

**From:** Pantano, Paul <ppantano@mwe.com>  
**Sent:** Monday, April 26, 2010 7:02 PM  
**To:** secretary <secretary@CFTC.gov>  
**Subject:** Proposed Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations  
**Attach:** EEI Comment Letter.pdf

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Dear Mr. Stawick:

Attached are the comments of the Edison Electric Institute in the rulemaking proceeding noted above. Please contact us if you have any questions.

Respectfully submitted,

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April 26, 2010

Via Email: [secretary@cftc.gov](mailto:secretary@cftc.gov)

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

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

Dear Mr. Stawick:

**I. Introduction / Our Members' Interest In The Proposed Rule**

The members of the Edison Electric Institute ("EEI") submit this letter in response to the notice of proposed rulemaking issued by the Commodity Futures Trading Commission (the "CFTC" or "Commission") seeking comment on its proposal to implement speculative position limits on futures and option contracts in four energy commodities (the "Proposed Rule").<sup>1</sup>

EEI is the association of shareholder-owned electric companies, international affiliates and industry associates worldwide. Our U.S. members serve 95% of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70% of the U.S. electric power industry. Many of EEI's electric utility company members utilize financial instruments, including energy futures contracts and swaps, to hedge the price risks associated with buying the fuels, including natural gas, used to produce wholesale power, and selling wholesale power. These risk management tools are a key method used by utilities to provide reliable electric service to consumers at stable prices that could, without adequate hedging mechanisms, become more volatile because of volatile wholesale electricity prices. As a result, EEI and its member companies have a direct interest in the Proposed Rule.

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<sup>1</sup> *Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*. 75 Fed. Reg. 4144 (Jan. 26, 2010). The comments contained in this filing represent the position of EEI as an organization, but not necessarily the views of any particular member.

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”).<sup>2</sup> EEI’s letter focuses on the following issues about which the CFTC has sought comment:

- The impact of the Proposed Rule on the ability of commercial enterprises to engage in sound risk management practices.
- How should hedge exemptions be determined for commercial entities?
- Should the CFTC aggregate positions from multiple accounts using a 10% common ownership or common control standard?

It is critically important to EEI members and their customers that the CFTC continue to fulfill its mission to protect all market users and the public from fraud, manipulation and abusive practices and to ensure that the futures and options markets are competitive, efficient and financially sound. Accordingly, EEI supports the CFTC’s work to promote markets that accurately reflect the forces of supply and demand and that are free from abusive trading activity. Nevertheless, EEI has concerns with several aspects of the Proposed Rule. Moreover, in light of the fact that Congress currently is considering several legislative proposals that, if passed, would substantially amend the CEA, and specifically address issues covered by the Proposed Rule, we urge the CFTC to wait until this legislative process is complete before taking any further action with respect to the Proposed Rule. If the CFTC decides to proceed before that time, we ask that it consider the amendments to the Proposed Rule that we propose herein, keeping in mind that our member companies depend on the energy futures, options and swaps markets to manage their commercial risk.

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<sup>2</sup> 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, including the position limit and large trader reporting requirements. 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 Hub Financial LD1 Fixed Price natural gas contract is the first and only contract to have been determined by the CFTC to be an SPDC under the CEA. *See* 74 Fed. Reg. 37988 (July 30, 2009). The CFTC announced that it will hold a public meeting on April 27, 2010, to consider whether other contracts offered for trading on the ICE, the Natural Gas Exchange, Inc. and the Chicago Climate Exchange, Inc. perform a significant price discovery function, and should thus 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 Mid-C Financial Peak Contract; Mid-C Financial Peak Daily Contract; Mid-C Financial off-Peak Contract; and Mid-C Financial Off-Peak Daily Contract, Offered for Trading on the IntercontinentalExchange, Inc., Perform Significant Price Discovery Functions*, 74 Fed. Reg. 51,261 (Oct. 6, 2009). EEI has filed comments in the Mid-C, SP-15 and PJM proceedings.

## **II. The Proposed Rule Will Negatively Impact EEI's Members Without Reducing Excessive Speculation**

Our members firmly support the CFTC in its goal of maintaining competitive and effective energy markets. However, based upon our members' considerable experience in the energy markets, we believe that certain provisions in the Proposed Rule are not consistent with, and will cause considerable disruption to, the way our members conduct their businesses.<sup>3</sup> The following aspects of the Proposed Rule cause particular concern for our members:

- The provision that will preclude commercial market participants relying on a bona fide hedge exemption from holding a single speculative position;
- The aggregation of accounts of related entities based solely on a 10% ownership test regardless of whether there is any common control; and
- The lack of clarity about the size of position limits in the future, which is likely to make it much more difficult to secure financing for investments in energy infrastructure projects.

