Edison Electric Institute
Power by Association

epsa
Electric Power Supply Association

February 7, 2014

<u>Via Electronic Submission</u>

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

Re: Position Limits for Derivatives (RIN Number 3038-AD99)

Dear Ms. Jurgens:

The Edison Electric Institute ("**EEI**") and the Electric Power Supply Association ("**EPSA**") (hereafter "**Joint Associations**") appreciate the opportunity to provide the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**") with the comments and recommendations set forth below in response to the Commission's Notice of Proposed Rulemaking concerning Position Limits on Derivatives ("**Proposed Rule**").[1] The Joint Associations and its members have been active participants in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"), including submitting comments on prior proposed position limits rules issued by the Commission.[2]

I. Description of EEI and Its Interest in the Proposed Rule

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members and more than 170 industry suppliers and related organizations as Associate members.

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[1] Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

[2] *See, e.g.*, Letter from EEI and EPSA to David Stawick, Sec'y, CFTC (Mar. 28, 2011) (on file with the CFTC); Letter from EEI to David Stawick, Sec'y, CFTC (Jan. 17, 2012) (on file with the CFTC); Letter from EEI, AGA, and EPSA to David Stawick, Sec'y, CFTC (Mar. 1, 2012) (on file with the CFTC); Letter from EEI and AGA to David Stawick, Sec'y, CFTC (Mar. 1, 2012) (on file with the CFTC); Letter from EEI to David Stawick, Sec'y, CFTC (June 29, 2012) (on file with the CFTC).

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. Competitive suppliers, which, collectively, account for 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

Joint Association's members are not financial entities. Rather, they are physical commodity market participants that rely on Referenced Contracts to hedge and mitigate their commercial risk.[3] Regulations that make effective risk management options more costly for end-users of derivatives and will likely result in higher and more volatile energy prices for retail, commercial, and industrial customers. As end-users of commodity derivatives who hedge commercial risk, Joint Association's members have a direct and significant interest in when and to what extent the Commission exercises its authority to establish speculative position limits. As such, the Joint Associations would request that the Commission consider its comments in determining what revisions are needed to the Proposed Rule. In addition, Joint Associations request that the Commission ensure that the forms align with the final rule and that the Commission take into consideration the effort needed to comply with the rules in determining the timeframe within which the forms need to be submitted.

II. The Commission Should Make a Fact-Based Necessity Finding for Each of the 28 Core Referenced Futures Contracts

The Commission stated in the preamble to the Proposed Rule that "the CEA mandates the imposition of speculative position limits."[4] The Commission appears to believe that it need not determine that speculative position limits are necessary in order "'to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the price of' commodities."[5] Yet, "out of an abundance of caution," the Commission also determined that speculative position limits are necessary.[6]

The Commission's necessity finding is qualitative, lacking in analysis, and thus insufficient to comply with its statutory obligation under the CEA. Joint Associations request that the Commission make a specific fact-based finding of necessity as to each of the 28 core referenced futures contracts in the Proposed Rule[7] as the Proposed Rule does not contain any analysis as to why the 28 core referenced contracts were chosen. Individualized necessity determinations are important to avoid imposing unwarranted costs on commercial parties and other exchange market participants. By including the CEA requirement that the Commission must find position limits are "necessary" and "appropriate" before imposing them, Congress recognized that position limits would impose significant costs on hedgers and that those costs may ultimately be borne by individual consumers and businesses that purchase and use commodity products and by-products. Position limits that are not necessary or appropriate

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3 Capitalized terms used but not defined herein have the meaning given them in the Proposed Rule.

4 Proposed Rule at 75,685.

5 *Id.* (quoting CEA section 4a(a)(1) pre-Dodd-Frank).

6 *Id.* 75,685.

7 *See* CEA section 4a(a)(1).

increase commercial parties' compliance costs and reduce market liquidity, which in turn increases the cost of hedging—costs the Commission did not adequately consider before imposing position limits on Referenced Contracts—without producing corresponding benefits.

In the Proposed Rule, the Commission acknowledges receipt of numerous studies regarding the imposition of speculative position limits that fail to establish a consensus regarding whether limits will be effective. This demonstrated lack of consensus provides objective evidence that position limits are not necessary. However, rather than address and attempt to analyze this evidence, the Commission simply makes a superficial finding based on incomplete market data that position limits are, as a precautionary matter, necessary.[8] Joint Associations respectfully submit that the inconclusive nature of studies concerning the need for, and efficacy of, position limits demonstrates why it is critical that the Commission take additional time to analyze and review each of the core referenced futures contracts to determine whether speculative position limits are necessary and, if adopted, will: (i) prevent excessive speculation; (ii) deter manipulation; (iii) allow for sufficient market liquidity for hedgers; and (iv) permit price discovery.[9]

One of several areas for which additional data are necessary prior to finding that position limits are necessary relates to commodity trade options that are physically-settled contracts upon the exercise of the option.[10] Joint Associations recommend that the Commission continue to collect and analyze data regarding commodity trade options through Part 45 and Form TO in order to determine whether extending its position limits regime to commodity trade options is necessary to diminish, eliminate, or prevent excessive speculation.[11] Indeed, without quantifiable data about how commodity trade options are used, the Commission cannot ensure that its regulations would not inappropriately limit or even foreclose the use of an important hedging instrument by producers, processors, merchants, and commercial users of the underlying commodity seeking to hedge the risks that they incur in connection with their businesses.[12]

Due to the potential impact on markets, Joint Associations respectfully requests that the Commission make the necessary finding of necessity based on quantitative market data.

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[8] Proposed Rule at 75,694.

[9] CEA section 4a(a)(3).

[10] As explained below, Joint Associations recommend that the Commission exclude trade options from the definition of Referenced Contract so they will not be subject to position limits.

[11] CEA section 4a(a)(1).

[12] *See* CEA section 4a(c)(1) ("No rule, regulation, or order issued under subsection (a) of this section shall apply to transactions or positions which are shown to be bona fide hedging transactions or positions, as such terms shall be defined by the Commission by rule, regulation, or order consistent with the purposes of this Act. Such terms may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange. To determine the adequacy of this Act and the powers of the Commission acting thereunder to prevent unwarranted price pressures by large hedgers, the Commission shall monitor and analyze the trading activities of the largest hedgers.").

