10-002
COMMENT
CL-02710

Electric Power Supply Association
Advocating the power of competition

April 23, 2010

Via Email: secretary@cftc.gov

David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: "Notice of Proposed Rulemaking for Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulation," 75 *Fed. Reg.* 4144 (Jan. 26, 2010)

Dear Mr. Stawick:

The Electric Power Supply Association ("EPSA") submits this letter in response to the notice of proposed rulemaking issued by the Commodity Futures Trading Commission (the "CFTC") seeking comment on its proposal to implement speculative position limits on futures and option contracts in four energy commodities (the "Proposed Rule").[1]

I. Introduction And EPSA's Interest In The Proposed Rule

EPSA is the national trade association representing competitive power suppliers, including generators and power marketers. These suppliers, who account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity to market participants throughout the country. EPSA seeks to bring the benefits of competition to all power customers.

Many of EPSA's member companies, in their role as competitive power suppliers, offer customized energy products to serve consumers with a wide range of risk appetites and electricity needs. Examples of these products include fixed-price

[1] *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, 75 Fed. Reg. 4144 (Jan. 26, 2010) (the "Proposed Rule"). The comments contained in this filing represent the position of EPSA as an organization, but not necessarily the views of any particular member with respect to any issue.

or load-following contracts, among many others, that require significant risk management to deal with fluctuating costs and uncertain demand levels. Competitive suppliers are also engaged in significant capital expenditure programs to develop the energy infrastructure to meet future demand needs, including expanding or upgrading existing facilities, as well as construction of new facilities. EPSA's members use financial instruments, including options and futures, to hedge the price risks associated with new project development and buying and selling wholesale power, as well as other key commodity inputs such as natural gas. More importantly for this proceeding, EPSA's members depend on a regulatory regime that promotes readily available and cost-effective risk management tools so they can continue to provide affordable and reliable power supply products today and in the future.

Pursuant to its authority under Section 4a(a) of the Commodity Exchange Act ("CEA"), the CFTC is proposing to adopt federal speculative position limits for contracts traded on the New York Mercantile Exchange ("NYMEX") related to Henry Hub natural gas, light sweet crude oil, New York Harbor No. 2 heating oil and New York Harbor gasoline blendstock. The rules also would apply to substantially similar contracts, including those traded on the IntercontinentalExchange, Inc. ("ICE") that the CFTC has found to be significant price discovery contracts ("SPDCs").[2] In broad terms, the CFTC has sought comment on the following:

- Are position limits needed to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations in the price of a commodity, or unwarranted changes in the price of the identified energy commodities?

[2] Under Section 2(h)(7) of the CEA, over-the-counter ("OTC") contracts traded on an electronic trading facility that have been determined by the CFTC to be SPDCs are subject to CFTC regulation. 7 U.S.C. § 2(h)(7). Exempt commercial markets listing SPDCs also are deemed to be registered entities with self-regulatory responsibilities with respect to such contracts. To date, ICE's Henry Financial LD1 Fixed Price natural gas contract is the first contract to have been determined by the CFTC to be an SPDC under the CEA. *Order Finding that the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function*, 74 Fed. Reg. 37,988 (July 30, 2009). Currently, the CFTC is reviewing several electricity and other contracts to determine whether they should be designated as SPDCs. *See, e.g., Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), to Undertake a Determination Whether the SP-15 Financial Day-Ahead LMP Peak Contract; SP-15 Financial Day-Ahead LMP Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Daily Contract; SP-15 Financial Swap Real Time LMP-Peak Daily Contract; SP-15 Financial Day-Ahead LMP Off-Peak Contract; NP-15 Financial Day-Ahead LMP Peak Daily Contract; and NP-15 Financial Day-Ahead LMP Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 51,264 (Oct. 6, 2009); *Notice of Intent, Pursuant to the Authority in Section 2(h)(7) of the Commodity Exchange Act and Commission Rule 36.3(c)(3), To Undertake a Determination Whether the PJM WH Real Time Peak Daily Contract; PJM WH Real Time Peak Contract; PJM WH Real Time Off-Peak Contract; PJM WH Day Ahead LMP Peak Daily Contract; and PJM WH Real Time Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 54,966 (Oct. 26, 2009). EPSA has filed comments in the SP-15 and PJM proceedings.

