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COMMENT
CL-08369

From: David Murphy <David.Murphy@NGSA.org>
Sent: Monday, April 26, 2010 1:49 PM
To: secretary <secretary@CFTC.gov>
Cc: Jenny Fordham <jenny.fordham@ngsa.org>
Subject: Comments of the Natural Gas Supply Association: 75 FR 4144
Attach: SKMBT_C65210042612370.pdf

Dear Mr. Secretary,

Please find attached the **comments** of the **Natural Gas Supply Association** regarding the **CFTC's Federal Speculative Position Limits for Referenced Energy Contracts proposed rule.**

Thank you,
David

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David W. Murphy
Energy Markets & Government Affairs
Natural Gas Supply Association
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April 26, 2010

Mr. David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: **Proposed Federal Speculative Position Limits for Reference Energy Contracts and Associated Regulations, 75 Fed. Reg. 4144 (Jan. 26, 2010)**

Dear Mr. Stawick:

The Natural Gas Supply Association ("NGSA") submits these comments on the Commodity Futures Trading Commission ("CFTC" or "Commission") Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations Notice of Proposed Rule Making ("Position Limits NOPR").

NGSA represents integrated and independent companies that produce and market [approximately 40 percent of the natural gas consumed in the United States.] Established in 1965, NGSA encourages the use of natural gas within a balanced national energy policy, and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers.

NGSA members enter into thousands of physical and financial natural gas market transactions daily and invest billions of dollars in the long-term development of natural gas supply for sale in the U.S. natural gas market. As large producers and marketers of natural gas, NGSA members would not be participating in the natural gas market if they did not believe the market exhibited three key bedrock principles of health: 1) integrity, 2) transparency and 3) efficiency.

NGSA supports the Commission's commitment to ensuring well-functioning, efficient markets that are free from manipulation. If position limits are required markets can function well if the position limits are appropriately set. The key is ensuring position limits that are dynamic, reflective of the underlying market, and established in a way that is transparent and principled, in order to minimize market disruptions and unintended consequences, such as reduced liquidity.

Since such unintended consequences would ultimately come at the expense of 60 million U.S. natural gas consumers, NGSA urges the Commission to exercise caution as it considers establishing new position limit rules. This need for caution is underscored by recent Commission staff reports. Specifically, the reports did not establish any definitive, consistent influence between the financial and physical markets[1], although they did suggest steps for greater transparency to improve market understanding and confidence. The Commission staff's preliminary analysis suggested that changes in the positions of swap dealers and noncommercial traders most often *followed* price changes. This refutes the hypothesis that the market activity of swap dealers and noncommercial traders, targeted by the Position Limits NOPR, is driving prices higher. Instead, positions of hedge funds appear to have moved inversely with the preceding price changes, suggesting that their positions might have provided a buffer against volatility-induced shocks.[2] Likewise, academics share the view that speculation plays an important role in markets. Dr. Peter Locke, former Financial Economist for the CFTC, noted "Speculators add liquidity.... The alternative, a lack of speculation, is [results in] potentially large liquidity shocks, with prices pushed far from fundamental values."[3] This leaves no doubt that caution is clearly necessary for a prudent path forward with respect to position limit regulations.

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[1] U.S. Commodity Futures Trading Commission (CFTC) Staff, ***Report on Commodity Swap Dealers & Index Traders with Commission Recommendations*** (September 2008), and CFTC-led Interagency Task Force on Commodity Markets (including the Departments of Agriculture, Energy, Treasury, Federal Reserve System Board of Governors, Federal Trade Commission and Securities & Exchange Commission) Interim Report on Crude Oil (July 2008). http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf and http://www.cftc.gov/ucm/groups/public@newsroom/documents/file/itfinterimreportoncrudeoil0708.pdf.

