

From: John Farr <johnfarr316@gmail.com>
Sent: Sunday, April 25, 2010 8:56 PM
To: secretary <secretary@CFTC.gov>
Subject: Commodity Futures Trading Commission Proposed Federal Speculative Position Limits
Attach: Comments on CFTC Speculative Position Limits.pdf

John Farr

65 Washington Street

Brooklyn, NY 11201

April 26, 2010

Mr. David Stawick, Secretary

Commodities Futures Trading Commission

Three Lafayette Centre

1155 21st Street, NW

Washington, DC 20581

secretary@cftc.gov

Re: Commodity Futures Trading Commission Proposed Federal Speculative Position Limits, 17 CFR Parts 1, 20 and 151; 75 FR 4143 (Jan. 26, 2010)

Dear Mr. Stawick:

I would like to submit comments on the CFTC's proposal to impose all-months-combined, single-month, and spot-month speculative position limits for contracts based on the NYMEX Henry Hub natural gas contract, the NYMEX Light Sweet crude oil contract, the NYMEX New York Harbor No. 2 heating oil contract, and the NYMEX New York Harbor gasoline blendstock (RBOB) contract (the "referenced contracts") and contracts based on the referenced contracts. As a consumer of natural gas,

electricity, crude oil and gasoline based products, I applaud the CFTC for examining ways to minimize or prevent the harmful effects of uncontrolled speculation, and “to insure fair practice and honest dealing on commodity exchanges and provide a measure of control over those forms of speculative activity which ...demoralize the markets to the injury of ...consumers...” Clearly, in light of the recent increases in commodity prices generally, and energy prices in particular, along with the unusual volatility in prices, this is a topic worthy of strong consideration. However, I would like to express some concerns that the proposed rules could result in higher electricity, natural gas and energy prices for consumers. My family purchases natural gas commodity from a gas marketer (in New York they are called Energy Services Companies or ESCOs) under a fixed price contract which locks in my price of gas for three years. I understand that the gas marketer is able to offer me this gas price certainty because the marketer is able to hedge its natural gas commodity price risk in the futures markets. I am concerned that limiting the marketer’s ability to hedge its price risk will result in the marketer being unable to offer me a fixed price contract and thus I would be exposed to natural gas price volatility, so that, for example, if there is a hurricane in the Gulf of Mexico then my gas prices will increase significantly. Additionally, I understand that my electric utility, ConEd, purchases natural gas to generate electricity and any increases in natural gas prices will result in increased electricity bills for consumers since electric utilities simply pass through their cost of purchasing electricity to the utility customers. Similarly, any regulation that will impact crude oil and gasoline prices has a direct impact on consumers of those commodities or products made with those commodities. We must remember that in our economy any additional cost of doing business is passed on directly to consumers. For example, over the last couple of years when wheat prices were increasing, there were signs in all of the pizza shops and bakeries in my neighborhood informing customers of those shops of increases in prices of pizza, bread and other goods made with wheat because of the increase in wheat prices. Also, most airlines have increase air travel rates, imposed charges on baggage and instituted other fees and charges related to increased fuel prices. Similarly, any additional cost to energy companies of doing business resulting from additional regulations will be passed on to consumers.

Here are some pertinent passages from ConEd’s annual financial report:

The company enters into certain derivative instruments relating to energy price hedging under which the utility hedges market price fluctuations associated with physical purchases and sales of electricity, natural gas, and steam by using derivative instruments including futures, forwards, basis swaps, options, transmission congestion contracts and financial transmission rights contracts. These derivative instruments represent economic hedges that mitigate exposure to fluctuations in commodity prices.

In general, the Utilities recover their purchased power costs, including the cost of hedging purchase prices, pursuant to rate provisions approved by the state public utility regulatory authority having jurisdiction over the utility. Common provisions of the Utilities’ rate plans may include “Recoverable energy cost clauses” that allow the Utilities to recover on a current basis the costs for the energy they supply. [The balance sheet and cash flow statement contain line items for Recoverable energy cost.] The Utilities generally recover all of their prudently incurred fuel, purchased power and gas costs, including hedging gains and losses, in accordance with rate provisions approved by the applicable state public utility commissions. If the actual energy supply costs for a given month are more or less than the amounts billed to customers for that month, the difference in most cases is recoverable from or refundable to customers. For the Utilities’ gas costs, differences between actual and billed gas costs during the 12-month period

ending each August are charged or refunded to customers during a subsequent 12-month period.

