LDC Gas Forum: "Powering Progress"
Chicago Marriott Downtown Magnificent Mile
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[Introduced by Christy Coleman, Director, LDC Gas Forum]

Thank you, Christy, for that kind introduction.

It is an honor and pleasure to be here with you today delivering the first keynote of this conference. I'm delighted to be here with my colleagues from our natural gas team from both New York and Houston, as well as so many of our valued customers.

Our CME Group team is here today because we have a long-term commitment to this industry, to maintaining efficient markets for you, your customers and all market participants around the world and – I stress this last point given our regulatory environment – advocating on your behalf on regulatory issues so that we can continue the competitiveness, efficiency and integrity of natural gas markets.

During our time together today, I hope you will gain an even better sense of our commitment to these principles.
And to begin, I want to briefly sketch out who we are and what we bring to the natural gas marketplace, out to the burner tip and back to the well head.

So let's start with who CME Group is and what we have to offer, and then I'll turn to an analysis of what we see as the most important regulatory issues at hand.

Who We Are
To provide just some very brief context around my point of view, as many of you know, CME Group is a leading and very diverse derivatives marketplace.

- We operate highly efficient derivatives markets with deep liquidity and low execution costs.

- Our products are industry benchmarks, the most diverse product line of any exchange – we trade interest rate products such as Eurodollars and U.S. Treasuries, equity index products, foreign exchange, metals products and agricultural commodities. I'll speak in detail about our energy complex in just a moment.

- We have a transparent and open market structure. And I think it's important to note that we have a very diverse and global customer base that includes, among others, banks, hedge funds, asset managers, corporations, commercial producers, distributors and merchandisers, intermediaries and proprietary trading firms.

- More than 85 percent of our business is transacted electronically via CME Globex, which operates virtually 24/7 and is distributed to 150 countries.

- CME Globex provides a transparent, level playing field for all participants, with non-discriminatory access to the same connectivity options at the same prices, depending on their business needs.

  Anonymity of traders and firms is protected on all bids, offers and execution reports; and those bids and offers are available to all participants and matched according to transparent algorithms.

  This is all to say that we recognize that speed is a part of an efficient marketplace. Many in the financial services world, and those who study it, have focused on what is wrong with speed. They frequently use the example of the rise of high frequency trading, which is a type of trading run by computerized algorithms that provides for rapid trading into and out of positions – sometimes in a matter of seconds. We at CME Group feel that high frequency and algorithmic traders are critical liquidity providers. We know that liquidity is arguably the best defense against disruptive markets and we are on record advocating the industry's need to promote rather than impede liquidity.

- Speaking of liquidity, in addition to these strengths in electronic trading, we also operate two very active trading floors, one in New York and the other in Chicago.

- We have a strong track record of innovation and customer service, and we are a global partner of choice for exchanges around the world who are looking to broaden the distribution of their products and leverage our technology capabilities to help them do that.

- Lastly, we also are unique in that part of the value we provide to our customers is our industry-leading central counterparty clearing services.
  - We have strong track records clearing both listed and over-the-counter derivatives.
  - And in more than a century of operations, no customer has ever lost money due to a clearing firm default. I will spend a little more time on the value of central clearing in just a moment.

Overall, we are a leading derivatives marketplace.

Because our customers have the ability to transfer their risk in our markets, they can trade more goods. Write more loans. Fly more flights. Businesses grow and economies expand because of the risk management capabilities offered at CME Group.

CME Group Advantages for the Natural Gas Market
So with that background in mind, let's move to three key advantages that I see CME Group offering the people and institutions in this room:

- First, a broad and diverse set of traditional and derivative futures products;
- Second, a choice of access points, with the benefits of straight-through processing;
- And third, a superior counterparty credit solution.

Let's spend just a moment on each of these areas before we move to discussing the regulatory issues at hand.

Breadth of Product
In terms of energy, which I know all of you are very familiar with, CME Group is home to the West Texas Intermediate light, sweet crude oil benchmark, the most actively traded energy contract in the world. Trading more than 1 million futures and options contracts daily, WTI futures and options volumes are over twice as large as Brent futures and options. And in the last year, WTI open interest had increased 17 percent while Brent open interest has gone down by 4 percent in the same period. WTI's superior transparency enables investors to make sound judgments on the basis of accurate weekly supply and demand information.