III. The Definition of "Referenced Contract"

Under the Proposed Rule, the position limits set by the Commission would apply to all Referenced Contracts.[13] Referenced Contract is defined in proposed CFTC Rule 150.1 as:

> on a futures equivalent basis with respect to a particular core referenced futures contract, a core referenced futures contract listed in § 150.2(d), or a futures contract, options contract, or swap, and *excluding* any guarantee of a swap, a basis contract, or a commodity index contract . . . [t]hat is:
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> (i) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular core referenced futures contract; or
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> (ii) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract . . .[14]

In an attempt to further clarify the practical application of the proposed definition, the CFTC's Division of Market Oversight posted on the CFTC's website a list of common exchange-traded contracts that it has concluded would fall either within or outside the definition of Referenced Contract.[15] Although Joint Associations appreciate that the Staff provided market participants with a list of Referenced Contracts, Joint Associations respectfully submit that posting the list of Referenced Contracts does not provide sufficient clarity or legal certainty. As such, Joint Associations request that the Commission incorporate the posted list of Referenced Contracts as an appendix to the final rule issued by the Commission. This will provide additional certainty in a number of ways.

First, if the list of Referenced Contracts is not explicitly incorporated into a final rule, market participants may not be able to determine with certainty whether their swap and other Referenced Contract positions are subject to limits. It is critical that market participants understand precisely which positions will count against the limits. Inclusion of the list in the rule will help ensure that all market participants have the same understanding of the scope of the list and will minimize the compliance and reporting uncertainties and discrepancies that inevitably will be caused by varying good faith interpretations of the definition of Referenced Contract.

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13 Proposed Rule at 75,724.

14 *Id*. at 75,825.

15 *See Position Limits Workbook*, COMMODITY FUTURES TRADING COMMISSION http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/ssLINK/poslimitsworkbook (last visited Jan. 13, 2014).

Second, the need for certainty is of the utmost importance as many (probably most) market participants will have to invest in process and IT system changes to ensure that they can identify and track referenced contracts, and comply with the final rule. Since this will result in market participants incurring substantial costs, it is imperative that market participants fully understand the scope of the definition of Reference Contract and have a definitive comprehensive list of Reference Contracts prior to incurring these costs.

Third, by incorporating the posted list into the final position limits rule, the Commission will provide certainty by indicating that it will follow a transparent process and seek public comment prior to making any future changes to the definitive list of Reference Contracts. This will provide market participants with certainty that they will have an opportunity to provide input into the list of Referenced Contracts and have the time necessary to adjust processes and systems to comply with any changes.

IV. The Commission Should Not Regulate Exempt Commodity Trade Options As Referenced Contracts

The proposed definition of "Referenced Contract" would include commodity trade options that technically fall within the definition of a "swap," but that generally are exempt from regulation under Part 32 of the CFTC's rules. Trade options are entered into by commercial market participants and, if exercised, result in the sale of a physical commodity for immediate or deferred shipment or delivery.[16] The Commission has requested comment on whether commodity trade options should be exempt from some or all aspects of the Proposed Rule.[17]

The Joint Associations urge the Commission to exclude trade options from the definition of Referenced Contract. As an initial matter, trade options are not speculative by definition. Under the CFTC's Interim Final Rule, the offeree to a trade option must "be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and such offeree <u>is offered or entering into the commodity option transaction solely for purposes related to its business as such</u>."[18] In other words, because a trade option must be related to the offeree's commercial business, it cannot also be a speculative derivative position (much less a cause of excessive speculation) under the position limits regime.

Subjecting commodity trade options to position limits would impose a complex and anomalous new regulatory regime on a category of commercial transactions that have never been subject to position limits set by the CFTC or the exchanges. These regulations would require, among other things, compliance with complex and costly monitoring, recordkeeping, and reporting requirements despite the fact that commodity trade options are typically used by commercial market participants either to ensure access to physical supply of a commodity or to hedge commercial risk, rather than to speculate in derivatives. In addition, as we explain below,

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[16] Proposed Rule at 75,711 ("the position limit requirements proposed herein still would be applicable to trade options qualifying under the exemption").

[17] *Id.*

[18] Commodity Options, 77 Fed. Reg. 25,320 (April 27, 2012) Interim Final Rule 32.3(a)(2) (emphasis added).

the Proposed Rule fails to take into account the manner in which many trade options are exercised and would effectively preclude utilities and other commercial market participants from using trade options to procure supply or commodity inputs to production.

To illustrate the anomalous and impractical results that the Proposed Rule would have on Joint Associations' members and other commercial market participants, Joint Associations offer the following examples:

Example 1:

Party A, the central hedging and trading affiliate of merchant generation entities, sells a *ten year* capacity product with a daily physical call option on power to Party B, a supplier of power to commercial, industrial and residential customers, that needs a reliable supply of power. The power option provides Party B with the right to require Party A to supply firm On-Peak power on each delivery day. The option must be exercised each business day for the following delivery day(s). In addition to paying for the capacity sold under the contract, Party B pays for the power delivered when it exercises its option based on price calculated for each day by multiplying a specified heat rate (*e.g*., 7.5) and a specified Gas Price Index. In this example, the Gas Price Index is based on the midpoint price for Louisiana – On-Shore South: Henry Hub natural gas for the relevant delivery day as published by Gas Daily. Accordingly, this trade option falls within the definition of Referenced Contract.

The Proposed Rule effectively would preclude the parties from using the trade option as a means to provide and source power because it does not permit them to carry a physically-settled Referenced Contract position that exceeds the speculative position limit through the spot month. The first exercise date for the trade option is the last business day of the month for delivery on the first day of the delivery month and all subsequent exercise dates for the daily options during the delivery month will occur during the delivery month. Because the transaction, as agreed by the parties, would cause a trade option to exist during the spot month for the NYMEX natural gas contract for each month during the ten-year term of the transaction, it could be prohibited by the Proposed Rule – a result the Commission hopefully did not intend.

The unintended practical consequences of subjecting such a trade option to position limits would severely and adversely affect EEI members and other commercial market participants. First, the ten-year contract would have to be terminated prior to start of the first Spot Month during the contract term. Because this is a bespoke physically-settled transaction, not an exchanged traded product that can easily be reversed, in order to terminate the transaction both parties would have to agree on the termination value. Second, subjecting trade options to position limits would negatively impact electric capacity and power markets because market participants will not be able to structure transactions in a manner that matches their commercial needs. For example, the load serving entity, in the example, will not be able to retain its right to call upon a power supply for its volumetric exposure. Similarly, the power supplier will not be able to use the option to maximize the value of its power generation assets.

Example Two:

The Proposed Rule could eliminate the ability of market participants to enter into multi-month and multi-year trade options. For example, Party A sells a two-year monthly physical call option on natural gas to Party B, a utility or generator that consumes natural gas or resells it to others that consume natural gas. The option gives Party B the right to require the delivery of natural gas at a non-Henry Hub delivery point on each day during a calendar month for which the option is exercised. The option must be exercised on the last business day prior to the delivery month. The gas price is based on the midpoint price for Louisiana – On-Shore South: Henry Hub natural gas for the relevant delivery day as published by Gas Daily. Accordingly, as was the case in the first example, the trade option in this example falls within the definition of Referenced Contract.

