

**February 10, 2014**

Melissa Jurgens  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21st Street, NW  
Washington, DC 20581

**VIA ELECTRONIC SUBMISSION**

**Re: *Position Limits for Derivatives, RIN 3038-AD99***

Dear Secretary Jurgens:

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission’s (the “**CFTC**” or “**Commission**”) Notice of Proposed Rulemaking, *Position Limits for Derivatives* (the “**Proposed Rule**”), published in the *Federal Register* on December 12, 2013,<sup>1</sup> which proposes to establish federal speculative position limits for certain physical commodity derivative transactions pursuant to Commodity Exchange Act (“**CEA**”) Section 4a(a),<sup>2</sup> as amended by Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**” or the “**Dodd-Frank Act**”).<sup>3</sup>

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

Over the past several years, the Working Group has been actively involved with the Commission, staff in the Chairman’s and Commissioners’ offices, and staff in the Division of Market Oversight (“**DMO**”) to help ensure that a federal speculative position limits regime for

<sup>1</sup> See *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

<sup>2</sup> 7 U.S.C. § 6a(a).

<sup>3</sup> H.R. 4173, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

energy derivatives is tailored to appropriately reduce the risk of excessive speculation and does not inadvertently restrict legitimate hedging activity. The Working Group appreciates that the Proposed Rule addresses several concerns that the Working Group raised under the Vacated Final Rule,<sup>4</sup> including:

- proposing to grant Requests for Exemptive Relief Nos. 1, 2, 6, 7 (Scenario 1), and 8 set forth in the *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act* filed with the Commission on January 20, 2012;<sup>5</sup>
- proposing a workable definition of “spot month” for exempt commodities that reflects the terms of physical delivery Referenced Contracts;<sup>6</sup>
- attaching to the Proposed Rule sample forms for reporting certain exemptions from applicable speculative position limits thereby allowing market participants the opportunity to analyze the practical implementation issues and costs the forms may raise; and
- including proposed Appendix B setting forth certain commodities and contracts that are deemed to be “substantially the same” as the commodity underlying a Core Referenced Futures Contract (“**CRFC**”) for purposes of meeting the “basis contract” definition.

The comments set forth herein are intended to continue the constructive dialogue that the Working Group has had with the Commission.

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<sup>4</sup> On November 18, 2011, the CFTC issued a final rule establishing federal speculative position limits for 28 exempt and agricultural commodity futures and options contracts and their economically equivalent contracts. See *Position Limits for Futures and Swaps*, Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011) (“**Vacated Final Rule**”). On September 28, 2012, the United States District Court for the District of Columbia vacated and remanded this final rule. See *Int’l Swaps and Derivatives Ass’n, et al. v. U.S. Commodity Futures Trading Comm’n*, 887 F. Supp. 2d 259 (D.D.C. Sept. 28, 2012), *appeal dismissed*, 2013 U.S. App. LEXIS 22618 (D.C. Cir. Nov. 6, 2013).

<sup>5</sup> See The Working Group of Commercial Energy Firms, *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act* (submitted Jan. 20, 2012), available at <http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf>. (“**BFH Petition**”). In February 2012, the Working Group of Commercial Energy Firms reconstituted itself as “The Commercial Energy Working Group.”

<sup>6</sup> “Referenced Contract” is defined in proposed CFTC regulation 150.1.

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**I. EXECUTIVE SUMMARY.**

The Working Group appreciates improvements to the federal speculative position limits regime that the Commission has made in the Proposed Rule, as compared to the Part 151 regulations adopted under the Vacated Final Rule. The Working Group sets forth herein its concerns with the Proposed Rule to facilitate an open and constructive dialogue with the Commission. A summary of these concerns follows.