We are also home to the Henry Hub futures contract, which now accounts for 70 percent of natural gas derivatives trading in the second quarter and representing nearly 29 million contracts – the equivalent of 10 thousand MM BTU – double our nearest competitor. What this means to you is a broad array of very liquid, benchmark products that allow you to not only manage your risk but to do so efficiently, so you can get in and out of the market when you need to do so.

Given the paradigm shift we have witnessed in the natural gas industry, Henry Hub is even more important in terms of risk management.

We have moved from a view of pervasive supply constraints to a view of plentiful natural gas resources able to supply U.S. consumption for many years to come. The development of domestic shale gas resources has principally effected this market view transformation. According to Bentek Energy, the year-to-date U.S. production of natural gas is 64.2 BCF per day, up six percent over 2010.

The enhanced supply has sharpened the price competitiveness of natural gas compared to alternate fuels. As of September 8, the MMBTU price difference between coal and natural gas was $1.09. This low price difference is encouraging generators to switch from coal to natural gas. Natural gas also has distinct environmental benefits due to its clear burn. In sum, improving supply and environmental advantages provide an optimistic future for the natural gas industry.

So when it comes to managing risk associated with that opportunity, our physically delivered Henry Hub contract is the industry standard. Its settlement price is an integral component to many downstream North American natural gas physical-market transactions, and open interest for futures based wholly on Henry Hub now stands at 1.8 million contracts, 10 thousand MMBTU, while options account for another 6.4 million.

These numbers are evidence of the deep, liquid markets in this contract which in turn provide certainty in pricing and managing risk for products at dozens of locations across North America on a daily as well as monthly basis.

We also recognize the Henry Hub benchmark as it relates to pricing spreads between natural gas in North America compared to other parts of the world. For example, in May 2009, we launched a futures contract that settles on the difference between the United Kingdom national balancing point and the Henry Hub. This particular product might be used in international applications by liquefied natural gas distributors whose supplies are headed to Europe and priced in dollars while in transit. In this example, distributors can use both Henry Hub to hedge their natural gas price risk, as well as CME Group currency contracts to hedge the dollar-euro risk.

Another important point to consider in our natural gas product line is that we are now clearing physical gas. This enables buyers and sellers to trade with each other directly, at a lower cost than what you pay now to transact peer-to-peer, depending on your internal credit costs. In other words, we are bringing natural gas risk management to a new universe of customers in a way that allows them to operate their businesses more efficiently.

Our new delivered natural gas futures enable industry participants to take delivery of product as early as the next day, and to conduct business in a more secure, cost-efficient way. A first of its kind product offering, delivered natural gas futures not only ensure delivery on shorter terms, but also provide for accelerated payment schedule. These contracts are centrally cleared, ensuring counterparty payment and providing margin offsets across the energy product complex. In short, you can now set your hedge, buy physical, sell paper, and the margins are offset. This creates the cheapest possible transaction scenario in the cleared product category.

Access

The second advantage we offer the market is a variety of access points for both listed and over-the-counter derivatives. We provide access to centrally cleared markets through CME Globex and CME ClearPort.

ClearPort is best known in the energy markets and was instrumental in solving many of the problems posed by the merchant energy crisis following Enron. During the financial crisis of the last few years, the call for counterparty credit risk mitigation remained strong as well.

When I talk to clients using ClearPort today, the number one advantage they talk about is the mitigation of their counterparty risk. They understand that having a central clearer opens their credit lines, thereby creating new trading opportunities with existing and potential clients. By using CME ClearPort, you are

essentially separating credit from price and that – we believe – is a competitive advantage for you. You can also achieve significant operational efficiencies because of the documentation time and expense that you don't have to invest with CME ClearPort.
Our netting benefits also reduce the number of payments and transfers you have to execute between counterparties, which also saves you money and time. You also get straight-through processing and real-time confirmations, all to make clearing your business even easier.

CME ClearPort currently facilitates over-the-counter trades in more than 1,000 products in energy, metals, environmental commodities, agricultural commodities and credit. The platform is extremely flexible, enabling more than 16,000 registered users to negotiate their own prices and submit the transactions through ClearPort to CME Clearing.

Building on the success in energy markets, we have the opportunity to leverage ClearPort capabilities to serve other markets, such as interest rates and foreign exchange.