The first exercise date for this natural gas trade option above is the last business day of the month preceding the delivery month, which is after the Spot Month for the NYMEX natural gas contract. The same exercise structure applies to all monthly options during the two year period of the transaction. Because the transaction, as agreed by the parties would cause a trade option to exist during the spot month for the NYMEX NG contract during each month of the transaction, it would be precluded by the Proposed Rule to the extent that this Referenced Contract position, plus other non-*bona fide* positions held by either party, exceeded the spot-month limit on physically-settled natural gas contracts. Thus, the Proposed Rule would have essentially the same adverse consequences on the parties to the trade option in this example as it would have on the parties to the trade option in the first example.

Separate and apart from the anomalous impact that subjecting trade options would have on long-standing and important commercial supply and merchandizing transactions, the Proposed Rule would require market participants to develop new systems for monitoring physical options positions, the sizes of which change constantly and rapidly because of the impact of option deltas. It also would complicate the ability of market participants to manage risk because they would be precluded from hedging the risks associated with trade option positions given that one Referenced Contract cannot be used to hedge another Referenced Contract and cannot be netted against financially-settled Referenced Contract positions in the spot month. Furthermore, because trade options, as proposed, would be physically-settled Referenced Contracts, a market participant holding a single trade option would be ineligible for the conditional limit on the same financially-settled Referenced Contract. In short, the Joint Associations respectfully submit that the adverse effects on commercial market participants of subjecting trade options to position limits greatly exceed any regulatory benefits.

V. The Commission Should Regulate Basis Contracts Consistently

The Proposed Rule would regulate two types of spread contracts differently depending on how they are structured. Basis contracts, which are defined as contracts that cash-settle based on the difference in price of the same (or substantially the same) commodity at two *different locations*, would not be subject to position limits.[19] Conversely, inter-commodity spread

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[19] Proposed Rule at 75,823.

contracts, which are contracts that cash-settle based on the difference between the settlement price of a Referenced Contract and the settlement price of another contract based on a *different commodity*, would be subject to position limits.[20] The Commission has not explained the rationale for treating basis contracts and inter-commodity spread contracts differently, even though both types of agreements often have similar characteristics.

Joint Associations support the Commission's decision to exclude basis contracts from the definition of Referenced Contract; however, Joint Associations also recommend that the Commission take a consistent approach for inter-commodity spread contracts. Both categories of agreements tend to be highly structured, customized transactions that do not easily convert into futures equivalent positions and, therefore, are not readily compatible with the Proposed Rule. For example, in cases where only one side of a contract can be converted into a Referenced Contract position, the market participant holding the position would be subject to limits even though approximately half of the position would count for netting purposes or as a *bona fide* hedge. As discussed further in section VII.F, below, this is a particularly troubling result in the electric industry, where inter-commodity spread transactions known as "heat rate" transactions are exceedingly common. Moreover, the bespoke nature of these agreements tends to make the risk of excessive speculation or potential market manipulation remote and impractical. Accordingly, the Commission should continue collecting data regarding basis contracts and inter-commodity spread contracts pursuant to Part 20 and Part 45, but should not subject either type of contract to position limits.

VI. The Commission Should Revise Its Approach to Spot and Non-Spot Month Limits

A. *Definition of Spot Month*

Under the Proposed Rule spot month is defined differently for physical delivery contracts and cash-settled contracts.[21] Prior to finalizing the list of Referenced Contracts, Joint Associations urge the Commission to make sure that that the definition is consistent with market practices as they exist in the energy industry. This is especially important if the Commission chooses to include commodity trade options in the Proposed Rule. As indicated above, the optionality included in these contracts is necessary for Joint Associations' members to meet their own electricity and gas needs and the needs of their retail consumers. Since electricity cannot be stored and called upon when needed the optionality is necessary to meet changes in customer demand. As such, the spot month limits should take into consideration how power markets operate.

B. *The Commission Should Use the Best Data Currently Available to Set Initial Spot Month Limits at 25 Percent of Deliverable Supply*

The Proposed Rule would establish spot month position limits based upon an estimate of 25 percent of deliverable supply for the commodity in each core referenced futures contract.[22]

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[20] *Id*. at 75,697 fn 163.

[21] Proposed Rule 150.1.

[22] Proposed Rule 150.2(a).

Initially, the Commission would adopt the existing spot month speculative position limits set by individual designated contract markets. However, as an alternative, the Commission is considering setting the initial spot month limits at levels based on estimates of deliverable supply submitted by CME Group on July 1, 2013.[23]

Joint Associations urge the Commission to adopt spot month position limits based upon the CME Group's estimates of deliverable supply. The deliverable supply estimates currently used by the Commission are severely outdated and do not accurately reflect the markets as they exist today. The CME Group's estimates of deliverable supply represent the most current and accurate data regarding the size of the markets for the commodities that underlie each core referenced futures contract. If the Commission relies upon out-of-date statistics, it risks imposing limits that are unnecessarily restrictive and that inadvertently harm the liquidity and utility of the derivatives markets. Since all futures transactions occur on an exchange, the exchanges are in the best position to provide accurate and current information on the market. The Commission should, therefore, follow its established practice of deferring to the exchanges' expertise and adopt spot month position limits based upon the most current and complete information they have provided.

C. *The Commission Should Adopt a More Flexible Approach to Limits for Cash-Settled Contracts*

The Proposed Rule would establish separate spot month speculative position limits for physical-delivery Referenced Contracts and cash-settled Referenced Contracts.[24] In addition, the Proposed Rule would permit a higher spot month limit for cash-settled Referenced Contracts equal to five times the standard spot month limit, provided that the person relying on this conditional limit does not hold any positions in the physical-delivery Referenced Contract.[25] Under the Proposed Rule, market participants relying on the conditional limit would be required to provide the CFTC with daily reports regarding their cash market positions on new Form 504.[26]

Joint Associations request that the Commission adopt a more flexible approach to limits for cash-settled Referenced Contracts because, as the Commission has acknowledged in the context of exchange-set position limits, cash-settled contracts are less susceptible to manipulation and excessive speculation.[27] Joint Associations suggest that the Commission adopt the spot month limit methodology used to determine the physical-delivery and cash-settled spot month position limits for the NYMEX Henry Hub contract in the 2011 Position Limits Rule.[28] Under the prior rule, the Commission established a limit for the physical-delivery Referenced Contract and a separate, aggregate limit of five times the size of the physical-delivery limit for both physical-

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[23] Proposed Rule at 75,727.

[24] Proposed Rule 150.2(a).

[25] Proposed Rule 150.3(c).

[26] Proposed Rule at 75,778.

[27] *See* 17 C.F.R. Part 38 Appendix B, Core principle 5, section (b)(2) (describing the potential for distortion of prices in connection with cash-settled contracts as "negligible").

