment is justified on sound prudential grounds (on behalf of future retirees) rather than (as could be caricatured) greed. Furthermore, we should note that this is not 'short-term' investment – pensions investments are typically done with a thirty year timeframe in mind.

The level of involvement in commodities investment of institutional investors varies from EU Member State to EU Member State. While pension fund involvement in commodities markets is at a very early stage, in most EU Member States. German and Dutch pension funds have been active in commodities investments for some time. The ABP pension fund, managed on behalf of the Dutch civil service, has an estimated Euros 216 billion in assets under management, for example (as of end-2007), and projects that 3% of its portfolio will be invested in commodities over the 2007-2009 period[3]. Pension fund investments are typically subject to quantitative limits on their investment in commodities.

Dealers and other Intermediaries

- International and regional banking institutions;
- Energy trading companies;
    - Non-regulated entities owned by utilities;
    - Other physical traders (mostly owned by refiners and transporters)
- Aggregators negotiate purchase of commodities on behalf of a group of customers (unlike other intermediaries, they do not provide liquidity).

[3] Figures taken from www.abp.nl

It is important to note that retail investors are not a major factor in commodities markets (where there is retail participation, it is intermediated by professional investors, such as pension funds).

What value do non-commercial market participants add to commodity derivatives markets?

Non-commercial market participants (whether they be dealer banks, pension funds, or hedge funds) play a vital role in commodity derivatives markets, by virtue of their willingness to take on the commercial risks confronted by producers in their core commercial activities.

For example, a wheat producer can agree a futures contract with a financial institution willing to take a view on the weather and season harvest yield. The wheat producer will thereby lock-in a guaranteed price for his product, regardless of the supply and demand conditions following the harvest. As the wheat producer agreed this transaction in advance, he therefore has no incentive to hoard wheat as a risk mitigator against futures shortages– his 'hedge' has already been facilitated by the financial institutions' willingness to take on this risk.

'Producers' in commodities markets – such as miners, oil producers and farmers depend on non-commercial market participants to take on their risks, add liquidity in the market, and stabilize market prices.

In brief, non-commercial participants add value in two ways. First, they provide a party with which dealers can hedge the risks they take on from other hedgers. And second, different types of non-commercial participants add diversity to the spectrum of ways in which dealers can lay off their risks. Such diversity is important because it allows risks taken on from hedgers to be dispersed more widely and deeply in a way that minimizes the impact on market prices.

For academic research on the effects of the limitation or prohibition of speculation in commodity markets, we suggest an article by David S. Jacks -*'Populists versus theorists: Futures Markets and the volatility of prices' (2006*) (enclosed).

Misunderstandings about the role of non-commercial market participants in commodity derivatives markets

There is evidence to suggest that there has been a marked increase in trading in commodity and energy derivatives, parallel with an increase in commodity and energy prices in recent years. This has led politicians and other observers to conclude that speculation in derivatives markets has driven up prices of commodities. These views are not new; virtually every period characterised by price rises in the past has also been marked by similar conclusions from politicians under pressure to "do something".

It is worth recalling that an increase in derivatives trading alone cannot drive up or drive down commodities prices in the long term. For every trader or investor who buys a commodity forward, for example, there must also be a seller. Most of these contracts are cash settled (this is particularly the case in the OTC derivatives sector), so derivatives trading need not have an impact on the underlying cash market. Moreover, if a non-commercial market participant were to take delivery of a commodity, they would then need to sell it back into the market since non-commercial market participants in derivatives markets typically have little interest in actually owning the underlying commodity.

If 'hoarding' is done in commodities markets, it is only practically possible for it to be done by producers and users with firstly the physical ability to do this, and secondly, the need to guarantee ready supplies when markets are volatile (there is no suggestion that this is the case). In this context, it is worth pointing out that restricting trading in commodity derivatives would likely make it more difficult to hedge using derivatives, therefore creating incentives for more hoarding, thereby increasing price volatility (as demand outstrips supply).

Furthermore, it should be underlined that non-commercial participants in commodities markets do not only take 'long' positions in commodities markets (positions betting on an increase in prices). It is equally possible, in practice, to generate returns from falls in prices of commodities. A recent speech by Jeffrey Harris of the CFTC cited data illustrating this point with reference to wheat and crude oil markets, where there are as many managed funds with a 'bearish view' of prices as those taking 'long' positions. [4] Investors taking short positions also play a key role in limiting price volatility in commodity derivative markets – any limitation on their ability to play this role would not be beneficial to the wider market.

<u>Conclusion</u>

ISDA remains convinced that criticism of the role of speculators is unjustified, and does a disservice to the important role that commodity derivative markets play in limiting volatility, to the benefit of the real economy. As previously mentioned, non-commercial market participants have often been the target of criticism and action at political level at times of price volatility in commodities markets, with negative economic consequences in every case.

We believe that there is clear evidence of a number of factors effecting fundamental supply and demand for commodities. In this context, we very much welcome the European Commission's wish to consider this issue at length, and look forward to providing assistance whether possible. We remain at your disposal if you have any questions on the any of the issues raised in this letter

Yours sincerely,

George Handjinicolaou
Deputy CEO and Regional Director EMEA

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[4] http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/harris-fenton051508.pdf. Harris also noted that prices have risen sharply for many commodities that do not have developed futures markets, that markets where percentages of total open interest coming from index funds are the largest (relative to percentage of open interest from index funds in other commodities) have suffered from falling prices, and mentioned that studies in agriculture and crude oil markets have found that speculators tend to follow trends in prices rather than set them.

Cc Commissioner Joaquin Almunia (ECFIN)
Commissioner Charlie McCreevy (Internal Market)
Commissioner Andris Piebalgs (Energy and Transport)
Commissioner Mariann Fischer Boel (Agriculture and Rural Development)
Mrs Catherine Day, Secretary-General, European Commission
Mr. Klaus Regling, Director-General, ECFIN
Mr Jorgen Holmqvist, Director-General, Internal Market
Mr Matthias Ruete, Director-General, Energy and Transport
Mr. Jean-Luc Demarty, Director-General, Agriculture and Rural Development
Mr. David Wright, Deputy DG, Internal Market
Mr. Emil Paulis, Director, Financial Services Policy and Financial Markets, DG Internal Market
Mrs. Maria Velentza, Head of Unit, Securities, DG Internal Market
Mr. Hannes Huhtaniemi, Policy Officer, Securities, DG Internal Market
Mr. Sabino Fornies Martinez, Cabinet of Commissioner Almunia