



June 5, 2011

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

VIA ELECTRONIC SUBMISSION

Re: *Position Limits for Derivatives*, RIN 3038–AD15 and 3038–AD16

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”)¹ and the Commodity Markets Council (“CMC”)² (collectively, the “Commercial Alliance”),³ Hunton & Williams LLP hereby submits these comments to supplement the individually filed comments of the Working Group and the CMC submitted in response to the Commission’s Notice of Proposed Rulemaking, *Position Limits for Derivatives* (the “Proposed Position Limits Rule”).⁴ While the Working Group and the CMC individually filed comments in response to the Proposed Position Limits Rule, the Commercial Alliance is filing the comments set forth herein because further issues were discovered that had not previously been addressed. Specifically, these comments address the Commercial Alliance’s concerns with the *bona fide* hedging exemption as set forth in the Proposed Position Limits Rule.

¹ The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities.

² CMC is a trade association bringing together commodity exchanges with their industry counterparts. The activities of our members represent the complete spectrum of commercial users of all futures markets including agriculture. Specifically, our industry member firms are regular users of the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Kansas City Board of Trade, Minneapolis Grain Exchange, and New York Mercantile Exchange. Please note that Hunton & Williams LLP is not counsel to CMC.

³ The Commercial Alliance is a combined effort among commercial agriculture and energy companies to address significant issues under the Commission’s rulemakings to implement derivatives reform under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

⁴ *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 76 Fed. Reg. 4752 (Jan. 26, 2011).

II. COMMENTS OF THE COMMERCIAL ALLIANCE.

Participants in the Commercial Alliance share a common concern that the Commission's proposed rules implementing Title VII of the Act, while primarily designed to address problems in the financial markets, will materially and adversely affect the commercial markets through which agricultural and energy-related commodities are ultimately delivered to United States consumers. The Working Group and CMC separately filed comments in response to the Proposed Position Limits Proposed Rule, presenting arguments opposing the imposition of position limits set forth in the Proposed Position Limit Rule.⁵

In this letter, we are not addressing whether the imposition of federal speculative position limits is appropriate as a legal or policy matter. Rather, the Commercial Alliance seeks to focus the Commission's attention on certain flaws in the proposed definition of a *bona fide* hedging transaction set forth in proposed CFTC Rule 151.5(a), which, if adopted as proposed, will disrupt the use of commercial markets for hedging purposes.

A. DEFINITION OF BONA FIDE HEDGE.

As addressed by CMC and the Working Group in their individually filed comments on the Proposed Position Limits Rule, the Commission has taken a narrower view of *bona fide* hedging than as defined by Congress in the Act. Specifically, the Commission has proposed to allow as *bona fide* hedges only transactions that fit within five specific categories of hedges, referred to as "enumerated hedges."

In addition, while Congress permitted the Commission to exempt "any transaction or class of transactions" from any position limits that it establishes pursuant to the Act, the Proposed Position Limits Rule has eliminated the opportunity for participants transacting in exempt and agricultural commodities to apply for exemptions from position limits for what have historically been known, and permitted, as "non-enumerated hedges." As a consequence, certain traditional risk-reducing commercial transactions executed in energy and agricultural markets would not fall within the definition of a *bona fide* hedging transaction under the Commission's Proposed Position Limits Rule.⁶ Such transactions include, but are not limited to, the following:

- Unfixed price commitments in the same calendar month;
- Unfixed price commitments in a different commodity;
- Hedges relating to assets that a person anticipates owning or merchandising;

⁵ See *Position Limits for Derivatives, Comments of the Working Group of Commercial Energy Firms* (Mar. 28, 2011); *Position Limits for Derivatives, Comments of the Commodity Markets Council* (Mar. 28, 2011).

⁶ See proposed CFTC Rule 151.5(a). The problems manifest themselves, in many circumstances, because cash settled swaps and DCM physically-settled futures do not offset each other in position calculations for purposes of these rules.

- Hedges of services;
- Hedges of “spread” and “arbitrage” positions;
- Hedging in the last five days of trading an expiring contract; and
- Hedges on assets.

The Commercial Alliance provides in Attachment A hereto specific examples of commercial transactions executed in energy and agricultural markets that would not fall within the definition of a *bona fide* hedging transaction under the Commission’s Proposed Position Limits Rule.

