UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

Position Limits for Derivatives	)	RIN 3038-AD15/RIN 3038-AD16

COMMENTS OF THE AMERICAN GAS ASSOCIATION

Pursuant to the Notice of Proposed Rulemaking ("NOPR") noticed in the Federal Register on January 26, 2011,[1] by the Commodity Futures Trading Commission ("CFTC" or "Commission"), the American Gas Association ("AGA") respectfully submits these comments. AGA believes that the Commission's rulemakings to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2] should ensure that the financial markets related to energy commodities function efficiently and protect the ability of commercial hedgers to engage in risk management activities at reasonable cost for the benefit of American energy consumers.

I. COMMUNICATIONS

All pleadings, correspondence and other communications filed in this proceeding should be served on the following:

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[1] *Position Limits for Derivatives*, 76 Fed. Reg. 4,752 (Jan. 26, 2011).
[2] Pub. L. No. 111-203 (July 21, 2010).

II. IDENTITY AND INTERESTS

The AGA, founded in 1918, represents 199 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. AGA is an advocate for local natural gas utility companies and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.[3] AGA's members engage in financial risk management transactions in markets regulated by the Commission. As such, AGA's members will be directly affected by the Commission's regulations promulgated under the Dodd-Frank Act.

AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Many gas utilities use a variety of financial tools, such as futures contracts traded on CFTC-regulated exchanges and over-the-counter energy derivatives, to hedge the commercial risks associated with providing natural gas service, particularly volatility in natural gas commodity costs.

III. COMMENTS

A. Background

In January 2010, prior to enactment of the Dodd-Frank Act, the Commission proposed to establish speculative position limits for futures and options contracts in certain energy commodities and to provide exemptions from such position limits for bona fide hedging

[3] For more information, please visit www.aga.org.

transactions for certain swap dealer risk management transactions.[4] In response to the Commission's proposal, AGA supported efforts to ensure that financial markets related to energy commodities were free from manipulation and unburdened by non-transparent systemic risks. With regard to specific elements of the proposed rules, AGA recommended that the Commission allow entities with sufficient separate and independent trading activities to obtain their own hedging exemption. AGA also recommended that the Commission conduct a study after the regulations have been in place for one year to determine whether the financial markets continue to function efficiently and there are no adverse unintended consequences associated with the final rules. In August 2010, the Commission withdrew its proposal to implement speculative position limits in anticipation of issuing a new proposal on position limits and related exemptions as directed by the Dodd-Frank Act.[5]

Under Section 737 of the Dodd-Frank Act, the Commission has significant new authority to establish limits on the positions, other than bona fide hedge positions, that may be held with respect to contracts of sale for future delivery or to options on the contracts or commodities traded on designated contract markets ("DCMs"), including significant price discovery function contracts and swaps traded on DCMs or swap execution facilities ("SEFs"). Dodd-Frank Act § 737 requires the Commission to set position limits that (1) diminish, eliminate or prevent excessive speculation; (2) deter and prevent market manipulation, squeezes and corners; (3) ensure sufficient market liquidity for bond fide hedgers; and (4) ensure that the price discovery function of the underlying markets is not disrupted.

[4] *See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations*, 75 Fed. Reg. 4,143 (Jan. 26, 2010).

[5] *See Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations,* 75 Fed. Reg. 50,950 (Aug. 18, 2010).

In its proposal, the Commission seeks to establish position limits and limit formulae for certain physical commodity futures and options contracts that are executed on exchanges (DCMs) and physical commodity swaps that are economically equivalent to such exchange-traded contracts.[6] The Commission also proposes aggregate position limits that would apply across different trading venues to contracts based on the same underlying commodity.[7] The Commission states that it will first adopt current DCM spot month limits and later establish single-month and all-months-combined limits based on open interest levels.[8] The CFTC also proposed an exemption for bona fide hedging transactions, and new account aggregation standards.[9]

In particular, the Commission's proposed definitions identify the spot-month period for referenced contracts based on existing spot-month definitions set forth by the exchanges for the listed contracts.[10] The proposed rules would impose and aggregately apply spot-month position limits for the referenced contracts set at 25 percent of estimated deliverable supply and adjusted annually.[11] The proposed rules would also apply spot-month position limits separately for physically delivered contracts and all cash-settled contracts, including cash-settled futures and swaps.[12] Further, the proposed rules would establish spot-month limits not only for referenced contracts that are futures but also for referenced contracts that are economically equivalent swaps that would during the initial implementation period be set at the spot-month limit levels