[2] Choo, Lee-Ken, **Annotated Bibliography on Financial "Fundamentals" in Natural Gas Markets**, April 6, 2010. **http://www.ngsa.org/newsletter/pdfs/2010%20Press%20Releases/12a-Bibliography%20for%20EIA%20release%20_2_.pdf**

[3] Locke, Peter, **Natural Gas Price Transparency and Liquidity**, October 2006, p. 6. **http://www.ngsa.org/newsletter/pdfs/Natural_%20Gas_Market_Transparency_October%202006_Final1.pdf**

Four concepts in the Position Limits NOPR risk unintended consequences to the natural gas market and consequently natural gas and energy consumers unless they are appropriately addressed. Specifically --

I. Any crowding out provisions must allow for diverse portfolio approaches to avoid harming liquidity.

II. New position limits, if required by the Commission, should be appropriately established by the exchanges, with guidelines and oversight provided by the Commission, to ensure a transparent, dynamic approach that is responsive to the market, and produces a single set of position limits instead of multiple conflicting limits.

III. Aggregation requirements must recognize the potential for multiple decentralized trading strategies based on unique subsidiary hedging interests.

IV. Risk management exemption categories must be clarified to correctly distinguish commercial hedgers.

I. Any crowding out provisions must allow for diverse portfolio approaches to avoid harming liquidity.

The Commission recognizes the importance of the bona fide hedge exemption in the Position Limits NOPR, and recognizes that positions held as bona fide hedges do not threaten the functioning of the market. The Commission also recognizes that speculative positions that are smaller than the position limit do not pose a threat to the market. There is no benefit, therefore, to prohibiting an entity from holding speculative positions that are within the speculative limits merely because the entity is also using a bona fide hedge exemption. Also, the financially settled contracts for which position limits are proposed are not subject to finite supply so the question of "crowding out" does not arise. It is simply not the case that a hedger that also speculates in any way reduces the supply of contracts available to another market participant, so there is no reason to limit the activity to a level below the normal position limit. In fact, while the Commission's argument for setting position limits as a percent of open interest is to limit the degree of concentration among speculators, this crowding out provision works to remove speculators from the market thus increasing concentration and reducing liquidity.

In addition, compliance with this requirement could require an entity to liquidate speculative positions abruptly, thus possibly creating the chaotic market conditions that the limits are intended to avoid. The requirement for abrupt liquidation would arise if an entity holding a mix of speculative and hedge positions crossed the threshold that required use of the bona fide hedge exemption, thus forcing immediate liquidation of all the speculative positions. If the speculative positions were within the appropriate limits, then they were not a source of potential harm to the market; the abrupt liquidation, however, is harmful to the market. Therefore, the proposed crowding out provisions have the perverse effect of creating the very harm they are intended to prevent. Worse, it would reduce the participation of the entities that are most familiar with market fundamentals, those with a physical presence in the contract markets. This means that contract prices may be less reflective of supply and demand conditions and the quality of price discovery may suffer.

In fact, active trading, including speculative trading, allows commercial hedgers (and speculators) to gain intelligence and insight into the market informing their decisions about when and how to implement hedges. Futures positions may also be initiated as speculative, but then used to acquire the underlying physical commodity needed for commercial purposes. If market participants retreat from the futures and options markets because they do not want to risk violation of the position limits, the markets may lose liquidity which will cause greater price volatility. If hedging price risk becomes more difficult and expensive for energy businesses, it will result in higher energy costs for consumers.

II. *Position limits, if required by the Commission, should be appropriately established by the exchanges, with guidelines and oversight provided by the Commission, to ensure a transparent, dynamic approach that is responsive to the market, and produces a single set of position limits instead of many "competing" regulations.*

As proposed, these position limits would be in addition to the existing limits managed by the exchanges. It is nearly impossible to determine, in advance, the market impact of the interactions between many CFTC-established and exchange-established different position limits or aggregate exchange position limits.