B. THE COMMISSION SHOULD INCORPORATE ALL OF THE ACTIVITIES DESCRIBED IN THE ATTACHED EXAMPLES INTO THE FINAL CFTC RULE 151.5(A)(2)—ENUMERATED HEDGES.

All of the examples in Attachment A represent commercial activities that fall within the definition of *bona fide* hedge set forth in Section 737 of the Act and CFTC Rule 151.5(a)(1) of the Proposed Position Limits Rule. Accordingly, they should be incorporated into the list of enumerated hedges to establish, beyond doubt, that such transactions would qualify as *bona fide* hedges under any final Commission rules.

C. THE COMMISSION SHOULD RETAIN THE FLEXIBILITY OF FORMER CFTC RULE 1.3(Z)(3)—NON-ENUMERATED HEDGES AND RELATED PROCESSES.

In addition to providing certainty for the types of transactions set forth in Attachment A, the Commission should preserve the rule and process for obtaining exemptions for non-enumerated hedges. Markets are dynamic and are subject to change. The Commercial Alliance submits that it is neither in the public interest nor in its own interest as a market regulator for the Commission to adopt a rule that effectively eliminates its discretion and flexibility to grant an exemption for a *bona fide* hedging strategy that it could not foresee today (or, for that matter, that was simply overlooked during this process). While the Commission would be permitted to amend CFTC Rule 151.5(a)(2) to accommodate any unforeseen *bona fide* hedging strategies, the Commercial Alliance submits that the process to amend such Rule would not be in the best interests of the markets or the economy, as it would effectively delay the applicant hedger from the opportunity to timely establish that legitimate hedge position. Therefore, the Commission should retain CFTC Rule 1.3(z)(3) to give it the flexibility to adapt to changing market circumstances.

D. COMPLIANCE WITH THE DAILY REPORTING REQUIREMENT WILL BE UNDULY BURDENSOME.

As discussed in both the CMC and Working Group individual comments on the Proposed Position Limits Rule, requiring market participants to report daily on their cash market positions will be extremely and unduly burdensome and is not justified by any corresponding benefit.⁷ In addition to the operational burdens of building and maintaining a compliance system to perform such reporting, the process, or lack thereof, for applying for an exemption in advance of exceeding any position limit creates significant uncertainty for market participants seeking to accommodate both their short-term and long-term hedging needs. Accordingly, the Commercial Alliance requests that the Commission consider these concerns and provide market participants clear guidance on the process for applying for, and complying with, exemptions from speculative position limits.

IV. CONCLUSION.

The Commercial Alliance supports regulation that brings transparency and stability to the agriculture and energy swap markets in the United States. The Commercial Alliance appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein prior to the adoption of any final rule implementing Title VII of the Act. The Commercial Alliance expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact Christine Cochran, President, CMC, at (202) 842-0400, or R. Michael Sweeney, Jr., counsel to the Working Group, at (202) 955-1500.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

R. Michael Sweeney, Jr.

David T. McIndoe

Mark W. Menezes

on behalf of the Commercial Alliance

cc: Hon. Gary Gensler, Chairman
Hon. Michael Dunn, Commissioner
Hon. Bart Chilton, Commission
Hon. Jill Sommers, Commissioner

⁷ See *Position Limits for Derivatives, Comments of the Working Group of Commercial Energy Firms at Part III.C* (Mar. 28, 2011); *Position Limits for Derivatives, Comments of the Commodity Markets Council at Part 4* (Mar. 28, 2011).

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Hon. Scott O'Malia, Commissioner
Dan Berkovitz, General Counsel, Office of General Counsel
Bruce Fekrat, Special Counsel, Division of Market Oversight

ATTACHMENT A

EXAMPLES OF TRANSACTIONS THAT DO NOT QUALIFY AS BONA FIDE HEDGING UNDER THE PROPOSED POSITION LIMITS RULE

The following provides examples of hedging transactions commonly entered into by commercial firms in agricultural and exempt commodity markets that will be effectively excluded from the definition of *bona fide* hedge as set forth under the Commission's Proposed Position Limits Rule.

I. UNFIXED PRICE COMMITMENTS.

A. IN THE SAME CALENDAR MONTH.

Proposed CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were based on different delivery months. The following example demonstrates the potential need to hedge basis risk in the same delivery month, but at a different delivery location. If one used a cash-settled swap in one location and a physical delivery futures contract at the other, these positions would not offset, and would not qualify as *bona fide* hedge positions.