***Threshold Considerations.*** As discussed in Section II, as the Commission finalizes rules and regulations establishing federal speculative position limits, it should consider the following overarching themes:

- Federal speculative position limits should not limit legitimate, commercial risk-reducing activities;
- Rules implementing speculative position limits should address the unique characteristics of each commodity and its underlying cash market; and
- The Commission should adopt a coordinated approach that draws upon the expertise and resources of designated contract markets (“DCMs”).

***Definition of “Bona Fide Hedging Position.”*** Rather than enacting rules that prescribe how commercial firms measure and mitigate risk to commodities pricing, the Commission should allow market participants to evaluate their portfolios and reduce their exposures in accordance with risk management practices they deem appropriate in their business judgment.

***Exemptions for Non-Enumerated Bona Fide Hedging Positions.*** The Commission should provide a clear and expeditious path for a party to seek approval for non-enumerated hedging transactions.

***Exemptions for Enumerated Bona Fide Hedging Positions.*** If the Commission retains a list of enumerated hedges as part of a final rule, the Working Group recommends the following amendments to the definition of “*bona fide* hedging position:”

- ***Merchandising and Anticipated Merchandising.*** Expand the definition of “*bona fide* hedging position” to include additional enumerated hedges of: (a) certain floating and variable price commitments; (b) irrevocable, binding bids and offers; (c) storage or transportation; and (d) assets owned or anticipated to be owned;
- ***Unfilled and Unfixed Priced Anticipated Requirements and Unsold and Unfixed Priced Anticipated Production.*** Expand the definition of “*bona fide* hedging position” to apply respectively to “hedges of unfilled or unfixed priced anticipated requirements” and “hedges of unsold or unfixed priced anticipated production;”

- *Utility Hedging Unfilled or Unfixed Priced Anticipated Requirements for Customers.* Expand the definition of “*bona fide* hedging position” to apply to “hedges of unfilled or unfixed priced anticipated requirements for customers” and permit a utility or other similar entity designated as a sole provider or a provider of last resort to its customers to claim the exemption;
- *Calendar Month Average Pricing.* Expand the definition of “*bona fide* hedging position” for hedging transactions that involve calendar month average (“CMA”) pricing or convert another pricing term to CMA pricing;
- *Heat Rate Transactions in Electricity Markets.* Expand the definition of “*bona fide* hedging position” to address the use of heat rate transactions;
- *Ongoing Good Faith Negotiations.* Expand the definition of “*bona fide* hedging position” to address anticipated cash transactions where a market participant has a good faith, reasonable belief that such transactions will be consummated; and
- *Commodity Transactions Priced as Differentials.* Expand the definition of “*bona fide* hedging position” to address hedging transactions that involve a differential between (i) locations, grades or qualities of two or more commodities, or (ii) a commodity (*i.e.*, electricity) and a fuel source (*i.e.*, natural gas), that arises from a fixed price differential in one or more transactions.

***Exemptions for Cross-Commodity Hedging.*** The quantitative test set forth in the Proposed Rule does not reflect prudent risk management practices and will be difficult, if not impossible to administer. The Working Group recommends that the quantitative test be abandoned in favor of a qualitative test that allows commercial firms to select the appropriate commodity derivative contract to reduce its risk.

***Five Day Rule.*** The restriction on holding physical delivery Referenced Contracts in the spot month (the “**five day rule**”) should be reconsidered in light of certain unique characteristics of energy markets.

***Trade Options.*** Trade options, which are more properly characterized as physical transactions than derivatives, should be exempt from federal speculative position limits. Further, any Referenced Contract used to hedge risks associated with a trade option should not be prevented from receiving *bona fide* hedging treatment.

***Spot Month Limits.*** The Commission should use the CME Group’s (“CME”) revised estimates of deliverable supply to determine spot month limits. For purposes of establishing subsequent spot month limits, the Commission should provide the public with an opportunity to comment on any new deliverable supply estimates. In addition, the Commission should provide an aggregate limit for physical delivery and cash-settled Referenced Contracts equal to five times the spot month limit applicable to the relevant physical delivery Referenced Contract, provided that a party holds physical delivery contracts at no more than the speculative position limits for those contracts.