- What energy contracts should be covered by the position limits?

- Are the specific Aggregate All-Months-Combined, Single-Month Position Limits and Single Exchange Limits the correct limits, and are they set appropriately?

- What hedge exemptions should apply to commercial entities and swap dealers?

- How should the CFTC apply exemptions for delta-adjusted positions?

- Should the CFTC aggregate positions from multiple accounts subject to common ownership or control, and, if so, under what standard?

EPSA's comments address these questions from the perspective of its member companies who depend on the futures and options markets to manage their risk. In sum, it is not clear to EPSA that the position limits and exemptions, as proposed, can be adopted under the standards Congress established in CEA Sections 4a(a) and 4a(c). Setting aside the legal arguments, EPSA also is concerned about several practical considerations:

- Counterparties historically willing to take the opposite side of an EPSA member's futures or options trade may be prevented from doing so based on the structure of the position limits, the risk management and swaps dealer exemptions, and the aggregation rule. This would impact liquidity and costs.
- Some market participants may elect to reduce or eliminate their participation in the U.S. futures and options markets in favor of other markets that do not impose comparable compliance challenges. This would impact liquidity and costs.
- The compliance risk associated with the proposed limits may have the perverse effect of causing some commercial entities to reduce or avoid using futures and options to hedge risk. For example, a commercial entity may realize it lacks the ability to track multiple positions, including across affiliates, or to maintain position balance to avoid inadvertently taking a speculative position. Thus, the commercial entity might decide it is safer to avoid the futures markets and not be adequately hedged rather than face CFTC penalties for position limit violations.[3] This would impact liquidity and costs.

[3] *See In the Matter of UBS AG*, CFTC Docket No. 10-07 (enforcement settlement imposing civil monetary penalty of $130,000 for NYMEX position limit violations).

- If the futures and options markets shrink, offer less reliable price signals or raise transaction costs, it could have an adverse impact on the ability of energy companies, like EPSA's members, to raise affordable capital and manage the risk associated with investing in infrastructure projects that are at the core of the U.S.'s energy policy.
- Market participants may have to make a significant resource commitment to implement systems to comply with the position limits, only to have to start over if Congress adopts financial reform legislation. In today's economy, it would be preferable if companies had to make such an investment only once.
- Based on the record support for the Proposed Rule, the Commission appears to be concerned about addressing market activity involving less than a dozen market participants.[4] It is not clear to EPSA why the Commission needs to adopt the Proposed Rule, which would impact hundreds of entities and the market overall, when it has several other more surgical options available to it.

It is important to EPSA members that the CFTC can continue to fulfill its mission to protect all market users and the public from fraud, manipulation and abusive practices and to support competitive, efficient and financially sound futures and options markets. Accordingly, EPSA supports the CFTC's work to promote markets that accurately reflect the forces of supply and demand. However, as discussed in these comments, EPSA has concerns with multiple aspects of the Proposed Rule. EPSA believes that allowing the existing risk management tools to remain in place is a critical component of ensuring that competitive power suppliers can continue to reliably deliver efficiently priced electricity and develop necessary energy infrastructure to meet consumer demand. As a result, EPSA and its member companies have a direct interest in the outcome of the Proposed Rule and urge the Commission to give serious consideration to its concerns.

II. There Is No Apparent Legal Basis For The Proposed Rule

The CFTC is proposing to adopt position limits pursuant to its statutory authority to prevent or minimize extreme or abrupt price movements resulting from large or concentrated positions.[5] CEA Section 4a(a) states, in relevant part, that: "Excessive speculation in [a specified contract] causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and

[4] Proposed Rule at 4144 ("[T]he Commission estimates that the total number of traders with significant positions that could be affected by the proposed regulations would be approximately ten."). EPSA has no idea about the identities of the ten entities and their identities are irrelevant to EPSA's point that the law does not support the use of position limits absent a showing of excessive speculation. In any case, the Commission can address individual market participant activity with its other surveillance tools even without the proposed position limits.