Example: A natural gas ("NG") wholesaler buys gas at (Point 1) and sells it at another point on the same pipeline (Point 2) to a different counterparty. Both contracts are at an index price plus or minus a differential. In order to lock in the current spread relationship between the prices at the two delivery locations, NG wholesaler sells a NYMEX Henry Hub futures contract and enters into a "long" swap on the price at Point 2, hedging the risk that the price at Point 2 will decline relative to the price at Point 1. Since the purchase and sale will occur during the same delivery month, this hedge would not constitute a bona fide hedge under proposed CFTC Rule 151.5(a)(2).

B. IN A DIFFERENT COMMODITY.

Proposed CFTC Rule 151.5(a)(2)(iii) would permit a hedge of offsetting unfixed price purchase and sale commitments only if they were in the same commodity. The following example demonstrates the potential need to hedge basis risk between two different commodities.

Example: Power plant operator buys natural gas from which it generates and sells power. It buys gas from one party at an index plus or minus a differential and it sells power to a different party at an index plus or minus a differential. In order to lock in the basis between gas and power prices, it enters into a swap on the power price and Henry Hub futures contracts in natural gas, effectively hedging the risk that the price of power will decline relative to the price of gas. Since the two prices are referencing different commodities, this

hedge would not constitute a bona fide hedge under proposed CFTC Rule 151.5(a)(2).

II. “ANTICIPATED” TRANSACTIONS.

Although hedges of “anticipated ownership” and “anticipated merchandising” transactions would be *bona fide* hedges under the language in the Dodd-Frank Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: Commercial entity X, a wholesale marketer of crude oil, has purchased a cargo of oil currently transiting the Atlantic from Europe to the US at the price of ICE Brent futures plus or minus a differential. It is negotiating to sell that cargo in the U.S. gulf coast at a price of NYMEX WTI plus or minus a differential. Although it has not concluded negotiations on the sale, it believes that it will do so in the next several days. Believing that prices may fall over the next several days, it places a hedge in NYMEX WTI futures. Under proposed CFTC Rule 151.5(a)(2), this would not constitute a bona fide hedge.

Example 2: In the example above, the parties have concluded their negotiations and, as is standard in the industry, agreed to the transactions subject to credit terms and legal review of documentation. Again, the NYMEX WTI hedge placed by Commercial entity X would not constitute a bona fide hedge under the proposed CFC Rule 151.5(a)(2).

Example 3: Farmers Elevator, a grain merchandiser, owns a 3 million bushel storage facility in Farmville, a town surrounded by thousands of acres of growing corn, soybeans, and wheat. As part of its normal business practices, Farmers Elevator expects in the future to enter into forward contracts with area farmers under which Farmers Elevator agrees to pay farmers a fixed price for their grain at harvest. In order to hedge this risk, Farmers Elevator “goes short” on CME by selling futures contracts. Under the proposed rule, this would not constitute a bona fide hedge since at the time of the futures position by Farmers Elevator there is no underlying physical contract. The result would be that Farmers Elevator may no longer be able to provide attractive forward cash market contracts to its farm customers.

Example 4: In February of 2011, prior to spring wheat planting, Elevator X, which has storage capacity that is currently sitting completely empty, locks in a spread of \$1.40 on a portion of its expected throughput for the crop year by buying July 2011 Wheat futures and selling July 2012 Wheat futures. Regardless of whether Elevator X actually buys wheat in 2011, this transaction represents a hedge by Elevator X of its capacity (i.e., the value of its grain storage assets). If there is a crop failure during the 2011 harvest resulting in little to no wheat deliveries at Elevator X, the spread position hedge will perform by providing

Elevator X the economic value of the position hedging against such an event. Alternatively if Elevator X (as expected) buys wheat, it will hedge these specific price risks by taking appropriate futures positions and reducing the July/July Wheat spread. This “hedging of capacity” strategy would not be a bona fide hedge under the proposed CFTC proposed Rule 151.5(a)(2).