[28] Position Limits for Futures and Swaps, 76 Fed. Reg. 71, 626 (Nov. 18, 2011).

delivery and cash-settled contracts.[29] The Commission should modify the Proposed Rule and adopt a similar approach, permitting market participants to rely on higher speculative limits for cash-settled contracts while still holding a position in the physical-delivery contract. Without this modification, the conditional spot month limit may cause market participants to choose between holding positions in either the physical-delivery or the cash-settled contracts, which could negatively impact the price discovery and risk management functions of both physical-delivery and financially-settled contracts.

Furthermore, because the Commission has also proposed to subject commodity trade options to position limits as physically-delivery contracts, any person that holds a single commodity trade option for a particular Referenced Contract would be unable to rely on the conditional spot month limit for that commodity. This restriction would make the conditional spot month limit unavailable for many of Joint Associations members and other commercial market participants.

Joint Associations also request that the Commission modify the Proposed Rule to permit market participants that rely on the conditional limit to file monthly *bona fide* hedging reports, rather than a daily filing of all cash market positions. The daily Form 504 filings, as proposed, would relate to a broad range of cash-market positions that, in most cases, are not currently subject to any periodic reporting requirements. Developing the reporting systems needed to identify and report the information required by Form 504 would impose significant burdens on commercial market participants with cash market positions, particularly when compared to purely speculative traders who do not hold cash market positions. Moreover, it is unclear what benefit the Commission would realize from receiving daily, as opposed to monthly, reports. The Commission should more appropriately balance the costs and benefits associated with Form 504 requirements by requiring market participants relying on the conditional spot month limit to submit monthly, rather than daily, reports.

D. *The Commission Should Not Set Non-Spot Month Limits Based on Incomplete Market Data*

The Joint Associations believe that additional limits outside of the spot month are not necessary. Instead, accountability levels would provide the oversight desired by the Commission without imposing limits based on incomplete data, as discussed below, which could harm the market. Accountability levels for non-spot months have been used effectively by exchanges for years and the Commission has neither explained a need for hard non-spot month limits nor explained why the current approach for exchange-set limits is not sufficient.

The Proposed Rule would set non-spot month speculative position limits based on 25 percent of open interest for the first 25,000 contracts and 2.5 percent of open interest thereafter.[30] To calculate specific non-spot month limits in the Proposed Rule, the Commission only relied upon open interest data from calendar years 2011 to 2012 for futures contracts, options on futures contracts, and significant price discovery contracts that are traded on exempt commercial

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[29] *Id.* at 71,635

[30] Proposed Rule at 75,730

markets.[31] Open interest data derived from the CFTC's Part 20 swaps large trader reporting rule and data derived from swaps reported to swap data repositories pursuant to the Commissions swap reporting rules were *excluded* from its calculation due to potential inaccuracies and other concerns.[32]

Joint Associations request that the Commission wait to set non-spot month speculative position limits until it has complete data regarding the markets it seeks to regulate. Omitting data from large portions of the swaps market – including all over-the-counter swaps traded between commercial end-users – incorrectly makes those markets appear to be smaller than they really are, and results in limits that are inappropriately and unnecessarily restrictive. The Commission recognized this limitation when it proposed and adopted the 2011 Position Limits Rule. Rather than impose potentially harmful limits based on data that was substantially incomplete, the Commission determined that it would not establish non-spot month limits until it had 12 months' worth of reliable data under Part 20.[33]

E. *EEI Supports the Proposal to Permit Netting of All Referenced Contracts Outside of the Spot Month*

The Proposed Rule would permit market participants to net positions in physical-delivery and cash-settled Referenced Contracts outside the spot month.[34] Joint Associations support this proposal. Netting positions outside of the spot months permits Joint Associations members and other market participants to efficiently manage their commercial risk, without presenting any of the concerns that the Commission has raised in connection with netting during the spot month. The Commission, therefore, should adopt this provision as it has been proposed.

VII. The Commission Should Revise the Definition of *Bona Fide* Hedging Positions to Fully Accommodate All Legitimate Commercial Risk Management Activity

Joint Associations members are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. If the Commission adopts a definition of *bona fide* hedging that is too narrow or inflexible, it will make important hedging activities more difficult for commercial end users which, as a consequence, may increase the price and volatility of energy for residential, commercial, and industrial customers. Accordingly, Joint Associations urge the Commission to adopt a definition of *bona fide* hedging that is easily understandable and commercially practicable by incorporating the specific recommendations described below.

A. *The Commission Should Not Limit Bona Fide Cross-Commodity Hedges*

The Proposed Rule would permit certain cross-commodity hedges to qualify as *bona fide* hedging positions, "provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are

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[31] *Id*.

[32] *Id*. at 75,733-34.

[33] 2011 Position Limits Rule at 71.688.

[34] Proposed Rule at 75,710.

substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract."[35] To further elaborate on when a cross-commodity hedge would be considered "substantially related" to a cash-market position, the Commission provided a non-exclusive safe harbor based on two factors: (1) a qualitative factor, requiring a reasonable commercial relationship between the underlying cash commodity and the commodity underlying the commodity derivative contract; and (2) a quantitative factor, requiring a reasonable and measureable correlation in light of available liquid commodity derivative contracts. Under the Proposed Rule, the CFTC would only presume an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[36] Positions that do not satisfy *both* the conditions of the safe harbor are presumed *not* to be *bona fide* hedging positions; however, a person may attempt to rebut this presumption.[37]

Joint Associations strongly oppose the approach to cross-commodity hedges in the Proposed Rule and urges the Commission to remove the quantitative test from the safe harbor when it finalizes the position limits rule. Rather than defining when a hedge is "substantially related" to the price of an underlying commodity using an arbitrary numeric threshold measured over an arbitrary period of time, the CFTC should permit market participants to make commercially reasonable determinations of which contracts are substantially related.

Joint Associations urge the Commission to reconsider the quantitative factor in the proposed safe harbor. In many cases, a quantitative test of correlation based on spot month prices is an unsuitable method of assessing whether a hedge is appropriate because it does not accurately reflect how prices converge across the forward curve. For this reason, many market participants assess and manage their forward price risk using customized analytical models that take into account the characteristics of their particular markets. The Commission should not attempt to reduce this complex, and often subjective, process to a crude mathematical formula which would, in many cases, yield a result that is incorrect. Further, the Commission has provided no explanation for requiring that a quantitative analysis consider 36 months of historical price data. Joint Associations members must be permitted to make commercially reasonable judgments when quantifying risk including normalizing historical data to account for unusual anomalies and using shorter or longer look-back periods. The proposed 36-month look-back period would also restrict the use of new cross-commodity hedging products that may provide a best available hedge, but that do not have 36-months of historical data.