[5] Proposed Rule at 4148.

unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the CFTC shall [set] such limits on ... positions ... as the CFTC finds are necessary to diminish, eliminate, or prevent such burden."[6]

EPSA's members share the view, expressed by several commenting parties with respect to the Proposed Rule, that the proposed position limits are not necessary to diminish, eliminate, or prevent excessive speculation. Nor has the CFTC set out in the Proposed Rule why the limits are necessary. Consequently, the CFTC has not met the necessary predicate under CEA Section 4a(a) to adopt the Proposed Rule.[7] Moreover, there is no evidence that there has been excessive speculation related to any of the four commodities or that excessive speculation has caused sudden or unreasonable fluctuations or unwarranted changes in the applicable commodity prices. Indeed, governmental entities studying the volatility of energy commodity prices uniformly have concluded that commodity prices reflected the underlying market fundamentals.[8]

The CFTC attempts to justify the Proposed Rule based on position concentration rather than speculation.[9] It states that the agency is responsible for "setting contract position limits in any commodity to prevent or minimize extreme or abrupt price movements resulting from large or concentrated positions."[10] This concentration test is not the standard that Congress expressly adopted as the basis for establishing position limits under CEA Section 4a(a). Nor does the Proposed Rule provide substantive support for the CFTC's alternative approach.

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[6] In light of the clear language in the CEA, if the CFTC fails to make the showing required by Section 4a(a), a court likely would reject the CFTC's position limits as contrary to clear congressional intent and otherwise unlawful. *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-44 (1984); Administrative Procedure Act, Section 706, 5 U.S.C. § 706. In addition, if the CFTC were to provide the missing justification in an order adopting the proposed position limits, it would likely face arguments that it failed to give proper notice and an opportunity to comment on such justification as required by Section 553 of the Administrative Procedure Act. 5 U.S.C. § 553.

[7] Our members are particularly concerned about this lack of statutory support because they will have to expend resources implementing costly compliance mechanisms in response to position limit rules that may later be challenged and overturned.

[8] *See, e.g.,* Proposed Rule at 4172 (concurring statement of Commissioner O'Malia noting the lack of a compelling justification for the proposed limits); *Interagency Task Force on Commodity Markets, Interim Report on Crude Oil*, at 3, 29, 31 (July 2008) (finding that fundamental supply and demand, rather than speculation, is the underlying causes of oil price volatility); *Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes,* GAO-09-285R at 5 (Jan. 30, 2009) (Government Accountability Office report addressing the cause of commodity prices volatility); *see also Task Force on Commodity Futures Markets Final Report*, International Organization of Securities Commissions, at 1 (Mar. 5, 2009) (finding that market fundamentals, rather than speculation, were the cause of 2008 price volatility in the physical energy and agricultural markets).

[9] Proposed Rule at 4148.

[10] Proposed Rule at 4148.

Moreover, CEA Section 4a(c) expressly prohibits the CFTC from limiting the size of an entity's bona fide hedge position.[11] Yet this is precisely what the Proposed Rule would do when it counts an EPSA member's hedge positions against the speculative position limit when that EPSA member exceeds that limit by even one speculative position. Congress has expressly protected the right of commercial entities to hedge their positions without concern that speculative positions could jeopardize their hedges. The Proposed Rule does not preserve this intent.

It also is not clear from the CFTC's experience with agricultural contracts that position limits are the correct tool for addressing perceived volatility in the energy markets. As Commissioner O'Malia has observed, agricultural contracts that have been subject to federally-imposed position limits also have experienced recent price fluctuations and spikes.[12] Instead of adopting federal position limits that may be of questionable benefit, EPSA's members support the comments of other market participants that have urged the CFTC to continue to use its reporting, surveillance and other oversight authority to monitor the markets and to take corrective action when it determines that unwarranted price changes are the result of market manipulation, fraud or other rule violations.