***Any and All Month Limits.*** In recognition of the reduced risks of manipulation outside of the spot month, the Commission should monitor any and all month positions through the use of accountability levels rather than hard limits. However, to the extent that hard limits are established, the Commission should take into consideration factors related to the energy markets and enact more flexible standards for establishing any and all month limits.

***Basis Contracts.*** The Working Group generally supports the Proposed Rule's definition of "basis contract," and the Commission's determination to exempt these contracts from the Referenced Contract definition.

***Referenced Contracts.*** To ensure uniformity among market participants and the Commission in interpreting the Referenced Contract definition, the Commission should analyze the contracts that are listed on DCMs, Exempt Commercial Markets ("**ECMs**"), and the successor to ECMs, swap executive facilities ("**SEFs**") (collectively, the "**Regulated Exchanges**") and publish its determination as to which constitute Referenced Contracts.

***Compliance Date.*** Given the complexity of implementing compliance programs to adhere to the Proposed Rule, market participants should be given at least nine months from the date that any final rule is adopted.

## II. THRESHOLD CONSIDERATIONS.

There are three themes the Working Group requests the Commission to consider as it finalizes a federal speculative position limits regime for energy markets.

*First*, and most importantly, the Commission should "do no harm" to the effective functioning of the energy commodity markets for price discovery and risk management. The purpose of speculative position limits is to prevent excessive speculation. In this respect, the Commission should use the authority given to it under the CEA to avoid unnecessarily limiting legitimate, commercial risk-reducing activities. In the two examples relied upon by the Commission to justify the imposition of federal speculative position limits in the Proposed Rule, the parties at issue, *i.e.*, the Hunt brothers and Amaranth Advisors L.L.C., were both recognized "speculators" in commodity markets. To the knowledge of the Working Group, neither of them abused an exemption from speculative position limits.<sup>7</sup>

*Second*, for several decades, the Commission's existing speculative position limits rules have been applicable only to certain agricultural futures products (the "**Enumerated**

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<sup>7</sup> See, *e.g.*, Proposed Rule at 75,686 ("The Hunt brothers were speculators who neither produced, distributed, processed nor consumed silver.") (citation omitted); *id.* at n.70 ("The Hunts had no apparent industrial use for silver . . ."); Complaint For Injunctive And Other Equitable Relief And Civil Monetary Penalties Under The Commodity Exchange Act at 4, *U.S. Commodity Futures Trading Comm'n v. Amaranth Advisors, L.L.C., et al.*, 2009 U.S. Dist. LEXIS 101406 (S.D.N.Y. 2009) (No. 07 Civ. 6682) ("Amaranth was not capable of accepting delivery of or of delivering physical natural gas . . ."), available at <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfamaranthcomplaint072507.pdf>.

**Agricultural Commodities”**).<sup>8</sup> Energy derivative markets did not even exist when the Commission established its framework for speculative position limits. Since then, speculative position limits for energy contracts have been established and overseen by DCMs and ECMs, and this is the first time that the Commission would adopt speculative position limits for energy contracts. In doing so, and consistent with historical policies, the Commission should take into account unique characteristics of the cash markets for energy commodities and terms of energy commodity derivative contracts.

*Third*, the Proposed Rule represents a significant paradigm shift for the energy markets and their participants. In developing a final rule in this proceeding, the Commission should (i) be mindful of the differences between (and resource requirements of) the existing exchange system and the regulatory framework outlined in the Proposed Rule, and (ii) avoid rigid, “one-size-fits-all” requirements that exchange oversight has been able to avoid. In addition, the Working Group recommends that the Commission recognize Regulated Exchanges will continue to administer their own speculative position limits rules and develop a coherent, coordinated approach that draws upon the experience, expertise, and resources of the Regulated Exchanges and avoids duplicative efforts.<sup>9</sup>

Throughout this letter, the Working Group explains how these policy considerations interact with the law and the comments it is raising herein. The Working Group also presents examples, where possible, to illustrate the issues identified herein and proposes solutions for the Commission’s consideration.