[6] *See* 76 Fed. Reg. at p. 4,752.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *See id.* at p. 4,756.
[11] *See id.* at p. 4,757.
[12] *Id.*

determined by the DCMs to be equal to 25 percent of estimated deliverable supply.[13] The Commission proposes to establish non-spot-month position limits in a second phase.[14] The Commission also proposes to establish trader visibility requirements which would set limits that would trigger reporting requirements similar to reports that certain hedgers currently submit.[15]

The proposed rules would exempt bona fide hedging transactions. Under the Commission's proposal, a trader may exceed the position limits to the extent that a position is used to mitigate commercial risk, defined to include, among other things, positions arising from the potential change in the value of: (1) assets that a person owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing, or merchandising; (2) liabilities that a person owns or anticipates incurring; (3) services that a person provides or purchases, or anticipates providing or purchasing; or (4) reduces risk attendant to a position resulting from a swap that was executed opposite a counterparty for which the transaction would qualify as a bona fide hedge or otherwise meets the requirements of a bona fide hedge.[16]

Further, the Commission proposes to establish account aggregation standards specifically for positions in the referenced contracts.[17] Under the proposed standards, Federal position limits would apply to all positions in accounts in which any trader, directly or indirectly, has an ownership or equity interest of 10 percent or greater or, by power of attorney or otherwise, controls trading. The proposed rules also establish several exemptions, including a limited exemption for entities to disaggregate the positions of an independently controlled and managed

[13] *Id.*
[14] *See id.* at p. 4,758.
[15] *See id.* at p. 4,759.
[16] *See id.* at p. 4,771.
[17] *See id.* at p. 4,762.

trader that is not a financial entity in which it has an ownership or equity interest of 10 percent or greater.[18]

AGA supports the Commission's efforts to ensure that the financial markets related to energy commodities function efficiently for the benefit of customers. The Commission should see that the markets are transparent and liquid and provide adequate opportunities for commercial entities to lay off risk to those better suited to bear it. AGA believes that position limits can benefit consumers by helping to ensure that the financial markets are free from excessive speculation and market manipulation. AGA continues to urge the Commission to conduct a study after the regulations have been in place for one year to determine whether the financial markets continue to function efficiently and there are no adverse unintended consequences associated with the final rules in this proceeding. In addition, AGA offers the following recommendations consistent with the goal of encouraging efficient commodities markets that work to provide benefits to consumers.

B. The Commission Should Permit Anticipatory Hedge Exemptions Up To Three Years In Advance.

Under proposed § 151.5, a gas utility that wishes to exceed the position limits in order to hedge unsold commercial production or unfilled anticipated commercial requirements connected to a commodity underlying a referenced contract must file with the Commission for approval at least ten days in advance of the date that such positions would be in excess of the position limits.[19] AGA is concerned that a requirement to obtain approval for an anticipatory hedge exemption close in time to when the position is expected to exceed the position limits would be

[18] *Id.*

[19] *See* 76 Fed. Reg. at p. 4,772.

cumbersome and ineffective to allow gas utilities to adequately hedge price volatility associated with providing service to their retail customers.

As AGA has previously noted, natural gas utilities develop plans to reliably meet the gas supply needs of their customers. Gas utilities build and manage a portfolio of physical supply, storage and transportation services in order to meet anticipated demand. For most gas utilities, system demand varies dramatically, yet predictably, based on seasonal weather patterns. In other words, the supply needs of their customers are often greatest in the winter months of November through March. Gas utilities are thus exposed to commodity risks, most especially the price of natural gas commodities. In general, gas utilities forecast the anticipated demand on their systems and assess the underlying physical exposure associated with that demand. Many gas utilities then determine if financial instruments are needed to mitigate all or a portion of that exposure. The financial instruments are often futures contracts traded on CFTC-regulated exchanges or over-the-counter energy derivatives that do not exceed in quantity the fixed-price sale of the same cash commodity or the unfilled anticipated requirements of the same cash commodity. These financial products would qualify as bona fide hedging transactions or positions as defined in proposed § 151.5(a).

AGA believes that gas utilities should be able to review their hedging needs and obtain any necessary approvals well in advance of when their positions may be expected to exceed the applicable limits. Requiring gas utilities to file for approval for an anticipatory hedge exemption close in time to when the utility expects to exceed the position limits could adversely impact the ability of the utility to enter into hedging transactions on favorable terms. Moreover, some gas utilities enter into long-term (greater then one year) contracts as part of their physical supply portfolios and seek to hedge their price exposure associated with those long-term positions through financial transactions further in the future than one year. AGA contends that gas utilities should be permitted to obtain approval for an anticipatory hedge exemption for such long-term positions. Accordingly, AGA urges the Commission to revise § 151.5(c) to permit a trader to obtain approval for an anticipatory hedge exemption up to at least three years in advance of when the financial transactions would be entered into.