Finally, as the CFTC is aware, Congress is currently considering several legislative proposals which, if passed, would substantially amend the CEA. Among other things, the proposals would address speculative position limits, expand the CFTC's jurisdiction over the OTC markets, clarify the treatment of swap agreements and dealers, and provide the CFTC with additional authority over foreign boards of trade. Our members, therefore, strongly urge the CFTC to suspend taking any further action with respect to the Proposed Rule until this legislative process is complete.[13]

III. The Proposed Rule Will Negatively Impact Energy Businesses Without A Comparable Benefit Of Reducing Excessive Speculation

In addition to EPSA's concern that the Proposed Rule lacks a sufficient legal basis, the exemptions and position aggregation provisions in the Proposed Rule are not consistent with, and will cause considerable disruption to, the way EPSA's members conduct their business. The following aspects of the Proposed Rule cause particular concern:

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[11] 7 U.S.C. § 6a(c).

[12] Proposed Rule at 4172 ("Despite federal position limits, contracts such as wheat, corn, soybeans, and cotton contracts were not spared record setting price increases.").

[13] The record does not indicate an immediate or material threat to the energy markets that could be addressed only through position limits. EPSA therefore believes that the benefits of waiting for Congress to act clearly outweigh any purported benefits that might arise from adopting the Proposed Rule now.

- The prohibition that will prevent commercial market participants relying on a hedge exemption from holding a single speculative position;

- The arbitrary cap on risk management positions, which will:

  - limit the ability of EPSA members and other energy companies to use futures to hedge the risks associated with their businesses; and

  - reduce the number of swap dealers available to act as important counterparties to help EPSA members manage basis and other risks associated with their commercial businesses;

- The aggregation of accounts of related entities based solely on a 10 percent ownership test regardless of whether there is any common control; and

- Reduced ability to secure financing for investments in energy infrastructure projects because of the lack of clarity as to the size of position limits going forward.

A. The Proposed Rule Will Prohibit EPSA Members From Taking A Single Speculative Position

The practical effect of the Proposed Rule will be the opposite of what the CFTC intends. Instead of preventing excessive speculation, it will unfairly restrict commercial market participants, prohibiting them from taking a single speculative position if they are relying on a hedge exemption to manage the risks associated with their physical energy businesses. This will not prevent excessive speculation. In fact, the CFTC, by setting the limits at a particular level, essentially is making the determination that speculation up to those limits is *per se* not excessive. As the CFTC only is authorized to promulgate a rule that is necessary to prevent excessive speculation, it is not authorized to prohibit commercial market participants from taking speculative positions up to the speculative position limit, as these would not be "excessive."[14]

While the CFTC proposes to deny commercial market participants relying on a hedge exemption from executing a single speculative trade, it would allow speculators who do not have a physical commodity business to speculate up to the limit. There is no apparent justification for this disparate treatment, which could significantly reduce the ability of EPSA members to manage their price risks.

[14] 7 U.S.C. § 6a(a).

In addition, the proposed exemption structure could reduce participation in the energy futures markets, not only by traditional speculators, but also by commercial entities. For example, although EPSA members are largely in the futures and options markets to hedge their physical position, they may take speculative positions, including when economic to do so, for price discovery purposes, or in anticipation of some business opportunity that may not yet qualify as a hedge. Although these positions may not be large, they still contribute to liquidity. On a related note, a more liquid market with many participants also tends to send out more accurate price signals. All market participants benefit from such a structure when making investment decisions because those price signals are a critical component of the price curves used to justify an investment. Consequently, EPSA cautions the Commission that the Proposed Rule may cause more than just traditional speculators to lessen their speculating, to the general detriment of the market.