III. HEDGING OF SERVICES.

Although hedges on the value of “services that a person provides or purchases, or anticipates providing or purchasing” would be *bona fide* hedges under the language in the Dodd-Frank Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: Commercial energy firm Z is a wholesale marketer of natural gas. It has an opportunity to acquire one year of firm transportation on Natural Gas Pipeline (“NGPL”) from the Texok receipt point to the Henry Hub delivery point for an all-in cost of \$.30/mmbtu. The “value” of that service at that time is \$.33/mmbtu, measured as the difference between the price at which one can sell the natural gas at the delivery point minus the price at which one can purchase the gas at the receipt point. At that time, commercial energy firm Z can enter into a swap locking in the calendar 2012 strip at Texok at a price of \$4.00/mmbtu and sell a calendar strip of NYMEX Henry Hub natural gas futures contracts locking in a sale price at a weighted average of \$4.33/mmbtu. Entering into those two separate transactions without having actually purchased or sold natural gas to transport has allowed commercial energy firm Z to hedge the value of the firm transportation service that it holds or can acquire.⁸ However, under the Commission’s proposal, the transactions would not qualify as bona fide hedge transactions.

Example 2: Natural Gas Producer X has new production coming on line over the next few years in the Gulf of Mexico. The production is located near Point A on Pipeline Y’s interstate natural gas pipeline system. Producer X has the desire to sell gas to customers in Region B as the price for natural gas in Region B is significantly higher than at Point A, where natural gas would currently be delivered into Pipeline Y’s system. Producer X contacts Pipeline Y and negotiates a Precedent Agreement with the pipeline under which Pipeline Y will build new transportation capacity from Point A to Region B. Under the Precedent Agreement, Producer A is obligated to pay demand charges to the pipeline for a term of 5 years from the date the pipeline goes into commercial operation, if Pipeline Y is able to complete a successful open season and obtains the necessary permits to construct and operate the new section or expansion of its pipeline system from Point A to Region B. The open season is designed to attract

⁸ Note that this “value” exists whether commercial energy firm Z ever owns or intends to own the physical commodity. In some circumstances, the firm might choose to release the capacity to a third-party and realize the value of the transportation service from the capacity release transaction.

commitments from other potential shippers to help support the cost of building and operating the pipeline expansion. The schedule calls for a completion of construction and commercial operation of the pipeline expansion on March 31, 2013.

Producer X is concerned that the natural gas price differential between Point A and Region B could collapse and is fairly confident the expansion project will be completed. In order to manage the risk associated with the 5-year financial commitment to Pipeline Y, i.e., pipeline demand charges, Producer X enters into swaps at Point B for a term of April 1, 2013 to March 31, 2018, to lock-in the price spread between Point A and Region B. Under the Commission's Proposed Rule, the swap transactions would not qualify as bona fide hedges. In this case, the expansion of the pipeline system that would afford customers in Region B more access to lower priced gas might not occur without the ability to count the swaps associated with this transaction as a bona fide hedge.

Example 3: Commercial energy firm A is an electric utility that owns coal-fired generation facilities. Firm A enters into contracts with major railroads to transport coal from producing regions to its various generating facilities. One or more of these contracts are subject to a fuel surcharge, whereby rates paid by firm A to transport coal are indexed to the price of diesel fuel. As prices for the diesel fuel rise, the rate paid by firm A to transport coal also rises. To mitigate this risk, firm A could enter into a long position in futures contracts or swaps for the diesel fuel, whereby gains realized on these instruments should prices rise would off-set any increase in the rate paid by firm A to transport coal. Under the Proposed Rule, however, these transactions would not qualify as bona fide hedge transactions since they would be entered into as a hedge of services — in this case, coal transportation services.

IV. HEDGES OF “SPREAD” OR “ARBITRAGE” POSITIONS.

Although hedges on the value of spread or arbitrage positions would be *bona fide* hedges under the language in the Act and seemingly under proposed CFTC Rule 151.5(a)(1), they would not be treated as such because there is no provision for them as “enumerated hedges” under proposed CFTC Rule 151.5(a)(2).

Example 1: The business model of Company X is to import crude oil from Europe to the United States. On an average year it imports 48 million barrels of crude oil. Its purchases in Europe are generally priced against Brent oil and its sales in the United States are priced against WTI. Those prices are readily available across the price curve, more than a year in advance. There are times when Company X believes the differential for a particular month is favorable and it seeks to lock in that differential by buying Brent swaps and selling NYMEX WTI futures, knowing that it will ultimately buy the oil priced in Brent and sell the oil priced in WTI. Under the proposed rule, even though this transaction allows Company X to hedge the risk of its business strategy and expected transactions, this would not be a bona fide hedge under proposed CFTC Rule 151.5(a)(1).