As the Commission is well-aware, utilities and other power generators have long used natural gas Referenced Contracts to hedge the price risk associated with their electricity production. They have done this based upon decades of commercial experience and reasonable

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[35] *Id.* at 75,824 (emphasis added).

[36] *Id.* at 75,717.

[37] *Id.*

business judgment. Nevertheless, according to the Commission, fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in the value of natural gas.[38] Joint Associations respectfully disagree and submit that the Commission should not attempt to substitute its administrative judgment for the commercially reasonable business judgment of market participants.

The Commission's stated belief about the correlation between power and natural gas prices is incorrect as there is substantial evidence in the assessments done by the Federal Energy Regulatory Commission as well as the system operators responsible for maintaining reliability in the electricity markets about the correlation between electricity contracts and natural gas contracts.[39] According to the Energy Information Administration ("EIA"), natural gas comprised 15.8 percent of the fuel mix for electric generation in 2000 and 30.7 percent of the fuel mix for electric generation in 2012. Due to retirements of coal-fired generation in response to EPA rules and low natural gas prices this trend is likely to continue going forward. This connection between natural gas prices and electricity markets is illustrated in the State of the Market Report prepared by the NYISO independent market monitor: "Average electricity prices fell 16 to 25 percent from 2011 to 2012, which was primarily due to lower natural gas prices. Natural gas prices fell 28 to 35 percent over the same period. Low natural gas prices increased the share of electricity production from natural gas from 38 percent in 2011 to 45 percent in 2012. The correlation between energy and natural gas prices is expected in a well-functioning, competitive market because natural gas-fired resources were the marginal source of supply in 80 percent of the intervals in New York in 2012. Additionally, over 1 GW of new gas-fired generating capacity was installed in New York City (between July 2011 and June 2012), which also contributed to the overall reduction in the energy prices in 2012." This inter-relationship will only increase as natural gas is increasingly used for electric generation and displaces baseload units such as nuclear and coal while still being used as peaking units and to back-up renewable generation such as solar and wind.[40]

There are also other significant problems with the Commission's proposed limitations on cross-commodity hedges. First, using spot prices to make this determination, as proposed by the CFTC, is inconsistent with actual market practice. Many market participants hedge long-term

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38 *Id.*

39 See *e.g*. Winter 2013 -14 Energy Market Assessment, FERC Staff Report to the Commission (slide 11 illustrates correlation between natural gas and electricity prices in New England), Docket No AD06-3 (October 2013); 2013 Special Reliability Assessment: Accommodating an Increased Dependence on Natural Gas for Electric Power, http://www.nerc.com/pa/RAPA/ra/Reliability%20Assessments%20DL/NERC_PhaseII_FINAL.pdf; Coordination Between Natural Gas and Electricity Markets , Docket No. AD12-12 FERC Staff Quarterly Reports, http://www.ferc.gov/legal/staff-reports/2013/A-4-presentation.pdf;; Potomac Economics 2012 State of the Market Report for the ERCOT Wholesale Electricity Markets, http://www.potomaceconomics.com/uploads/ercot_reports/2012_ERCOT_SOM_REPORT.pdf; ISO New England 2013 Regional Electricity Outlook, http://www.iso-ne.com/aboutiso/fin/annl_reports/2000/2013_reo.pdf;

40 Annual State of the Market Report by the NYISO Independent Market Monitor for 2012, Executive Summary page 1.

electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. In that case, a market participant will often convert its hedges from gas derivatives to electricity derivatives as the risk moves closer to, or into, the spot month. Requiring the proposed correlation in outer months would eliminate all available tools for hedging at illiquid locations which, in turn, would result in higher risks for market participants and higher costs for consumers. Because the CFTC only evaluated correlation during the spot month, it did not take into account the closer correlation that typically exists between these prices in the non-spot months. As a result, the Proposed Rule would impermissibly and inappropriately limit a necessary, well-established, and beneficial hedging practice. Due to the close relationship between natural gas and electricity, Joint Associations would suggest that the Commission modify the safe harbor provision to require compliance with the qualitative component only and that the Commission remove all statements about a general lack of correlation between electricity and natural gas.

B. *The Commission Should Revise the Orderly Trading Requirement to Make it Consistent with the Disruptive Trading Practices Policy Statement*

The definition of *bona fide* hedging position in the Proposed Rule requires that hedge positions be established, maintained, and liquidated in an orderly manner in accordance with sound commercial practices.[41] In the preamble to the Proposed Rule, the Commission elaborates on this requirement stating that it intends to impose a standard of "ordinary care" on *bona fide* hedgers when "entering, maintaining and exiting the market in the ordinary course of business and . . . in establishing, maintaining or liquidating a position in excess of position limitations."[42] Under this standard, which, to Joint Association's knowledge, has never been previously announced or applied, negligent trading, practices, or conduct would be a sufficient basis for the Commission to disallow a *bona fide* hedging exemption. The Commission also proposes to apply its disruptive trading practices policy regarding orderly markets to its orderly trading requirement for purposes of position limits.[43]

Joint Associations request that the Commission revise the standards in the proposed orderly trading requirement to make them consistent with the Disruptive Trading Practices Policy Statement. Specifically, Joint Associations request that the Commission clarify that it only intends to exercise its authority to disallow *bona fide* hedges that are established, maintained or liquidated in a reckless, rather than negligent, manner. Indeed, the policy statement only focuses on intentional or reckless conduct under section 4c(a)(5)(B) and states "that accidental, or even negligent, trading, practices or conduct will not be a sufficient basis for the Commission to claim a violation . . . ."[44] As a result, the standard of care in the Proposed Rule would disallow *bona fide* hedging treatment based on standard of care that is not well-suited to position limits because each commercial market participant hedges risks that are unique to its particular business. Given the company-specific nature of hedging risks associated with a physical commodity business, the Commission, at a minimum, should apply the higher state of

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[41] Proposed Rule 150.1.

[42] Proposed Rule at 75,707.

[43] *Id.*

[44] *See* 78 Fed. Reg. 31,890, 31895 (May 28, 2013).

mind standard in the Disruptive Trading Practices Policy Statement to any determination to disallow *bona fide* hedging treatment, or it should articulate its rationale for why a different standard is necessary or appropriate in the position limits context.

C. *The Commission Should Permit All Forms of Bona Fide Hedging Regardless of Whether Hedges Are Executed on a Gross or Net Basis*

To qualify as a *bona fide* hedging position, a position in a commodity derivative contract must be, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[45] Historically, market participants have had significant flexibility with regards to how they manage their commercial risk, including discretion to determine whether to hedge their risk on a gross or net basis.[46] However, in the Proposed Rule, the Commission suggests that hedging on a gross basis may only be appropriate "under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of the cash commodity being hedged."[47]

Joint Associations request that the Commission modify the Proposed Rule to continue to permit all forms of *bona fide* hedging regardless of whether those hedges are executed on an enterprise-wide gross or net basis, or at a portfolio level within a single company. Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. As long as a company organizes portfolios of risk based on commercially reasonable risk management principles, market participants should have the flexibility to manage risk and hedge on a portfolio level without regard to other portfolios within the same legal entity. For example, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (*i.e.*, it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region.[48] The same is true for other commodity businesses that deal with other types of physical commodities. For Joint Associations members and other

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[45] Proposed Rule 150.1.