The nature of EPSA members' businesses requires them to manage a broad portfolio of trades. Their portfolios include, in addition to futures and options, forwards and swaps which may not equate exactly to listed futures contracts. Given this context, it would be extremely challenging, and potentially unachievable, for many of our members to maintain a book of trades without a single speculative position. As market conditions can change rapidly and unexpectedly, it is important that our members retain the flexibility that allows them to manage their portfolios in a manner that is commercially viable and in their best interests. This may, and often will, result in a need to have some speculative positions, sometimes simply because an underlying physical trade expires or is otherwise terminated.[15] Many of our members are also simply not operationally set up to be able to monitor their entire portfolio at all times in order to ensure that it does not contain a speculative trade.

Compounding the compliance challenge is that fact that there is no clear practical definition of what constitutes a speculative versus hedging position that can be applied to all energy market participants in the same way. EPSA understands that the CFTC's regulations define what constitutes a bona fide hedge. However, EPSA's members participate in energy markets that do not always lend themselves to standardized counterparty demands that can be easily matched with and hedged by complementary futures or options contracts. This is particularly true when an energy company has to manage risk associated with an illiquid market or a shaped product. In such cases, an energy company might enter into a position that could be deemed speculative in certain circumstances but actually represents the best alternative for

[15] For example, a position put on by an energy company to hedge its physical natural gas delivery obligations to commercial and industrial customers could face a significant reduction in demand due to a downturn in the economy affecting the customer's business, mechanical failures that slow or stop demand at an industrial plant, or a service contract lost to competitive bidding. In some cases, the energy company will not have enough notice or time to immediately liquidate the hedge in response to such changed circumstances and may thus, inadvertently, hold what would appear to have become a speculative position.

reducing that company's risk. EPSA's members need the ability to take such positions without worrying that they might run afoul of the speculation limits.

The CFTC and the Exchanges historically have permitted commercial market participants relying on a hedge exemption to hold speculative positions up to the speculative limit. We see no justification for departing from this long-standing precedent, which will increase our members' costs, which thus likely will have to be passed onto consumers.

B. The Cap On Risk Management Exemptions Will Reduce The Ability Of Many Energy Companies To Hedge All Of The Price Risks Associated With Their Businesses

Many of EPSA's members are integrated energy companies that operate primarily in the physical energy markets, but also actively trade OTC swaps. Under the Proposed Rule, integrated entities that rely on a commercial hedge exemption will not be able to hedge any of the risks associated with their swaps if their bona fide hedge exemption exceeds two times the position limit. This arbitrary cap could have a significant and negative impact on many of our members whose swap hedges would be crowded out if they have large physical commodity positions to hedge. This likely would compound the increased price volatility for our members' customers, and also may limit our members' ability to invest in important energy infrastructure projects.

There is no reasonable basis for treating commercial hedges and risk management hedges differently because both serve the same function as bona fide hedges. Under CEA Section 4a(c), the CFTC is proscribed from limiting the size of a market participant's bona fide hedge position. As EPSA has indicated, the CFTC seems to be circumventing this statutory prohibition by re-naming hedges designed to offset risks associated with OTC swaps as risk management hedges, and then excluding them from the definition of bona fide hedges. It is contrary to the plain language and intent of the statute to treat an entire category of hedges in this manner.

EPSA members largely purchase energy products for commercial or risk management purposes and as such would have most of their transactions in the identified contracts fall under a hedge exemption. While our members are not banks, hedge funds or other pure financial players, the liquidity of the marketplace and the ability to contract with these types of counterparties is essential to maintaining a robust risk management practice. Transparency and effective regulatory oversight is necessary for any well-functioning marketplace, however, regulations should not impede or unnecessarily raise the costs of commercial activity. [16]

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[16] For example, EPSA has consistently stated its support for the creation of a central data repository of all derivatives transactions to provide regulators with information regarding activity in these markets.