Clearing
Finally, related to ClearPort, the third advantage I want to mention is that of a central counterparty clearing service that we can provide to you and your customers.
As you all are aware, all clearing is not created equal. We believe risk management is crucially important, and it impacts both implicit and explicit costs of doing business.

At CME Clearing, we have more than 100 years of experience mitigating counterparty credit risk. We have continued to serve as the buyer to every seller, and seller to every buyer during countless financial crises. From Barings to Refco to Lehman, no CME Clearing customer has ever lost money due to a counterparty default. We guarantee the performance of each trade. And, our clearing house is backed by the strength $8 billion dollars in financial safeguards. All of this is to say that the track record of CME Clearing translates into a very important benefit for our customers: security.

There are two cornerstones of our strong risk management record.

First, our daily mark-to-market practice, which creates a zero debt system by removing losses from the system on a daily basis.

Second, our risk-based margining, which ensures that losses are pre-paid so as to ensure both the market and market participants can cover a portfolio's probable losses in a given day.

Both have served the markets and market participants very well in the listed space. And both of these principles also are applied to the OTC market through CME ClearPort.

So with all of this background, why is this important to you? Because CME Group is the leading choice for natural gas risk management that also offers you a superior counterparty credit solution.

Regulation
With these three advantages in mind – products, access and the security of clearing – I think another important area to spend our time on today is the role that CME Group plays in advocating on behalf of the natural gas industry in Washington.

I would like to spend my remaining time updating you on a few regulatory issues that we consider most important to this community. My colleague and CME Group Chief Regulatory Officer Tom LaSala will cover these issues more fully later in the conference.

Overall, CME Group supports the CFTC's mission to ensure that energy markets effectively serve their important economic functions for the benefit of all market participants. We also have, however, raised several substantive issues with specific proposals that the CFTC has put forward.

In a comment letter sent to the CFTC in March, CME Group pointed out that the evidence is clear that speculative position limits in the energy markets, beyond those already in place, are not warranted.

At the heart of the issue is our belief that any steps taken to impose hard position limits must support the national policy of enhancing transparent markets and central counterparty clearing. In addition, they should prevent market participants from moving away from the best regulated, most transparent, safest marketplace to less regulated or even completely unregulated markets that are and will continue to be beyond the control of the commission and congress.

What we are suggesting here is balance.

The Commission must ensure that such limits do not have a detrimental effect on the price discovery and hedging functions of futures markets, or drive trading to unregulated markets.

Another regulatory issue to note is margining. Under the CFTC's proposed rules, cleared products would be margined differently based on where the transaction occurs.

For cleared swaps trading over-the-counter or on a SEF, a designated clearing organization, or DCO, would be required to collect margin calculated based upon a minimum liquidation time of five business days. In contrast, for cleared futures *or* swaps trading on a designated contract market, a DCO would be required to collect margin calculated based upon a minimum liquidation time of one business day.
We also need to make sure that hedge exemptions are set appropriately.

The CFTC's proposed definition of "bona fide hedging" applies to all referenced contracts, excluding swaps. According to the Commission, exemptions would be more restrictive than those we have today.

Overall, CME Group believes that the proposed bona fide hedging definition is too narrow because it may limit existing participants from being able to use these products in the way they are used to for managing risk.

As such, the definition is at odds with the broader definition of hedging. Or, said another way, we think there are unintended consequences to this more restrictive approach. In the interest of promoting liquidity and efficient price risk management, we believe the CFTC should use its broad exemptive authority to grant exemptions to market participants who use futures, options, or swaps when economically appropriate to reduce risks they face in conducting regular business.

After all, Dodd-Frank is intended to help us transparently reduce risk, not to make hedging so expensive that enterprises cannot afford to hedge in the first place.

Conclusion

In closing, I hope today I have given you a sense of how CME Group actively engages with the energy complex, including our work to shape regulation in areas that are critical to this community.

Given what we have witnessed during the financial crisis, risk management is more important than ever. We welcome your feedback as we work to extend the breadth of our products, the ease of access and the benefits of central counterparty clearing.

CME Group looks forward to continuing to partner with you to improve market efficiency for customers everywhere.

Thank you for your kind attention, and I would be happy to take any questions you have.