[46] *See* 42 Fed. Reg. 14,832, 14834 (Mar. 16, 1977).

[47] Proposed Rule at 75,709. The CFTC provides an example of a market participant that enters into a fixed price sales commitment and an offsetting fixed price purchase commitment. According to the CFTC, "if such a merchant were to offset only the cash purchase contract, but not the cash sales contract (or vice versa), then it reasonably would appear the offsetting commodity derivative contract would result in an increased value exposure of the enterprise (that is, the risk of changes in the value of the cash commodity contract that was not offset is likely to be higher than the risk of changes in the value of the calendar spread difference between the nearby and deferred delivery period) and, so, the commodity derivative contract would not qualify as a *bona fide* hedging position." *Id.*

[48] In the Proposed Rule, the Commission has stated its intention to ultimately subject all physical commodities to federal position limits in the future. Proposed Rule at 75,728. Therefore, the Commission must consider potential impacts on *all* physical commodities, especially electricity, in crafting provisions that form the base of the federal position limits such as the concept of "economically appropriate." The Commission must also consider the impacts on *all* physical commodities, because the proposed rules would also apply to exchange-set position limits, which apply to all commodities.

commercial commodity companies, hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions.

The CFTC previously permitted market participants to hedge on a net or gross basis.[49] Although the CFTC appears to rely upon the 1977 proposed rule as the basis to argue that the Commission previously restricted hedging on a gross basis; the 1977 proposed rule permits market participants to hedge their positions consistently with the then existing definition of *bona fide* hedging, which allowed market participants to hedge "their gross cash position irrespective of their net cash position."[50] This is another area where the Commission should not substitute its administrative judgment for the commercially reasonable judgment of market participants who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. Joint Associations respectfully submit that the Commission does not have, and has not articulated, a sound basis for departing from its long-standing policy of permitting market participants to hedge on a gross or net basis.

D. *The Commission Should Provide a Commercially Practicable Process for Requesting Exemptions for Non-Enumerated Bona Fide Hedges*

The Proposed Rule does not provide a dedicated process by which market participants may apply for an exemption for non-enumerated hedges. Instead, the Proposed Rule would require market participants seeking relief to request either: (1) an interpretative letter under CFTC Rule 140.99; or (2) a non-enumerated hedge exemption through a petition under section 4a(a)(7) of the CEA.

Joint Associations are concerned that the two methods that the Commission has proposed for seeking exemptive relief for non-enumerated hedging positions would be too time consuming and cumbersome to be practicable for many commercial market participants. Both procedures require an affirmative determination by either Staff or the Commission. Absent such action, market participants would not be able to treat a non-enumerated hedge as *bona fide*. Because both CFTC Rule 140.99 and section 4a(a)(7) provide no timeframes within which the CFTC must respond, this is problematic for many commercial market participants that need to be able to manage their risk on a real-time basis. By contrast, under current CFTC Rules 1.3(z)(3) and 1.47, the CFTC must respond to a request for a non-enumerated hedge within 30 days for a new filing or 10 days for an amendment to an existing filing. Joint Associations request that the CFTC adopt a procedure analogous to the Staff level exemption process in current CFTC Rule 1.47, including reasonable standards and timing for determining whether to grant a non-enumerated hedge exemption. Joint Associations also request that Staff not be limited to interpreting the existing exemptions. Staff should be able to grant an exemption for a non-enumerated hedge exemption for *bona fide* risk reducing Referenced Contract positions. The alternatives in the Proposed Rule would not provide market participants with the ability to hedge non-standard risks or provide them with responses in a timely or commercially workable manner.

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[49] *See, e.g.*, 42 Fed. Reg. 14,832, 14,834 (Mar. 16, 1977) (proposed rule).

[50] *Id.* See also Proposed Rule at 75,703.

E. *The Commission Should Revise the Definition of Bona Fide Hedging to Include Risk Management Practices Commonly Used by Commercial Market Participants*

Joint Associations support the Working Group of Commercial Energy Firm's ("**Working Group**") request for clarification that various types of common hedging activities qualify as *bona fide* hedging positions and appreciates the Commission's willingness to incorporate certain of these activities into the Proposed Rule.[51] However, Joint Associations request that the Commission revise various aspects of the definition of *bona fide* hedging position to include risk management practices commonly used by commercial market participants.

- Unfixed price purchases and unfixed price sales. The CFTC's proposed definition of *bona fide* hedging positions includes the Working Group's request for a hedge of an unfixed price purchase and unfixed price sale, in which one leg of the hedge is a Referenced Contract and the other leg is a non-referenced contract. The CFTC's proposed definition of *bona fide* hedging positions also includes the Working Group's request for a hedge of an unfixed price purchase and an unfixed price sale of a physical commodity in which the separate legs of the hedge are in the same calendar month, but which do not offset each other, because they are in different contracts. Joint Associations support the inclusion of these underlying transactions as a basis for a *bona fide* hedging position.

- Certain price differentials. The Proposed Rule would *not* include within the definition of *bona fide* hedging positions the Working Group's request regarding Referenced Contracts used to lock in a price differential where one leg of the underlying transaction is an unpriced commitment to buy or sell, and the offsetting sale has not been completed. Joint Associations support the inclusion of this underlying transaction as a basis for a *bona fide* hedging position and requests that the CFTC amend the definition of *bona fide* hedging position to include this as an enumerated exemption. Joint Association note that the statutory definition of *bona fide* hedging position expressly includes anticipatory merchandizing.[52] Moreover, the CFTC could monitor hedging versus speculation based on a review of historical cash market sales to determine if, at the time of the transaction, there was a reasonable basis to infer that an offsetting transaction was likely to occur.

- Market price volatility hedges associated with fixed-price bids and offers. The Proposed Rule would *not* include within the definition of *bona fide* hedging positions the Working Group's request regarding a hedge of market price volatility associated with binding and irrevocable fixed-price bids or offers. Solicitations of binding bids and offers have long been used by utilities and special entities to procure electricity, natural gas, and environmental commodity

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[51] Joint Association Comments in Support of Petition for Exemptive Relief for Certain *Bona Fide* Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act (March 1, 2012).