### **III. THE DEFINITION OF *BONA FIDE* HEDGING POSITION.**

A principal driver for enacting Section 737 of the Dodd-Frank Act and amending CEA Section 4a was a Congressional concern that so-called “massive passives” (otherwise referred to as “long-only” money) had a significant impact on commodity pricing, with a strong upward bias.<sup>10</sup> Congress actively sought to avoid constraining the legitimate hedging activities of commercial market participants. In fact, the *only* change made by Congress to the general definition of “*bona fide* hedging transaction or position” was the removal of the word “normally” before the statutory phrase “represents a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel.”<sup>11</sup> The Proposed Rule notes that this change was not made to limit legitimate commercial hedging activities, but to substantively revoke “risk management” exemptions that allowed a counterparty to a speculative swap transaction to lay off its risk in the futures markets and claim a *bona fide* hedge exemption from

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<sup>8</sup> See CFTC Regulation 150.2.

<sup>9</sup> See *Establishment of Speculative Position Limits*, Final Rule, 46 Fed. Reg. 50,938, 50,940 (Oct. 16, 1981) (“[T]he Commission fashioned rule 1.61 to assure that the exchanges would have an opportunity to employ their knowledge of their individual contract markets to propose the position limits they believe most appropriate.”).

<sup>10</sup> See Letter from Hon. Bernard Sanders, U.S. Senate to Hon. Gary Gensler (Oct. 17, 2011) (expressing concerns that “excessive speculation by commodity index funds has severely disrupted and dramatically challenged energy markets needlessly pushing oil and food prices higher”) (citing a Better Markets Report).

<sup>11</sup> CEA Section 4a(c), 7 U.S.C. § 6a(c).

speculative position limits.<sup>12</sup>

Congress has been clear that speculative position limits should not be used to harm commercial hedging activities.<sup>13</sup> Present and former Commissioners have shared those concerns.<sup>14</sup> As the Commission acknowledges, however, the perceived problems from the pre-

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<sup>12</sup> The preamble to the Proposed Rule states in relevant part:

Section 4a(c)(2)(A) of the Act incorporates many aspects of the general definition of *bona fide* hedging in current § 1.3(z)(1). However, there are significant differences. Section 4a(c)(2)(A)(i) of the Act does not include the adverb “normally” to modify the verb “represent” in the phrase “represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel.” The statutory requirements are more stringent than the conditions for swap risk management exemptions the Commission previously granted under §§ 1.3(z)(3) and 1.47. As discussed above, the Commission granted risk management exemptions for persons to offset the risk of swaps that did not represent substitutes for transactions or positions in a physical marketing channel, neither by the intermediary nor the counterparty. Thus, positions that reduce the risk of such speculative swaps would no longer meet the requirements for a *bona fide* hedging transaction or position under the new statutory criteria.

Proposed Rule at 75,708-09.

<sup>13</sup> In 1974, when adopting the legislation that formed the Commission and delegated it the authority to define *bona fide* hedging, the Report of the Committee on Agriculture of the House of Representatives stated that “the goal . . . of the Committee was to free the Commission to define hedging in a manner more consistent with the times and practices of the industry. It is not the intent of the Committee that it be used to overtly restrict industry use of the futures market for hedging.” See *Bona Fide Hedging Transactions or Positions*, Proposed Rulemaking and Request for Comment, 42 Fed. Reg. 14,832, 14,832 (Mar. 16, 1977).