C. The Commission Should Exempt Gas Utilities From The Aggregation Requirements.

Similarly, proposed § 151.7(f), would permit an entity to not aggregate its positions with the positions of its owned non-financial entities if the entity can sufficiently demonstrate, in an application to the Commission, that the owned non-financial entity's trading is independently controlled and managed based on certain specified factors.[20] Under the Commission's proposal, this exemption would only become effective upon the Commission's approval of the application filed by the entity.[21]

As noted above, gas utilities are comprehensively regulated at the local level by a state commission or other regulatory authority with jurisdiction. In many instances, such regulations prohibit the regulated utility from sharing information or coordinating operations with affiliates or business units that are not regulated by the state commission to ensure that the utility's customers do not bear cost risks associated with the unregulated entity's activities. For some utilities, energy trading and financial hedging transactions are types of activities that are required to be kept separate. In other words, aggregation of accounts under proposed § 151.7 would be contrary to state regulation.

[20] *See id.* at p. 4,774.

[21] *See id*. at p. 4,762.

AGA urges the Commission not to put gas utilities in a position where compliance with Federal regulatory requirements would result in a violation of state regulatory requirements. AGA believes that proposed § 151.7(f) should be interpreted to allow gas utilities to be exempted from the aggregation requirements. Gas utilities are non-financial entities whose trading activities are independently controlled and managed, often as required by state regulation. Accordingly, AGA requests that the Commission clarify that gas utilities would qualify for an exemption from the aggregation requirements under § 151.7(f).

D. The Commission Should Not Require Position Summaries Of Entities Granted An Exemption.

Proposed § 151.5(i) would require entities relying on the bona fide hedge exemption to file position reports for each business day on which the position was maintained, up to and including the day after the entity's position fell below the position limit that was exceeded.[22] In the alternative, the Commission asks whether it should only require such reports to be submitted when the position limit is first exceeded or the hedging need increases, with a monthly summary while the position remains in excess of the limit.[23] AGA request that the Commission reconsider whether any daily or monthly position summary is necessary for entities that have been granted a bona fide hedge exemption under proposed § 151.5. Bona fide hedgers will have already been required to file with the Commission Form 404 or Form 404A in order to obtain the exemption. Accordingly, as long as the positions the bona fide hedger takes are consistent with the information provided in the Form 404 or Form 404A, any additional reporting would be redundant.

[22] *See id.* at p. 4,773.
[23] *See id.* at p. 4,761.

AGA thus urges the Commission to reconsider its requirement in proposed § 151.5(i) that entities that have been granted a bona fide hedge exemption must also file an additional position summary report on a daily or monthly basis. In the event the Commission determines that a position summary report is required, AGA urges the Commission to adopt its alternative recommendation that position reports only be filed the business day after a position limit is exceeded with a monthly summary while the position remains in excess of the limit. This alternative filing requirement would provide the same transparency with much less burden on filing entities.

E. The Commission Should Reconsider The Need For Position Visibility Reports.

The Commission proposes in new § 151.6 to require an entity holding or controlling net long or net short referenced contracts in specified commodities, when such positions in all months or in any single month (including the spot month) are in excess of specified position levels, including 21,000 contracts of NYMEX Henry Hub Natural Gas futures, to file with the Commission a position visibility report.[24] According to the NOPR, the Commission set the visibility level for NYMEX Henry Hub Natural Gas futures at a relatively low level to capture approximately 30 unique owners over the course of the year.[25] The proposed rules define under proposed § 151.1 a "referenced contract" to include the specified futures contract in proposed § 151.2, or a referenced paired futures contract, option contract, swap or swaption, other than a basis contract or contract on a commodity index.[26] AGA is concerned that an expansive interpretation of the definition of "referenced contract" would result in far more entities having to file position visibility reports than intended by the Commission in the NOPR.

[24] *See id.* at p. 4,773.
[25] *See id.* at p. 4,761.
[26] *See id*. at p. 4,768.