Here is a quote from the CFTC's website:

Speculators do help make futures markets function better by providing liquidity, or the ability to buy and sell futures contracts quickly without materially affecting the price. Long and short hedgers may not be sufficient to create a liquid futures market by themselves. The participation of speculators willing to take the other side of hedgers' trades adds liquidity and makes it easier for hedgers to hedge

It seems to me that reading these passages leads to a few observations. One, the state Public Service Commission allows the utility to charge (recover from) me for the cost of purchasing electricity and gas. Two, in that case it is prudent for my utility to hedge the cost of electricity and gas by entering into derivative instruments to reduce the exposure to commodity price changes. Three, for the utility to enter into these hedging transactions the utility needs speculators on the other side of the hedge transaction to provide liquidity and make it easier for my utility to hedge and thereby reduce the cost of electricity and gas. Four, if the CFTC imposes limits on the positions that speculators (who, it seems, should better be referred to as liquidity providers) can hold then those limits probably will prevent speculators from entering into hedging contracts, which means that there would be less liquidity in the energy markets, the markets would not function better, and hedgers would not be able to buy and sell futures contracts quickly without materially affecting prices. Five, this would drive up the cost of electricity and gas for utility customers since fluctuations in the prices of those commodities would have more of an influence on customers' electricity and gas bills.

Based upon some research and reading that I have done about these issues, it seems to me that the CFTC's proposal to impose Federal Speculative Position Limits on the referenced contracts may reduce liquidity in the market for those commodities. In the economics literature, it is generally accepted that in markets high liquidity resulting from large numbers of contracts being traded is beneficial to market participants. High liquidity shrinks the margin between the *bid price* and the *ask price* (known as the *bid-ask spread*) and benefits both sides to a transaction. It is also generally accepted that in the energy markets, liquidity depends upon the existence of speculators who are willing to accept the price risk that hedgers, like the utility, want to avoid and without speculators' participation, futures markets simply would not exist. The speculators' participation in the market substantially enlarges the number of potential buyers and sellers of commodities and therefore makes it easier for the utility to make firm commitments for future delivery at a fixed price. The liquidity of a futures contract, upon which hedging depends, is directly related to the amount of speculation that takes place.

As the Supreme Court observed in the case of *Merrill Lynch v. Curran*:^[1]

The principal role of the speculator in the markets is to take the risks that the hedger is unwilling to accept. The opportunity for profit makes the speculator willing to take those risks. The activity of speculators is essential to the operation of a futures market, in that the composite bids and offers of large numbers of individuals tend to broaden a market, thus making possible the

execution with minimum price disturbance of the larger trade hedging orders. **By increasing the number of bids and offers available at any given price level, the speculator usually helps to minimize price fluctuations, rather than to intensify them.** Without the trading activity of the speculative fraternity, the liquidity, so badly needed in futures markets, simply would not exist. Trading volume would be restricted materially, since, without a host of speculative orders in the trading ring, many larger trade orders at limit prices would simply go unfilled due to the floor broker's inability to find an equally large but opposing hedge order at the same price to complete the match."

It is also generally agreed by economists that in a futures market with a large volume of trading, where transactions occur in quick succession, the transaction cost of hedging tends to be quite small. While in a futures market with very little trading the average transaction cost of hedging may be large, tending to discourage the use of futures.

As stated above in the passages from my utility's annual financial report, electric and gas utilities are exposed to fluctuations in the price of natural gas and thus face commodity price risk because the electric utilities purchase large amounts of natural gas to generate power to serve the electricity needs of the utilities' customers while gas utilities purchase gas to serve their customers' gas demand. Rising natural gas prices directly results in higher electricity prices for electricity customers since the cost of natural gas used to generate electricity is a component of the rates customers are charged for electricity service. Additionally, rising natural gas prices results in higher cost to heat my house or cook my food using natural gas. Therefore, it seems that it is prudent for electric and gas utilities, gas marketers and other participants in the energy markets to hedge their commodity price risk to minimize their exposure to spot-market price spikes. I mentioned earlier that airlines have imposed new and additional charges, including fees for baggage. The one exception to this is Southwest airlines whose television ads tout the fact that they do not charge baggage fees and I understand that the reason for this is that Southwest is able to properly hedge its fuel cost. Proper hedging of price risk leads to lower energy commodity prices and also lowers prices on other goods and services that depend on oil, gas, and other energy commodities. It seems that the ability of energy companies to effectively hedge their exposure to price spikes depends upon the existence of broad and liquid markets for energy products with small bid-ask spreads, minimal price fluctuations and low transaction cost. I am concerned that speculative position limits on the referenced energy contracts may impede the trading activities of my utility, the gas marketer from which I purchase my natural gas and other businesses that depend on these commodities, and that this will restrict trading volumes in those energy commodities, which will reduce liquidity, increase bid-ask spreads, increase transaction costs, and even lead to increase price fluctuations which is what the CFTC is trying to combat. These consequences will increase the cost of hedging natural gas exposure for my utility and my gas marketer and result in higher electricity and natural gas bills for consumers. If speculative position limits result in higher energy commodities price fluctuations then would that not defeat the purpose of the proposed rules?

I appreciate the opportunity to comment on the proposed rule and urge the CFTC to carefully consider imposing these rules so as to avoid increasing my electricity rates, natural gas commodity prices, oil and gasoline prices.

Sincerely,

John Farr

[1] 456 U.S. 353, 359 (1982).

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