

**UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION**

Position Limits for Derivatives) RIN 3038-AD99

**COMMENTS OF THE
AMERICAN GAS ASSOCIATION**

Pursuant to the Notice of Proposed Rulemaking (“NOPR”) noticed in the Federal Register on December 12, 2013,¹ by the Commodity Futures Trading Commission (“CFTC” or “Commission”), the American Gas Association (“AGA”) respectfully submits these comments. While AGA believes that position limits can benefit consumers by helping to ensure that the commodity markets are free from excessive speculation and market manipulation, they must be established in a way that allows commercial end-users, such as gas utilities, to continue to manage risks in a cost-effective manner on behalf of their customers. Therefore, AGA respectfully recommends that the Commission modify its proposal in this proceeding to make clear that trade options are not subject to position limits. AGA also urges the Commission to provide market participants with a definitive list of contracts considered to be referenced contracts for purposes of position limits. Further, AGA recommends that the Commission delete the requirement that a utility be “required or encouraged to hedge by its public utility commission” in order for such utility’s transactions to be eligible for the bona fide hedge exemption. Finally, AGA requests that the Commission clarify that its proposed bona fide hedge exemptions related to unfilled anticipated requirements and unsold anticipated production would also apply to circumstances in which a market participant has filled its anticipated requirements or sold its anticipated production with index-priced contracts.

¹ *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013).

I. COMMUNICATIONS

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II. IDENTITY AND INTERESTS

The American Gas Association, founded in 1918, represents more than 200 local energy companies that deliver clean natural gas throughout the United States. There are more than 71 million residential, commercial and industrial natural gas customers in the U.S., of which 92 percent — more than 65 million customers — receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs. For more information, please visit www.aga.org.

AGA's members engage in financial risk management transactions in markets regulated by the Commission. AGA member companies provide natural gas service to retail customers under rates, terms and conditions that are regulated at the local level by a state commission or other regulatory authority with jurisdiction. Many gas utilities use a variety of financial tools, such as futures contracts traded on Commission-regulated exchanges and over-the-counter energy derivatives, to hedge the commercial risks associated with providing safe, reliable and cost-effective natural gas service to its customers. As such, AGA's members will be directly affected by the Commission's regulations governing position limits for futures and swaps.

III. COMMENTS

A. Background

In its current proposal, the Commission seeks to establish position limits for 28 exempt and agricultural commodity futures, as well as the futures, options and swaps that are economically equivalent to such futures contracts.² Under the proposal, “referenced contracts” include the enumerated core referenced futures contracts, in particular the New York Mercantile Exchange Henry Hub Natural Gas (NG) futures contract, and any futures contract, options contract, or swap that is: (i) directly or indirectly linked, including being partially or fully settled on, or at a fixed differential to, the price of the core referenced futures contract; or (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 the core referenced futures contract for delivery at the same location or locations as specified in the core referenced futures contract.³

The Commission also proposes to restructure how bona fide hedge exemptions may be obtained and established. In general, any bona fide hedge must: (1) offset price risks incidental to commercial cash operations; and (2) must be established and liquidated in an orderly manner in accordance with sound commercial practices.⁴ A bona fide hedge must also be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and either be specifically enumerated, or be recognized as a bona fide hedge by a designated contract market or swap execution facility.⁵ Among the specifically enumerated hedge exemptions is a new exemption for unfilled anticipated requirements for resale by a utility.⁶

² *Id.*

³ *See* 78 Fed. Reg. at p. 75825, proposed § 150.1.

⁴ 78 Fed. Reg. at p. 75707.

⁵ *Id.*

⁶ *Id.* at p. 75713.

AGA supports efforts to ensure that the financial markets related to energy commodities function efficiently for the benefit of consumers. While AGA believes that position limits can benefit consumers by helping to ensure that the commodity markets are free from market manipulation and excessive speculation, they must be established in a way that allows commercial end-users, such as gas utilities, to continue to manage risks in a cost-effective manner on behalf of their customers. Accordingly, AGA respectfully requests that the Commission consider the recommended modifications to its proposal set forth below.

B. The Commission Should Not Subject Trade Options To Position Limits.

Under the Commission's proposal, trade options would potentially be subject to position limits; however, the Commission sought comment on whether it would be appropriate to exclude trade options from the definition of referenced contracts thus exempting trade options from position limits.⁷ Alternatively, the Commission sought comment on whether it should include trade options as one of the enumerated bona fide hedge exemptions.⁸ AGA contends that trade options should not be subject to positions limits and urges the Commission to amend its proposal to exempt trade options from the definition of a "referenced contract."