<sup>14</sup> See Statement of Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission, Washington, DC, *Continuing Oversight of the Wall Street Reform and Consumer Protection Act*, Hearing before the Committee on Agriculture, Nutrition and Forestry, United States Senate, 112<sup>th</sup> Cong. 1<sup>st</sup> Sess., S. Hrg. 112-503 (Dec. 1, 2011) (“The swaps market and the futures market are meant to be there so end users of all sorts can hedge risk, lock in a price of corn, wheat, or a rate, and then focus on what they do best and not be brought into the margining or clearing and so forth. We are conscious of that. We are dedicated to it.”); App. 2—Statement of Chairman Gary Gensler—to Vacated Final Rule at 71,699 (“The final [speculative position limits] rule also implements Congress’s direction to narrow exemptions while also ensuring that *bona fide* hedge exemptions are available for producers **and merchants.**”) (emphasis added); see also *The End-User Bill of Rights*, Statement of Hon. Bart Chilton, (Apr. 3, 2013) (addressing end-user’s right to hedge, “[s]peculative position limits should encourage and not unduly complicate prudent commercial risk management practices”), available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement040313>; *Nomination of Mark P. Wetjen, of Nevada, to be a Commissioner of the Commodity Futures Trading Commission*, Hearing before the Committee on Agriculture, Nutrition and Forestry, United States Senate, 112<sup>th</sup> Cong. 1<sup>st</sup> Sess., S. Hrg. 112-284 (July 21, 2011) (“Position limits have been in place, as you know, in the futures space, but they had not been in place for the swaps markets. So that is the goal behind the position limits rule generally, is to give the agency an additional tool . . . it is very important, however, that in crafting this rule that the Commission remains mindful of the impact . . . on liquidity in the swaps markets. If liquidity dries up, there are no swaps markets, and so these very markets that some of the co-ops and other end users in your State rely on for risk management would be diminished and that is not a desirable outcome . . . .”); “*Does the Commission Always Know Best?*” Opening Statement by Commissioner Scott D. O’Malia, Open Meeting on Position Limits for Futures and Swaps; Derivatives Clearing Organizations; Effective Date for Swap Regulation (Oct. 18, 2011), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/omal Niestatement101811> (“If the commercial entities who use futures and swaps markets for hedging commercial risk feel like we are waging war on them, I don’t blame them. According to the Commission’s cost-benefit analysis, legitimate hedgers will pay close to 1/3 of the total annual

Dodd-Frank era are *not* those addressed by the Proposed Rule.<sup>15</sup> Rather, the Proposed Rule is almost entirely directed at hedgers. The comments provided herein (i) identify where the Proposed Rule would negatively impact commercial hedging, and (ii) offer proposed solutions that prevent harm to commercial hedging activity.

#### A. The “Economically Appropriate” Test.

Like existing CFTC regulation 1.3(z)(1), the Proposed Rule requires a *bona fide* hedging position to be, among other things, “economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise.”<sup>16</sup> The Commission does not point to any historical abuse of the “economically appropriate” test, nor does it find that historical misapplication of the test has led to excessive speculation that must be eliminated. Yet, language in the preamble and the Proposed Rule, if adopted, would substitute pre-determined Commission limitations for the discretion of the managers of a business to determine which risks they should shed and how best to shed them. This “solution,” without a related “problem,” would be a radical departure from historic practices with respect to commercial hedging.

The relevant language first appears on page 75,709 of the preamble and states:

In order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account *all* inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price.

(Emphasis added).

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\$100 million cost of this proposal for reporting alone. These are the market participants to which Congress extended specific protection, yet this rulemaking will increase the cost of hedging and managing risk.”).

<sup>15</sup> “The speculative position limits that the Commission now proposes do not directly address these concerns as they relate to commodity index funds, commodity index speculation and passive investment in the commodity derivatives markets.... [T]his means that index speculators remain unconstrained on the size of positions in diversified commodity index contracts that they can accumulate so long as they can find someone with the capacity to take the other side of their trades.” See Proposed Rule at 75,740 n.483.