### **A. Entities Utilizing A Bona Fide Hedge Exemption Should Be Allowed To Speculate Up To The Applicable Position Limit**

EEI respectfully submits that the practical effect of the Proposed Rule will be the opposite of what the CFTC intends. Instead of preventing excessive speculation, it will unnecessarily restrict the hedging activities of commercial market participants who need to manage the risks associated with their physical energy businesses. Under the Commission's proposal, members who need to rely on a bona fide hedge exemption are prohibited from taking a single speculative position (*i.e.*, their speculative positions are "crowded out"). This restriction will not prevent excessive speculation. In fact, the CFTC, by proposing to set the limits at a particular level, essentially is making the determination that speculation up to those limits is not excessive. Given that the intent of position limits is to prevent excessive speculation, the CFTC should not prohibit commercial market participants from taking speculative positions up to the limit that the CFTC has determined is not excessive.<sup>4</sup>

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 our members' ability to manage the price risks associated with their commercial operations. It may also reduce liquidity in the energy futures markets, widen the bid-offer spread and, thereby, increase our members' transaction costs.

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<sup>3</sup> See Comments of Commissioner O'Malia, Proposed Rule at 4172: "If position limits are implemented, the Commission must ensure that such limits do not affect market liquidity and thus hinder the market's fundamental purpose of allowing commercial hedgers to manage risk."

<sup>4</sup> Section 4a(a) Commodity Exchange Act, 7 U.S.C. §6a(a).

Speculation increases market liquidity and enables meaningful price discovery in the energy futures markets. Indeed, EEI members and other commercial enterprises rely upon the transactions of speculators to help make the energy markets function in a competitive and efficient manner. For example, the price data generated by speculative transactions provide electric companies with insights that help them establish effective hedges to reduce the exposure of their industrial, commercial and residential customers to wholesale price volatility.

There are also practical reasons not to prohibit all speculative trading by hedgers. It is very difficult for many of our members to maintain a perfectly hedged position at all times, as the nature of their businesses require them to manage a broad portfolio of trades. Their portfolios include, in addition to futures and options transactions, forwards and swaps that may not equate exactly to listed futures contracts. Given the components of their trade portfolios, it would be extremely challenging, and likely unachievable, for many of our members to maintain a book of trades without a single speculative position.

Because 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, or because the demand for certain physical inputs or outputs changes *vis-a-vis* a member's existing hedge position. For example, in the electric power industry, decisions about which plants to operate often depend upon changes in the supply and demand for different fuels. In many markets, plant dispatch priorities are determined by third parties. All of these factors can affect the composition of our members' physical transactions and their related hedge positions.

Electric utilities' load serving obligations also can vary materially from projections due to exogenous factors, including weather, a broad economic downturn or a cyclical or seasonal shift in regional industrial demand. To illustrate the problem, consider a situation where a major manufacturing facility closes due to outsourcing or some other reason, thus permanently affecting realized electricity demand. This could require a member to adjust a long-term hedge (such as selling gas forward as a proxy for power) taken based upon expected demand. Because futures positions may not be able to be offset immediately, they could appear to be speculative in the short-term.

EEI, therefore, urges the Commission to amend the Proposed Rule to allow entities utilizing a bona fide hedge exemption to engage in speculative trades up to the applicable position limit, as the CFTC and the exchanges historically have permitted with respect to energy and agricultural futures contracts. We see no reason for the Commission to depart from this long-standing precedent. This is especially true because the Commission's proposal to prohibit commercial companies that rely on a hedge exemption from taking a single speculative position could increase volatility in, and may raise our members' costs, which, in the ordinary course of business, likely will need to be passed onto consumers. We assume that it is not the Commission's intent to issue a rule that would increase energy costs for retail electricity customers.

## **B. The Proposed Aggregation Rules Will Unreasonably Restrict Legitimate Hedging Activity**

Under the Proposed Rule, positions will be aggregated across the corporate group structures of our members based upon an inflexible 10% ownership test. This is contrary to the CFTC's long-standing regulations which allow exchanges to aggregate positions based solely on whether a person exercises direct or indirect "control" over the futures trading accounts of affiliated companies.<sup>5</sup> In practice, many corporate structures include entities that share a 10% ownership interest, but that have no control or even knowledge of each others' positions. In fact, even if two entities would otherwise be subject to common control, state and federal energy regulators often require information barriers be put in place between regulated and unregulated affiliated utility trading operations, to ensure each entity is operated independently.<sup>6</sup> If an unregulated and regulated entity were forced to aggregate their positions based solely upon 10% ownership, either could (and likely at some stage would) be in a position where it was unable to hedge all of its commercial risk. If this does occur, the Proposed Rule will have had the effect of precluding a regulated utility from prudently hedging its price risk.