In the Commission's interim final rules regarding commodity options, it has proposed to exempt trade options from most swap regulations.⁹ For a commodity option to be a "trade option," the offeror, offeree and the transaction must meet certain requirements, including that: (1) the offeror must be an Eligible Contract Participant or a producer, processor, or commercial user of, or a merchant handling the commodity underlying the option transaction and offer or enter into the transaction solely for the purpose related to its business as such; (2) the offeree

⁷ *Id.* at p. 75711.

⁸ *Id.*

⁹ *See Commodity Options*, Final Rule and Interim Final Rule, 77 Fed. Reg. 25320 (Apr. 27, 2012).

must also be a producer, processor, or commercial user of, or a merchant handling the commodity underlying the option transaction and be offered or enter into the transaction solely for the purposes related to its business as such; and (3) the commodity option must be intended to be physically settled such that its exercise would result in the sale of an exempt or agricultural commodity for immediate or deferred delivery.¹⁰ AGA contends that trade options are not the type of transactions for which position limits are necessary to diminish or prevent excessive speculation or market manipulation.

Trade options, by definition, are entered into by commercial entities for purposes related to their businesses with physical delivery of the commodity as the intent. As the Commission has noted, “the trade option exemption is intended to permit parties to hedge or otherwise enter into transactions for commercial purposes.”¹¹ Since both the offeror and the offeree are commercial entities in the commodity value chain, and thus likely to be sophisticated entities able to negotiate at arm’s length, the Commission should have little concern about market manipulation or even market power abuse. Due to physical constraints on the amount of natural gas that many customers could ever possibly buy and use, many natural gas trade options are structured such that there is no contractual upper limit on the volume of natural gas that could be sold pursuant to that trade option. While this is not an issue with Form TO reporting, which simply requires reporting of the total dollars spend pursuant to the trade option for the previous calendar year, the lack of a contractual upper limit would make position limit reporting impossible.

Given that many trade options are non-standard transactions tailored to meet the particular needs of the contracting parties, it is unlikely that an entity would be able to amass an

¹⁰ *Id.* at p. 25326; *see also* proposed § 32.3(a)(1) – (3).

¹¹ 77 Fed. Reg. at p. 25326.

excessive speculative position to the detriment of any financial market. Indeed, the examples in the NOPR that the Commission uses to justify the establishment of position limits – the Hunt brothers’ speculating in the silver market and Amaranth Advisors’ accumulating large speculative natural gas futures positions – do not apply to trade option transactions. As the Commission noted, the Hunt brothers were speculators who neither produced, distributed, processed nor consumed silver,¹² and Amaranth Advisors was a hedge fund.¹³ Thus, the Commission has not shown that the imposition of position limits on trade options is necessary to achieve its regulatory objectives.

AGA believes that many trade options with respect to natural gas commodities are likely to be natural gas peaking supply transactions that should not be subject to the Commission’s swap regulations in any event. As AGA has argued in the commodity options rulemaking proceeding and elsewhere, natural gas peaking supply transactions should not be subject to regulation by the Commission either as swaps or commodity options.¹⁴ The Commission has proposed that a commodity option embedded in a forward contract where the option provides flexibility as to delivery could be excluded from regulation as a swap if it meets a seven-factor test.¹⁵ As evidenced by the comments filed in response to that proposal and subsequent requests for interpretative guidance, including by AGA, there is tremendous disagreement in the industry as to how the seven-factor test is to be applied. The practical result is that many counterparties,

¹² 78 Fed. Reg. at p. 75686.

¹³ *Id.* at p. 75691.

¹⁴ See Comments of the American Gas Association on Commodity Options, RIN 3038-AD62 (June 26, 2012) (arguing that natural gas peaking supply contracts are forward contracts intended to be physically settled such that they would not be considered “swaps” or “commodity options” notwithstanding the fact that they contain certain flexibility as to the delivery terms).

¹⁵ *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 at p. 48238 (Aug. 13, 2012).

out of an abundance of caution, have chosen to treat such transactions as if they were trade options. AGA contends that natural gas peaking supply transactions and other similar commodity options embedded in forward contracts that arguably do not pass the seven-factor test are not the types of transactions for which position limits are needed. More to the point, the primary purpose of trade options is to facilitate the transfer of ownership in the underlying commodity rather than facilitating the transfer of price risk.