<sup>16</sup> Specifically, proposed CFTC regulation 150.1 provides, in relevant part:

Hedges of a physical commodity: For a position in commodity derivative contracts in a physical commodity:

(i) Such position:

...

(B) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise [(the “**economically appropriate**” test)] . . . .

When coupled with the requirements of Section 150.3(i) of the Proposed Rule, it appears that the Commission is requiring parties to consider the physical positions among all aggregated affiliates in determining whether a derivative is “economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise.” Specifically, Section 150.3(i) provides:

Entities required to aggregate accounts or positions under Section 150.4 shall be considered the same person for the purpose of determining whether they are eligible for a *bona fide* hedging position exemption under paragraph (a)(1)(i) of this section with respect to such aggregated account or position.

Thus, it appears that the Proposed Rule would require a party to manage its commodity pricing exposures at the level of aggregated affiliates. If, in fact, that is the Commission’s intent, it would be the first time that the Commission has prohibited a party from managing its exposures in accordance with its business objectives, whether at the level of aggregated affiliates, legal entity, desk, book, asset or any other level at all. This constraint would be at odds with good risk management practices.<sup>17</sup> Each commercial enterprise has made, and should be permitted to continue to make, its own determinations on how to analyze its operations from a risk management perspective and, as discussed more fully below, value those risks and reduce them as and if it deems appropriate.<sup>18</sup>

The Proposed Rule extrapolates a theory from an oversimplified example. Specifically, in the preamble, the Commission states:

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<sup>17</sup> To the extent that this view is premised on the inclusion of the phrase “of the commercial enterprise,” it is misreading the importance of that phrase. That phrase is only intended to mean that in order to qualify as a *bona fide* hedge, it must reduce risk associated with commercial activities – as contrasted with risks associated with non-commercial (*i.e.*, financial) activities.

<sup>18</sup> For example, a diversified company with both a petrochemical group that consumes natural gas as a feedstock for producing petrochemicals and a natural gas marketing group that buys and sells natural gas (including under fixed priced contracts) would likely manage the petrochemical group and the natural gas marketing group separately. It would not, therefore, view natural gas inventory held by the petrochemical group as offsetting the risk of fixed-priced sales contracts entered into by the natural gas marketing group.

A crude oil producer that sells its production to multiple customers may have several customer service agents, each managing a distinct set of customer accounts. In order to assure line-of-sight accountability, the producer would hold each customer service agent accountable for the market risks in his or her customer portfolio, and more experienced customer service agents are likely to be given authority to carry more risk. As a result, the company would measure risk and make hedging decisions customer service agent by customer service agent.

Within the energy business, some entities as a matter of company policy prohibit hedging of anticipated production or requirements, while other entities, again as a matter of company policy, require anticipated production or requirements to be hedged according to a specified schedule (within certain tolerances). These differences may be related to the size of the company, and thus the strength of the balance sheet, but ultimately the differences arise as fundamental differences in corporate policies.

[A party] may have sold a certain quantity of a commodity for deferred delivery in the current year (*i.e.*, a fixed-price cash sales contract) and purchased that same quantity of that same commodity for deferred receipt in the next year (*i.e.*, a fixed-price cash purchase contract) . . . . [If such a party] 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.<sup>19</sup>

The reality of commercial business is far more complex than the simple portfolio in the example provided. Most energy portfolios contain (i) inventories of numerous commodities (some that are deliverable under a CRFC and some that are considered “cross-commodities”) at a variety of locations, and (ii) purchase and sale contracts on those commodities (some fully priced, some partially priced and some priced at index), with different durations stemming from several days to several years. Some portfolios also contain physical options.