For these and other reasons, many EEI members do not have systems in place that would enable them to aggregate trading positions among affiliates with whom they do not share control. In addition to creating possible federal and state regulatory problems, the imposition of the 10% ownership aggregation requirement will place a significant administrative and financial burden on EEI's members. It will require costly new group-wide collaborative monitoring systems, which our members believe will make no discernable contribution to the CFTC's goal of reducing excessive speculation. EEI, therefore, urges the CFTC to amend the Proposed Rule to provide for only commonly controlled positions to be aggregated.

## **C. Uncertainty About The Size Of Future Position Limits May Inhibit Investments In Power Generation Assets And Related Infrastructure**

The Proposed Rule allows the CFTC to adjust the position limits each year based on an "open interest formula." This could adversely affect the risk-reward characteristics of long-term investments, including those in crucial infrastructure, such as solar, wind and other renewable power and transmission projects. In order to secure financing for these types of investments, our members must be able to hedge price risk many years into the future. Unpredictability as to how

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<sup>5</sup> 17 C.F.R. 150.5.

<sup>6</sup> The Federal Energy Regulatory Commission's ("FERC") rules require that a public utility with captive customers function independently of its market-regulated power sales affiliate and restrict the sharing of certain non-public information between them. *See* 18 C.F.R. 35.39. Those regulations currently are subject to a proposed rulemaking that likely will result in further clarification about the type of information that may not be shared. *See* FERC Order and Notice of Proposed Rulemaking dated April 15, 2010 (respectively the "April 15 FERC Order" and the "April 15 NOPR", and collectively the "April 15 FERC Announcements"). Paragraphs 41-43 of the April 15 FERC Order prohibit the sharing of information dealing with resource planning and fuel procurement between traditional regulated public utilities and market-regulated power sales affiliates. Depending on the outcome of the April 15 FERC Announcements, many of EEI's members may not be permitted to share the information necessary for them to coordinate their use of the futures markets to ensure that their positions (when aggregated) do not violate the speculative position limits.

position limits will vary from year to year may reduce the number of entities, especially financial institutions, that are willing and able to enter into hedging transactions with energy asset owners because of the uncertainty about whether they will be able to maintain effective hedges for the full duration of the projects. If our members are unable to hedge their project risk, or are forced to hedge at higher prices because of regulatory uncertainty, this will adversely affect their ability to secure funding for such projects.

Section 151.3(b) of the Proposed Rule allows position limits to be “exceeded to the extent that such positions remain open and were entered into in good faith prior to the effective date of any rule, regulation, or order that specifies a limit.” In order to increase the predictability necessary for effective hedging and financing, EEI requests that the Commission clarify that this exemption applies to adjustments made by the Commission pursuant to the “open interest formula” in the Proposed Rule.

### **III. The CFTC Should Wait For Legislation Pending In Congress**

As the CFTC is aware, Congress is considering several legislative proposals which, if passed, would substantially amend the CEA. Among other things, the proposals specifically would address speculative position limits, expand the CFTC’s jurisdiction over swap transactions, and provide the CFTC with additional authority over foreign boards of trade.

Enacting the Proposed Rule prior to the conclusion of pending legislation, would increase regulatory uncertainty in the energy markets. This, combined with the other concerns described above, may lead market participants to move their businesses to OTC markets or less-regulated foreign markets.<sup>7</sup> EEI, therefore, strongly urges the CFTC to suspend taking any further action with respect to the Proposed Rule until the legislative process is complete.

### **IV. Conclusion And Recommendations**

For the foregoing reasons, EEI respectfully recommends that the CFTC suspend consideration of the Proposed Rule while the legislative process is ongoing. If, before or after the completion of the legislative process, the CFTC decides to proceed with implementation of the Proposed Rule, EEI respectfully requests that the Commission amend certain aspects of the Proposed Rule, so that:

- (1) commercial entities utilizing a bona fide hedge exemption are permitted to engage in speculative trades up to the applicable position limit;
- (2) only commonly controlled positions are aggregated; and

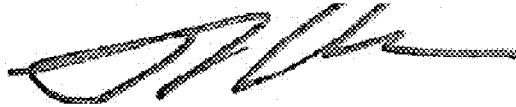
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<sup>7</sup> See closing statement of Commissioner Dunn, Meeting on Energy Position Limits and Hedge Exemptions, January 14, 2010: “[T]he adoption of this proposed regulation, without the corresponding OTC regulatory authority and similar undertakings by other nations’ regulators, may result in less transparency in the futures markets if those presently trading on an exchange move to OTC and other opaque markets to circumvent the proposed position limits.”

(3) the exemption set forth in Section 151.3(b) with respect to grandfathered futures positions applies to adjustments made by the Commission pursuant to the “open interest formula.”

Please contact me at (202) 508-5571, or Aaron Trent, Manager, Financial Analysis, at (202) 508-5526, if you have any questions regarding EEI’s comments.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'R. McMahon, Jr.', with a long horizontal flourish extending to the right.

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