The Commission has determined that it is reasonable and appropriate that trade options be subjected to a significantly lesser regulatory burden than other types of transactions that fall under the Commission's definition of the term "swap." Imposing position limits on trade options would be burdensome and inconsistent with the approach of an overall lesser regulatory burden for such transactions. In proposing the trade option exemption, the Commission recognized that the full panoply of swap regulations was not required for trade options. In developing the reporting requirements for various entities to report trade options, the Commission explicitly balanced the burdens of reporting against the greater transparency the reporting would bring.¹⁶ The Commission should similarly consider, in subjecting trade options to position limits, whether any incremental benefit in reducing the potential for excessive speculation or market manipulation would justify the burdens on trade options holders.

To the extent the Commission continues to believe that trade options should be subject to position limits, AGA urges the Commission to delay establishing any limits or limit formulae with respect to trade options. The Commission has not yet begun to receive any significant data regarding trade options through reporting on Form TO. In the absence of meaningful data regarding trade options, the Commission has no basis to determine that position limits would be

¹⁶ 77 Fed. Reg. at p. 25327.

necessary or effective in diminishing or preventing excessive speculation or market manipulation, or to understand the impacts of position limits on market liquidity and price discovery. Accordingly, AGA recommends that if the Commission maintains that position limits may be appropriate for trade options, the Commission delay implementation of such limits with respect to trade options until such time as it can fully assess the data soon to be reported by market participants on Form TO.

C. The Commission Should Publish A Definitive List Of Referenced Contracts.

Under the Commission’s proposal, position limits would apply not only to the 28 core referenced futures contracts listed in the NOPR, but also to economically equivalent swaps defined as “referenced contracts.”¹⁷ Such transactions would include swaps that are directly or indirectly linked, including being partially or fully settled on, or at a fixed differential to, the price of the core referenced futures contract; or 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 the core referenced futures contract for delivery at the same location or locations as specified in the core referenced futures contract.¹⁸

AGA believes that the Commission should provide market participants with a definitive list of referenced contracts. Market participants should not be left guessing whether a particular swap transaction would qualify as economically equivalent to a core referenced futures contract so as to make it a referenced contract. Any such uncertainty would only invite disagreement among counterparties, leading to increased transaction costs, potential loss of liquidity, and compliance strategies that generally make the markets less efficient – all to the detriment of consumers. Commission staff has issued a workbook listing certain commodity derivative

¹⁷ See 78 Fed. Reg. at p. 75742.

¹⁸ *Id.* at p. 75825, proposed § 150.1.

contracts that would be considered referenced contracts under the Commission's proposal.¹⁹

AGA respectfully requests that the Commission either clarify that the commodity derivative contracts listed on the workbook by Commission staff are the only swaps that will be considered referenced contracts under the position limits regulations or revise such list to include any other commodity derivative contracts that would also be considered referenced contracts for purposes of position limits. In the event the Commission does not publish a definitive list of referenced contracts, AGA urges the Commission to establish a specific and time-limited process by which market participants may obtain clarification that a particular transaction will be considered a referenced contract.

Regardless of whether the Commission accepts AGA's recommendations to exempt trade options from position limits and to establish a definitive list of referenced contracts, AGA contends that trade options that do not provide for physical delivery of natural gas at Henry Hub should not be considered economically equivalent to the NYMEX Henry Hub Natural Gas (NG) contract, *i.e.*, the natural gas core referenced futures contract. In general, physical delivery contracts that do not provide for physical delivery to the same underlying location as the applicable core referenced futures contract should not be considered economically equivalent to the core referenced futures contract and should not be considered referenced contracts.

¹⁹ See CFTC Staff Workbook of Commodity Derivative Contracts Under the Proposed Regulations Regarding Position Limits for Derivatives, <http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/index.htm>.

D. The Commission Should Clarify The Bona Fide Hedge Exemption For Utility Resales.

In its proposal, the Commission provides for an enumerated exemption for utilities such as AGA's members to hedge unfilled anticipated customer requirements.²⁰ As described in the Commission's proposal, this exemption applies to long positions in commodity derivative contracts that do not exceed in quantity unfilled anticipated requirements of the same cash commodity for resale by a utility that is required or encouraged to hedge by its public utility commission on behalf of its customers' anticipated use.²¹ AGA is concerned that this utility hedge exemption as defined is too restrictive to satisfy its intended purpose. Accordingly, AGA encourages the Commission to revise the definition of the exemption to allow for more effective use by utilities.