Instead of Commission-established position limits, NGSA suggests that the Commission establish a process for routine monitoring of exchange-set position limits. This would leverage the existing system without introducing a duplicative layer of

regulation. NGSA is not aware of anything in the record that demonstrates the existence of a market problem for which an additional layer of position limit regulation is an appropriate solution. Absent such a finding, we believe that it is more appropriate to monitor the existing process. If the monitoring identifies issues for which federal position limits are an apt solution, the CFTC can promulgate position limits at that time. This would mitigate the impact of any political uncertainty, allow for objective position limits that are dynamic and responsive to changing market conditions, and result in a transparent approach to formation of new position limits should they prove necessary.

III. Aggregation requirements must recognize the potential for multiple decentralized trading strategies based on unique subsidiary hedging interests.

Common corporate ownership does not imply common trading direction "as if the trading were done by a single person," especially when the threshold for aggregation is as described in the NOPR. Under the Commission's proposal, the corporate position aggregation rules will limit the ability of companies to hedge adequately. The inability to adequately hedge will inevitably lead to greater energy market volatility and unnecessarily increase the risk of bringing additional natural gas supplies to market. To avoid this unintended consequence, the methodology for establishing position limits must consider individual company trading strategies regardless of corporate ownership. The proposal would also require companies that operate both certain regulated entities and their affiliated marketing entities to violate existing federal requirements that limit information sharing between such regulated entities and marketing groups.

IV. Risk management exemption categories must be clarified to correctly distinguish commercial hedgers.

In order to craft a potential distinction between the limits afforded to commercial hedgers and those afforded to swap dealers versus pure speculators, the Commission is proposing a new risk-management exemption category. To achieve these various distinctions, the Commission is proposing a definition of the term "swap dealer" to be based on whether swap dealing is a "significant part" of an entity's business. While NGSA appreciates the Commission's efforts to identify those who are primarily risk-management dealers, market participants may interpret "significant part" in different

ways than the Commission, not only in terms of percentage, but also in terms of the underlying metric (gross income, net revenue, number of employees, promotional expenditures, etc.), and then, as similarly discussed above, measured relative to which corporate entity. This lack of clarity creates a risk that bona fide commercial hedgers could be subjectively pulled into a net that is overly broad and applied case by case without consistency.

To correct this shortcoming, the Commission should provide additional clarity regarding the metrics it will consistently employ, and how often, to make its determinations about who will be eligible for which category of exemption. Certainly, any test of significance should not be based on an either an unreasonable or fluctuating percentage.

Conclusion

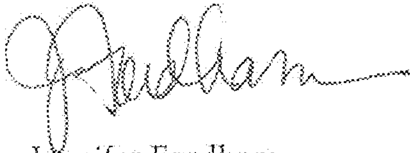
NGSA member companies are in the business of producing and marketing natural gas, investing billions of dollars annually under the watchful eye of countless shareholders, investors, citizens, and federal, state and local regulators. While natural gas producers and marketers have many different business models, risk profiles and strategies that involve a huge variety of unique, graphically dispersed assets, the fundamental objective is the same - the sale of natural gas through efficient and robust U.S. natural gas markets. Fulfilling this objective requires a U.S. market that is free from manipulation and unencumbered by policy uncertainty and conflicting regulations.

Natural gas producers and marketers make investment decisions and commitments to assets and strategies for the long-term. Just as it can take years to bring natural gas supplies to market, it can take years for the unintended consequences of policy decisions to be recognized and many more years for the market to restore balance after policy missteps are corrected. Additionally, industries invest millions annually to establish and ensure robust regulatory compliance programs. For these reasons, NGSA urges the Commission to pause its efforts in the rulemaking until legislative resolution of the financial reform debate, which could place new, or perhaps conflicting, compliance obligations on energy industry financial market participants. We urge you to consider the value to the American energy consumer in taking the time

necessary to resolve the legislative debate before making a determination on the Position Limits NOPR, enabling a more measured and appropriate approach to establishing any new position limit rules, and reducing the probability of additional future revisions.

NGSA stands ready to work with the Commission on the issues raised in the Position Limits NOPR. Please do not hesitate to contact us if we can provide any additional information.

Sincerely,



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