Example 2: Grain Merchandiser X is in the business of buying wheat in, among other places, North Dakota, using a Minneapolis Grain Exchange (MGEX) reference price. Grain Merchandiser X is also in the business of selling wheat to Italian flour mills, using a Euronext France (MATIF) price. These prices are readily available across the price curve, more than a year in advance. As such, there are times when Grain Merchandiser X believes the differential for a particular month is favorable and it seeks to lock in the differential by selling MATIF futures (or swaps) and buying MGEX futures, even though it will ultimately buy North Dakota wheat priced in MGEX futures. This transaction, which allows Grain Merchandiser X to hedge the risk of the expected transactions in its business strategy, would not be a bona fide hedge since it is not enumerated under proposed CFTC Rule 151.5(a)(2).

V. HEDGING IN THE LAST FIVE DAYS OF TRADING AN EXPIRING CONTRACT.

The following examples illustrate the uneconomic consequences of prohibiting a bona fide hedge positions from being held in the last five days of trading.

A. UNSOLD ANTICIPATED PRODUCTION – Proposed CFTC Rule 151.5(a)(2)(i)(B)

Example 1: Company A anticipates producing 2000 barrels of crude oil in July. That production is currently unsold. To hedge its risk that the value of those barrels may decline prior to their sale, Company A will sell 2 July NYMEX WTI crude oil futures contracts, which represent delivery ratably during the month of July. The last trading day of the July futures contract is June 21st. The last day that Company A could hold the position as a bona fide hedge under the proposal is June 14th. This means that if Company A holds the contract from June 15th through June 21st and delivers its oil under the July futures contract, it could not treat those positions as a bona fide hedge during that period. Alternatively, in order to maintain bona fide hedge status, it would be required to roll its hedge into the August contract on June 14th, taking basis risk on the July/August spread for the additional 5 days.

B. UNFIXED PRICE CONTRACTS – Proposed CFTC Rule 151.5(a)(2)(iii)

Example 1: Company B has a contract to buy natural gas at the Henry Hub in July at NYMEX + \$.10 and a contract to resell it at the Henry Hub in August at NYMEX + \$.15. To hedge the basis risk, it sells NYMEX July futures and buys NYMEX August futures. Under the Commission's proposal, this position would not be a bona fide hedge if it was carried into the last five days of trading of the NYMEX July futures contract. Company B would be forced to roll its position to a less efficient hedge.

C. CROSS-COMMODITY HEDGES – Proposed CFTC Rule 151.5(a)(2)(v)

Example 1: Commercial energy firm J supplies jet fuel to airlines at a variety of airports in the United States, including Houston Intercontinental Airport. It has a fixed-price contract to purchase jet fuel from a refinery on the gulf coast during early June. Because there is no liquid jet fuel futures contract, commercial energy firm J uses the June NYMEX physically-delivered WTI crude oil futures contract to hedge its price risk. Under the Proposed Rule, commercial energy firm J would be required to liquidate its hedge during the last five trading days of the June contract and either remain unhedged or replace its June hedge with a contract that represents a different delivery period and, therefore, a different supply/demand and pricing profile.

Example 2: AgriCorp, a grain warehouse, grain merchandiser and feed ingredient wholesaler, buys wheat from farmers. At the same time, AgriCorp enters into a fixed price agreement with a feedyard to supply feed (the exact components of which could be satisfied using wheat, corn, DDGs, or other ingredients). In order to hedge its risk, AgriCorp enters into a swap, hedging the risk that the price of wheat will decline relative to the price of corn (the corn futures price better correlates to feed prices, thereby providing a more effective hedge). Since the two prices are referencing different commodities, this hedge would not constitute a bona fide hedge if held in the last five days of trading.

VI. HEDGES ON ASSETS.

Example: XYZ Corp. is planning on buying a liquefied natural gas (“LNG”) vessel. The value of that asset is based upon the spread between natural gas prices between and among various continents. XYZ will need financing in order to make the purchase. The lenders will only make a loan if XYZ can demonstrate a level of certainty as to its future revenue stream. As it negotiates with the shipbuilder and as it negotiates with lenders, the current differentials are favorable for robust demand for LNG. XYZ wants to enter into separate swaps and/or futures positions in the US, Europe and Asia to lock in the potential purchase prices in producing regions and the potential sales prices in consuming regions at current differentials. This will allow it to lock in the value of LNG transportation and satisfy lenders that this is a good credit risk for them to take on. Those swaps and/or futures positions would not be bona fide hedges under the Proposed Position Limit Rule because the ship-owner does not own or anticipate owning the underlying commodities.