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C. The Proposed Aggregation Rules Will Restrict Legitimate Hedging Activity

Under the Proposed Rule, positions will be aggregated across our members' group structures based upon an inflexible 10 percent ownership test. EPSA urges the Commission to focus more on whether an ownership interest is indicative of control, as it does in its regulations allowing exchanges to aggregate positions based solely on whether a person exercises direct or indirect "control."[17] Such an approach is not only more consistent with the CFTC existing regulations and even the proposals in this proceeding related to certain funds, it also is more consistent with the approach of other regulators that oversee ownership and control issues related to EPSA's members, including the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 and the Federal Energy Regulatory Commission ("FERC").[18] EPSA appreciates that the CFTC has its own regulatory mandate. However, it is possible to harmonize these different ownership and control regulations without diminishing the CFTC's market oversight. Indeed, if the Commission adopts the Proposed Rule, greater consistency on ownership and control is apt to lead to better and more cost effective compliance.

In practice, many corporate structures include entities that share a 10 percent ownership interest, but have no control or even knowledge of each others' positions. In fact, FERC rules require that a public utility with captive customers function independently of its market-regulated power sales affiliate and restrict the sharing of non-public information between them.[19] Given these circumstances, many energy companies would not have systems in place to enable them to aggregate trading positions among affiliates with whom they do not share control.

The imposition of the new 10 percent ownership aggregation rules will therefore place an enormous burden on EPSA's members. It will require costly new group-wide collaborative monitoring systems to be put in place, which our members believe could be contrary to FERC regulations and make no discernable contribution to the CFTC's goal of reducing excessive speculation.[20]

Aggregated trading data, free of proprietary or identifying materials, should also be publicly released for review by market participants and other stakeholders.

[17] 17 C.F.R. § 150.5.

[18] At a minimum, the CFTC should consider procedures that would recognize exceptions for passive or non-controlling investments, including for those recognized under the SEC's Beneficial Ownership Reporting Requirements and Regulation 13G. 17 C.F.R. § 13d-1, *et. seq.*

[19] *See, e.g.*, *Standards of Conduct for Transmission Providers*, Order No. 2004, FERC Stats. & Regs., Regulations Preambles ¶ 31,155 (2003), *as amended,* codified at 18 C.F.R. Part 385.

[20] The CFTC also may want to take into account "control" and "affiliation" issues currently being considered at FERC in Docket No. RM09-16. In 2008, EPSA had filed a Petition for Guidance with FERC on levels of ownership an entity could have in non-affiliated companies before triggering

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D. Uncertainty About The Size Of Future Position Limits May Stifle Investment

The Proposed Rule allows the CFTC to adjust the position limits each year based on the "open interest formula." This could adversely affect the economics of long-term investments, including crucial infrastructure projects, which often require prices to be hedged many years into the future. The unpredictability as to how these position limits will vary from year to year may reduce the number of entities, especially financial institutions, who are able to take the other side of important hedging transactions because of the uncertainty as to whether they will be able to maintain effective hedges for the full duration of the projects. If EPSA members are unable to hedge their project risk, or are forced to hedge at an inflated price, this will adversely affect their ability to secure funding and engage in such projects.

IV. Conclusion

The consequences of implementing position limits at this point in time, and structured in the manner as those in this Proposed Rule, would increase energy costs to consumers and lead to under-investment in infrastructure at a time when the industry is working to develop the resources to meet consumer demand. With this concern in mind and for the reasons identified in these comments, EPSA recommends that the Commission suspend implementation of the Proposed Rule unless and until it shows that position limits are both necessary and the correct tool for addressing perceived volatility in the energy markets. EPSA urges the Commission to continue to use its reporting, surveillance and other oversight authority to monitor the markets and to take corrective action when it determines that unwarranted price changes are the result of market manipulation, fraud or other rule violations.

Respectfully Submitted,

Daniel S.M. Dolan

"control" and "affiliation" thresholds for market-based rate requirements. In response to the petition, FERC recently issued a proposal to implement a mechanism that would create a rebuttable presumption that an investor does not control a company with market based rate authority if it owns less than 20 percent of the company's voting securities and has affirmed that it has no intention of changing or influencing control of the company. The proposed rule would grant a new blanket authorization for transactions covered by an affirmation and exemption from requirements applicable to "affiliates" under the market-based rate regime.

VP, Policy Research & Communications
Electric Power Supply Association
1401 New York Avenue, NW, 11th Floor
Washington, DC 20005
(202) 628-8200