[52] CEA Section 4a(c)(2)(A)(i); 7 U.S.C. § 6a(c)(2)(A)(i).

contracts. Despite this well-established and important commodity procurement practice, the CFTC asserts that a binding bid or offer by itself is too tenuous to serve as the basis for an exemption from speculative position limits, because it is an uncompleted merchandising transaction.[53] As a result, the commercial entity submitting a binding, fixed-price bid or offer is effectively subject to a contingent price risk that cannot be hedged.[54] Joint Associations respectfully submit that binding and irrevocable bids create legitimate, reasonably anticipated contractual risk (*i.e.*, risk that the bid will be accepted) that must be hedged. For example, many states in which the utility has been required to divest its generation conduct competitive auctions to select the suppliers for the utility's retail load. Since these auctions are generally conducted under rules and regulations established by the state public service commission, there is delay between the acceptance of the long term electricity offer and official review by the state commission of the auction results. Prohibiting the hedging of a binding and irrevocable bid could increase the costs incurred by utilities and special entities to provide power or gas to their customers by forcing bidders to incorporate into their bids or offers the cost associated with the risk that the Commission will not allow them to hedge.[55]

- Hedges of anticipated contracts based on ongoing good faith negotiations. The Proposed Rule does *not* include in the definition of *bona fide* hedging position the Working Group's request regarding Referenced Contracts used to hedge ongoing, good faith negotiations that the hedging party reasonably expects to conclude. Similar to binding and irrevocable bids and offers, a cash transaction that is the subject of ongoing negotiations is anticipated, but not yet a purchase or sale agreement, and therefore would not satisfy the requirements of the proposed definition of *bona fide* hedging position. Joint Associations request that the Commission include hedges of ongoing good faith negotiations in the definition of *bona fide* hedging position because an anticipated merchandizing transaction, which is part of the statutory definition of *bona fide* hedging transaction,[56] includes a transaction that is not already subject to a binding agreement. As noted above, the CFTC could monitor hedging versus speculation based on a review of historical cash market purchases and sales to determine if there is a reasonable basis at the time to infer an anticipated offsetting transaction.

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[53] Proposed Rule at 75,720.

[54] The Commission also noted that "some commercial entities submit bids or offers merely to obtain information about the request for proposal, without an intention of submitting a quote that is likely to be accepted." Proposed Rule at 75,720.

[55] Although the CFTC noted that it is concerned about undue volatility when the winning bid is accepted and all the losing bidders simultaneously reduce their total position to get below the speculative position limit, Joint Associations note that the Commission cites no historical, objective data substantiating a realistic basis for this concern. Moreover, Joint Associations submit that, even if there is a basis for this concern, it is sufficiently addressed through the existing requirement that market participants exit their hedge positions in an orderly manner.

[56] CEA Section 4a(c)(2)(A)(i); 7 U.S.C. § 6a(c)(2)(A)(i).

- <u>A state-regulated public utility hedging the requirements of its retail customers.</u> The CFTC's proposed definition of *bona fide* hedging includes the Working Group's request regarding long positions in Referenced Contracts purchased by a state-regulated public utility to hedge the anticipated natural gas requirements of its retail customers.[57] Joint Associations support the inclusion of this underlying transaction as a basis for a *bona fide* hedge position. However, the Commission should eliminate the restriction such hedging be "required or encouraged to hedge by its public utility commission on behalf of its customers"[58] as public utility commissions by and large do not "require or encourage" hedging, but instead permit regulated utilities to engage in prudent hedging practices.

- <u>Other unfilled anticipated requirements.</u> The Commission should incorporate guidance from CFTC Staff letter 12-07 into the final rule and unambiguously permit unfilled anticipated requirements to qualify as a *bona fide* hedge where a commercial enterprise, such as an electric company, holds "long-term, unfixed-price supply or requirements contracts."[59] As indicated above, the Commission also should eliminate the restriction on utility hedging of unfilled anticipated customer requirements to permit all reasonable and prudent hedging activities, regardless of whether they are explicitly "required or encouraged to hedge by its public utility commission on behalf of its customers."

F. *The Bona Fide Hedging Definition Needs to Accommodate "Heat Rate Transactions" That Are Exceedingly Common Among EEI Members.*

The definition of "*bona fide* hedging position" does not contemplate transactions common to the electricity markets known as "heat rate" transactions. Generally, a "heat rate" transaction refers to a physical or financial transaction in an electricity commodity where the price of electricity (or one leg in the case of a heat rate swap) is determined by multiplying an agreed upon heat rate[60] times a gas index price. The term "heat rate" is generally the measure of efficiency for a power plant. The higher the heat rate, the more inefficient a power plant it is and the more expensive it is to run that power plant. Many power markets around the country trade based upon a market heat rate or implied heat rate, which is calculated by dividing the electricity price by the price of natural gas. Because of the inextricable link between the price of natural gas and the price of electricity, many wholesale and commercial electricity transactions are priced on heat rates.

Heat rate transactions may take several forms such as forward sales of physical power (either from an electric generator or from a merchant), forward purchases of physical power, options on physical power, or swaps. Heat rate transactions have many uses in the electric markets. For example, an owner of gas-fired electric generation may use a heat rate swap or

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[57] Proposed Rule at 75,714.

[58] Proposed Rule at 75,713..

[59] CFTC Interpretive Letter No. 12-07 at 1, Aug. 16, 2012.

[60] "Heat rate" refers to the amount of energy (typically expressed in British thermal units ("**Btu**") required by an electrical generator to generate one kilowatt-hour ("**kWh**") of electricity.

option to hedge electric and gas price risk associated with physical commodity transactions. Or, a market participant (either a generation owner or merchant) may sell physical electricity priced at a heat rate[61] or sell physical heat rate options, then hedge both the electric and gas components of the physical transaction using a combination of electric and gas derivatives. These types of physical heat rate transactions and heat rate derivatives reflect very common transactions in present-day power markets.

Joint Associations are concerned that both natural gas derivatives used to hedge physical heat rate transactions and heat rate derivatives used to hedge commodity price risk would be excluded from the definition of "*bona fide* hedging position" set forth in proposed CFTC regulation 150.1 even though they clearly perform a risk-reducing function and achieve the same purpose as other types of hedge transactions that qualify for *bona fide* hedging treatment under the Proposed Rule.

Specifically, a natural gas Referenced Contract used to hedge a physical heat rate transaction might not qualify under the enumerated *bona fide* hedging exemption for hedges of cash commodity sales or purchases in proposed CFTC regulation 150.1 (3)(i) or (ii) because:

- The enumerated exemptions require the Referenced Contract to reference the same commodity as the cash commodity transaction;
- The enumerated exemptions require that the cash commodity transaction be a fixed price, but a physical heat rate transaction is still a floating price transaction.

Similarly, a heat rate swap or physical heat rate option used by an electric generator would not qualify as a *bona fide* hedging position under the enumerated hedging exemption for unsold anticipated production set forth in proposed CFTC regulation 150.1(4)(i). This enumerated hedge provision requires that the Referenced Contract reference the same commodity as the commodity the person anticipates producing. It appears that the natural gas price component of a heat rate derivative would not meet this requirement because the heat rate derivative hedges physical electricity price risk.