Risk management practices, when dealing with a more complicated portfolio, are far too nuanced and complex than the Commission’s proposed approach reflects. Location, product, and timing characteristics, each individually and in combination, all factor differently into the evaluation of risk. Even using the above-quoted example from the Proposed Rule, the difference in volatility between the two delivery months could be enough for a commercial participant to determine to hedge one leg and not the other. Similarly, the commercial participant’s *perception* of expected future volatility is another determination based on its business judgment. Said differently, if in the exercise of its sound commercial judgment, a party values the risk of one leg of a transaction differently than it values its risk on the other leg, there is no reason that it could not hedge a single leg and treat that hedge as a *bona fide* hedge. As discussed herein, every market participant has different hedging objectives and subjectively evaluates risk differently. While one market participant may be willing to bear certain risks, another may look to shed those same risks.<sup>20</sup> Congress never directed the Commission to dictate a particular method of evaluating and managing risk, and it would be inappropriate for the Commission to do so here.

**Proposed Solution:** The Commission should (i) acknowledge that a commercial market participant may choose to look at its exposures as it deems appropriate in its business judgment

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<sup>19</sup> Proposed Rule at 75,709.

<sup>20</sup> For example, some market participants may wish to convert a floating price to a fixed price as a means of mitigating exposure to price risk; whereas other market participants may wish to convert from a fixed price to a floating price to mitigate its price risk.

and take the risk-reducing steps it believes are warranted, and (ii) treat that risk reduction as *bona fide* hedging under the Commission's rules.

### **B. The Orderly Trading Requirement.**

The Proposed Rule requires that *bona fide* hedging positions must be established and liquidated in an orderly manner in accordance with sound commercial practices (the “**orderly trading**” requirement).<sup>21</sup> As active participants in energy markets, the Working Group fully supports this concept. However, as proposed, the orderly trading requirement raises the following procedural questions that must be addressed by the Commission.

- *First*, who will determine whether a party has established or liquidated a position in an orderly manner? Is it the DMO? The Division of Enforcement? The Commission itself?
- *Second*, in the event a party's behavior is challenged, what process will the party be afforded to defend itself?
- *Third*, what are the consequences of a finding that a party did not act in an orderly manner? Is it a loss of a claimed exemption for the particular position? A loss of the ability to claim future exemptions? A separate disciplinary violation for which sanctions under CEA Section 6(d) would apply?

**Proposed Solution:** The Working Group requests that the Commission address these questions in adopting any final requirements.

## **IV. PROPOSED EXEMPTIONS FOR *BONA FIDE* HEDGING.**

The Working Group notes that the CEA does not specifically require that the Commission adopt “enumerated” categories for *bona fide* hedging positions, or require that a hedge fit into an enumerated category to be treated as a *bona fide* hedging position. However, if the Commission adopts the enumerated hedge categories it should refine and expand them consistent with the following recommendations.

### **A. Non-Enumerated Hedges.**

The Proposed Rule provides that the only positions that would be recognized as “*bona fide* hedging positions” are “enumerated hedging positions,” “other enumerated hedging

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<sup>21</sup> See proposed CFTC regulation 150.1 (“*Bona fide* hedging position means any position whose purpose is to offset price risks incidental to commercial cash, spot, or forward operations, and such position is established and liquidated in an orderly manner in accordance with sound commercial practices . . .”).

positions,” or “cross-commodity hedges.”<sup>22</sup> Unlike the CFTC’s existing regulations, the Proposed Rule excludes a provision for “non-enumerated hedges.” Instead, market participants must apply for, and receive, staff interpretive guidance or an exemption from speculative position limits for “non-enumerated hedging positions” under CFTC regulation 140.99 or CEA Section 4a(a)(7), respectively.<sup>23</sup> Under CFTC regulation 140.99, staff’s authority is limited to confirming that a particular transaction is *within* the defined set of enumerated hedges. If Commission staff determined that a particular transaction is *outside of that set*, a market participant’s only option would be to petition the Commission for exemptive relief under CEA Section 4a(a)(7). This framework would unnecessarily restrict the Commission’s flexibility and limit the ability of a commercial market participant to timely place a hedge that is not currently identified<sup>24</sup> and do nothing to prevent excessive speculation.