The enumerated hedge exemption for unfilled anticipated requirements allows for an exemption for long positions in commodity derivative contracts that do not exceed in quantity unfilled anticipated requirements of the same cash commodity for processing, manufacturing, or use by the same person.²² The Working Group of Commercial Energy Firms pointed out, however, that utilities take positions to hedge anticipated requirements not for "use by the same person," but for use by the utilities' retail customers. In fashioning a utility hedge exemption for unfilled anticipated requirements, the Commission noted that a utility's risk management transactions are typically considered by a state public utility commission, that the state commission considers whether such transactions are prudent allowing gains and losses to be

²⁰ 78 Fed. Reg. 75824, proposed § 150.1.

²¹ *Id.*

²² *Id.*

retained by customers, and that a utility typically does not directly profit from its hedging activity.²³

While AGA certainly agrees that a utility's risk management transactions on behalf of its customers should be treated as bona fide hedges and exempt from position limits, AGA asserts that not all utilities enjoy the same regulatory treatment with respect to such risk management transactions. In particular, state regulatory authorities vary significantly in how they review a utility's risk management program. For example, not all state regulatory authorities "require" or "encourage" their utilities to hedge. In fact, many do not. Nor do they typically review (or approve) in advance a utility's hedging program. As the Commission noted, a state regulatory authority will consider whether a utility's hedging practices have been prudent, normally after-the-fact, to determine whether any gains or losses associated therewith should be passed through to consumers.²⁴ In addition, for government-owned and cooperatively-owned utilities, a state's public utility commission may not have jurisdiction over such utility's hedging program or rates for service to consumers. Such utility may instead be subject to a municipal authority or other government authority with jurisdiction as defined by state law, or may be subject to governance by its cooperative member-owners.

For these reasons, AGA contends that the Commission's requirement that the utility "be required or encouraged to hedge by its public utility commission" in order to be eligible for a bona fide hedge exemption for its risk management transactions is unduly limiting and unnecessary. The Commission should not require any particular type of state regulation in order for a utility to be able to obtain a bona fide hedge exemption for its risk management transactions on behalf of its customers. Accordingly, AGA recommends that the Commission delete "be

²³ *Id.* at p. 75714.

²⁴ *See id.*

required or encouraged to hedge by its public utility commission” from the definition of bona fide hedging positions.

E. Hedge Exemptions For Unfilled Anticipated Requirements And Unsold Antipated Production Should Apply Equally To Unpriced Anticipated Requirements And Unpriced Anticipated Production.

Utilities such as AGA’s members typically enter into contracts to purchase natural gas with respect to anticipated customer requirements months or even years in advance of a particular anticipated delivery period in order to ensure that sufficient natural gas supply is available to provide safe and reliable service to customers. While some utilities may enter into fixed price forward contracts for this purpose, many utilities enter into forward contracts with floating prices based on monthly or daily price indices compiled independently and published in a number of industry publications. Accordingly, while the portion of these utilities’ anticipated customer requirements acquired through these index-priced contracts is no longer unfilled, and from their suppliers’ standpoint the portion of anticipated production represented by these contracts no longer remains unsold, these contracts effectively remain unpriced and exposed to price risk. For this reason, the Commission should clarify that its proposed bona fide hedge exemptions related to unfilled anticipated requirements and unsold anticipated production would also apply to circumstances in which a market participant has filled its anticipated requirements, or sold its anticipated production, with index-priced contracts, whereby such anticipated requirements or production, while not “unfilled” or “unsold,” respectively, remain unpriced and therefore remain exposed to price risk.

IV. CONCLUSION

Wherefore, for the reasons stated above, the American Gas Association respectfully requests that the Commission consider these comments in this proceeding. Specifically, AGA recommends that the Commission modify its proposal in this proceeding to make clear that trade options are not subject to position limits; that the Commission provide market participants with a definitive list of referenced contracts such that swaps not included on such list would not be considered referenced contracts for purposes of position limits; that the Commission delete the requirement that a utility be “required or encouraged to hedge by its public utility commission” in order for such utility’s transactions to be eligible for the bona fide hedge exemption; and that its proposed hedge exemptions related to unfilled anticipated requirements and unsold anticipated production would also apply to circumstances in which a market participant has filled its anticipated requirements, or sold its anticipated production, with index-priced contracts.

Respectfully submitted,

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February 10, 2014