Further, under the Proposed Rule, a natural gas Referenced Contract apparently would not qualify as a cross-commodity hedge for a physical power transaction under the proposed Safe Harbor Test. The Commission's proposed correlation threshold under the Safe Harbor Test creates additional problems with some natural gas derivatives. For example, in the context of a heat rate transaction, market participants may use two natural gas derivatives—a Henry Hub Referenced Contract and a basis contract—to hedge the natural gas price risk at a delivery point near the delivery point of the electricity. The market participant could not get *bona fide* hedge treatment even if the natural gas price at the other delivery point satisfied the proposed

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[61] In addition, some power markets around the country trade based on market heat rates or implied heat rates, which are calculated by dividing the market price for electricity by the market price of natural gas. Participants in these markets may hedge physical positions through combinations of electricity and gas derivatives that economically lock in a market heat rate, which positions should be treated as *bona fide* hedging positions.

correlation requirement for a cross-commodity hedge. Economically, the Henry Hub Referenced Contract nets against the basis contract and leaves the market participant with a natural gas position priced at the other, non-Henry Hub delivery point. The Proposed Rule, however, would not permit the market participant to treat the Henry Hub Referenced Contract as a *bona fide* hedge, while also excluding the basis contract and not recognizing the economic offset to the Henry Hub position.

If heat rate transactions are not granted *bona fide* hedging treatment, heat rate options and swaps will create an unusual situation wherein a derivative in one commodity (*i.e.,* electricity) is priced in a way that, for position limits compliance purposes, also creates a derivative position in another commodity (*i.e.,* natural gas). This could result in a situation in which a single transaction is treated as two derivative positions in two separate commodities—electricity and natural gas—with the electric component satisfying the *bona fide* hedging definition.[62]

The proposed rules will harm energy commodity markets and various types of market participants by not permitting heat rate transactions to either qualify as *bona fide* hedging transactions or providing a basis for treating a natural gas position as a *bona fide* hedging transaction.

Based on these concerns, the Joint Associations recommend that the Commission (i) create a new enumerated hedging position in proposed CFTC regulation 150.1 that includes heat rate derivatives used to hedge physical risk as well as electricity and natural gas derivatives used to hedge physical heat rate transactions, (ii) modify the proposed definition of "*bona fide* hedging position" to make clear that (a) where a cash commodity transaction or anticipated production of a cash commodity is priced by reference to another commodity, a derivative can qualify as a *bona fide* hedging position if it references either the cash commodity or the other commodity on which the cash commodity is priced, and (b) "fixed price" includes a price structure like a heat rate transaction, or (iii) modify the proposed enumerated exemption for cross-commodity hedges to include as *per se* cross-commodity hedges heat rate transactions and electricity and natural gas transactions used to hedge physical heat transactions.

VIII. Exchange Set Limits

Under the Commission's Proposed Rule, market participants do not need to apply for an exemption to net positions for purposes of the CFTC's limits, but must apply to net positions for purposes of exchange-set limits.[63] Joint Associations request that the Commission amend the Proposed Rule to permit the netting of positions for purposes of exchange-set limits on a self-certification basis. This is a practical approach given that entities will already be required to comply with the CFTC-set limits. The costs associated with monitoring netting activity, as well

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[62] For example, a heat rate swap that hedges a physical heat rate transaction would appear to be a *bona fide* hedge for the power component but not the natural gas component. Joint Associations believe that it is essential for the Commission to address definitional issues like this that may impact electricity commodities that are not Core Referenced Futures Contracts under the proposed rule because of the Commission's stated intention to adopt position limits on electricity transactions in the future. Proposed Rule at 75,726.

[63] Proposed Rule at 75,774.

as the reporting burden placed on market participants, would be grossly disproportionate to the limited benefits.

IX. The Commission Should Clarify *Bona Fide* Hedging Example No. 7 to Provide That Aggregation Pursuant to an "Expressed or Implied Agreement" Is Only Required Where the Parties Trade or Manage Positions Pursuant to Such an Agreement

Example No. 7 in Appendix C of the Proposal Rule describes the application of the proposed definition of *bona fide* hedging positions to a fact pattern in which a sovereign induces a farmer to sell his anticipated production forward at a fixed price for delivery during the expected harvest. In connection with this transaction, the sovereign: (1) agrees to pay the farmer the difference between the market price at the time of harvest and the price of the fixed-price forward, in the event that the market price at the time of harvest is above the price of the forward; then (2) purchases call options on the Chicago Board of Trade contract to offset its exposure.[64] In its analysis of this example, the Commission states that, because "the [s]overeign and the farmer are acting together pursuant to an express agreement, the aggregation provisions of § 150.4 apply and they are treated as a single person for purposes of position limits."[65]

Joint Associations respectfully submit that the Commission has incorrectly applied the aggregation requirement in this example. Section 4a(a)(1) of the CEA provides, in part, that "limits upon positions and trading shall apply to derivative positions held by, and *trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding*, the same as if the positions were held by, or the trading were done by, a single person."[66] A reasonable interpretation of this provision would be that the "agreement or understanding" at issue must involve trading or managing positions. However, the only "agreement or understanding" in Example No. 7 is the agreement between the Sovereign and the farmer – an agreement that is, in effect, a bilateral swap between two independent legal entities.

Accordingly, Joint Associations request that the Commission clarify Example No. 7 to eliminate the discussion of the aggregation requirement. Without this clarification, Example No. 7 suggests that, contrary to a reasonable reading of section 4a(a)(1) and long-standing commercial practice, common, bilateral transactions may constitute "acting together pursuant to an express [or implied] agreement," which would thereby trigger the aggregation requirement in proposed CFTC Rule 150.4.[67] This would mean that the market participant would be required to aggregate with all its counterparties. Joint Associations submit that this would be a harmful and disruptive interpretation that would limit important hedging activity and create considerable uncertainty regarding the interpretation and implementation of the proposed aggregation rules.[68]

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[64] *Id*. at 75,835-39 (emphasis added).

[65] *Id*. at 75,837.

[66] CEA Section 4a(a)(1); 7 U.S.C. § 6a(a)(1) (emphasis added).

[67] Proposed Rule at 75,837.

[68] Aggregation of Positions, 78 Fed. Reg. 68,946 (Nov. 15, 2013).

X. Conclusion

Joint Associations appreciate the Commission's consideration of its comments on the Proposed Rule. For the foregoing reasons, Joint Associations respectfully request that the Commission adopt its comments and allow its members to continue to operate in a commercially reasonable manner in the commodities markets.

Please contact us at the number listed below if you have any questions regarding these comments.

Respectfully submitted,

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