In the notice of proposed rulemaking regarding Position Reports for Physical Commodity Swaps, the Commission adopted an expansive definition of the kinds of swaps that would be economically equivalent to a listed futures contract.[27] In that proposal, swaps that were directly linked to a listed contract, indirectly linked to a listed contract, partially settled to a listed contract, and priced at a differential to a listed contract would all be considered economically equivalent to the listed contract.[28] In addition, swaps that were based on the same commodity as a listed contract but deliverable at locations different from the listed contract's delivery location as long as such locations have substantially the same supply and demand fundamentals as that of the listed contract delivery location would also be considered economically equivalent to the listed contract.[29] As described in that proposal, swaps that would be considered economically equivalent to the NYMEX Henry Hub Natural Gas futures contract would include not only the ICE Henry Hub Physical Basis LD1 Contracts, but also the NYMEX Columbia Gulf, Mainline Natural Gas Index Swap (Platts Gas Daily/Platts Inside FERC) Futures Contracts and NYMEX Transco Zone 6 Natural Gas Index Swap (Platts Gas Daily/Platts Inside FERC) Futures Contracts, as well as potentially many others.[30]

AGA believes that the position visibility reporting requirements are overly broad and potentially confusing. Contracts referencing points other than those listed in a core referenced contract are not economically equivalent to the core referenced contract simply because the two points are "physically connected."[31] Even in cases where the price of a contract has sometimes been correlated to a core referenced contract in the past, market participants cannot know that

[27] *See Position Reports for Physical Commodity Swaps*, 75 Fed. Reg. 67,258 (Nov. 2, 2010).
[28] *See id.* at p. 67,260.
[29] *See id.* at p. 67,261.
[30] *Id.*
[31] *Id*.

such correlations will continue in the future.[32] Moreover, market participants cannot reasonably be expected to reach consistent conclusions about whether a particular location has and will continue to have the same supply and demand fundamentals as a referenced contract location. In order to achieve its stated objective of only capturing approximately 30 unique owners with respect to NYMEX Henry Hub Natural Gas futures contracts, the Commission should, at the very least, interpret its definition of a "referenced contract" narrowly to include the listed contract itself. A broad interpretation could result in far more entities required to submit position visibility reports than the Commission intended.

AGA believes that it may be more appropriate for the Commission to reconsider its proposed visibility reporting requirement. The reporting requirements included in the Commission's Swap Data Reporting and Recordkeeping, Real-Time Reporting, and End User Exception proposals will provide the Commission with complete information about every market participant's portfolio. In the instant proceeding, the Commission has proposed processes that will inform it about market participants' holdings in excess of position limits, before consideration of bona fide hedge exemptions and exemptions from aggregation. AGA recommends, therefore, that the Commission consider whether any additional position visibility requirements are necessary.

F. The Commission Should Gain Experience Before Setting Additional Position Limits for Swaps.

In the NOPR, the Commission proposes to impose non-spot-month position limits for exchange-traded futures and options and for swap transactions during a second phase of

[32] We note, for example, that the correlation between physical spot market Transco Zone 6 New York and the Henry Hub has varied between 0.88 and 0.34 in the last five years.

implementation.[33] In particular, the Commission proposed to establish such limits as a function of open interest using a general formula as the sum of 10 percent of the first 25,000 contracts of open interest base and 2.5 percent of the open interest based above 25,000 contracts.[34]

AGA believes that the Commission should obtain additional detail regarding positions and open interest in the swap transactions markets before committing to apply a specific formula for limits of single-month and all-months-combined positions. The Commission admits that it requires additional, reliable and verifiable swaps data to enforce the proposed position limits.[35] In the absence of such data, it is difficult to assess the Commission's evidentiary basis for concluding that the proposed position limits would be effective to diminish or prevent excessive speculation, deter and prevent market manipulation, ensure sufficient market liquidity for bona fide hedgers, and ensure that price discovery is not disrupted, as required by the Dodd-Frank Act. AGA believes that the Commission should proceed cautiously in this area and develop a solid foundation for regulatory action. Accordingly, AGA recommends that the Commission not establish non-spot-month position limits for swaps transactions at this time and gain additional experience before making a determination with regard to such limits.

If the Commission were to proceed with its proposal, AGA seeks clarification regarding how the positions limits would be applied in forward months. If the position limits were applied to forward months when open interest is below a specified level, it would appear to be impossible for the first trade in a given month to be executed without violating a position limit.

[33] *See id.* at p. 4,758.
[34] *See id.* at p. 4,759.
[35] *See id.*

IV. CONCLUSION

Wherefore, for the reasons stated above, the American Gas Association respectfully requests that the Commission consider these comments in this proceeding.

Respectfully submitted,

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