**Proposed Solution:** The Commission should (i) adopt provisions similar to those contained in existing CFTC regulations 1.3(z)(3) and 1.47 for market participants to submit applications for exemptions for “non-enumerated hedges,” and (ii) deem such applications granted unless rejected by Commission staff within five days.<sup>25</sup>

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<sup>22</sup> Specifically, proposed CFTC regulation 150.1 provides, in relevant part:

Hedges of a physical commodity: For a position in commodity derivative contracts in a physical commodity:

- (i) Such position:
  - (A) Represents a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel;
  - (B) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
  - (C) Arises from the potential change in the value of –
    - (1) Assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing or merchandising;
    - (2) liabilities that a person owns or anticipates incurring; or
    - (3) services that a person provides, purchases, or anticipates providing or purchasing; *and*
  - (D) ***Is enumerated in paragraph (3) [(Enumerated hedging positions)], (4) [(Other enumerated hedging positions)] or (5) [(Cross-commodity hedges)] of this definition . . . .***

(emphasis added).

<sup>23</sup> Existing Commission regulations 1.3(z)(3) and 1.47 allow market participants to receive an exemption for non-enumerated *bona fide* hedging positions. Under the Proposed Rule, CFTC regulation 1.3(z) would not apply to speculative position limits for exempt and agricultural commodities, and CFTC regulation 1.47 would be eliminated altogether.

<sup>24</sup> The Working Group, having filed a petition under Section 4a(a)(7) seeking relief under Part 151 in January 2012 (six weeks after Part 151 was finalized) and having received no formal response when Part 151 was vacated in September 2012 (two weeks before Part 151 was to go into effect), is clearly qualified to raise this issue. Hedge determinations need to be made promptly, and market participants need to be afforded effective regulatory guidance and certainty.

<sup>25</sup> This timing is analogous to the time period in which Regulated Exchanges act on similar matters. See ICE Futures U.S. Inc., Regulatory Requirements, Rule 6.26 Hedge Exemption, *available at* [https://www.theice.com/publicdocs/rulebooks/futures\\_us/6\\_Regulatory.pdf](https://www.theice.com/publicdocs/rulebooks/futures_us/6_Regulatory.pdf) (stating “[w]ithin five (5) Business Days of the submission of the information set forth above, the Exchange shall notify the Member whether the exemption has been granted and the limitations placed thereon”).

Additionally, the Commission should defer to the expertise of the Regulated Exchanges for granting non-enumerated hedges by expanding section (2)(i)(D) of the definition of “*bona fide* hedging position,” as follows:

(D)(I) Is enumerated in paragraph (3), (4) or (5) of this definition; or

**(II) Such position is recognized as a bona fide hedging position by the designated contract market or swap execution facility that is a trading facility, pursuant to such market’s rules submitted to the Commission; or**

**B. The Treatment of Merchandising and Anticipated Merchandising Transactions.**

The Proposed Rule severely restricts the availability of *bona fide* hedge treatment for transactions that reduce the risk of merchandising and anticipated merchandising transactions. The regulatory benefit of such restriction is unclear. Not only is such a restriction contrary to the statutory definition, but the apparent result is to discount the role merchandising plays in moving energy commodities from production to consumption and from locations where supply/demand forces place lesser value on them to locations where the market indicates they are in greater need.

Merchandising plays a critical role in the physical supply chain in every commodity market, linking producers to processors and processors to wholesalers and consumers. With respect to present-day energy markets, merchants often own, operate, and otherwise control assets that facilitate the production, movement, storage, and processing of physical energy commodities.<sup>26</sup> These include vessels, barges, train cars, tanker trucks, pipelines, storage, and

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<sup>26</sup> Not all producers and processors have commercial relationships with each other.

- For example, small crude oil producers, on the one hand, and small refiners, on the other, may lack the contacts and the credit to establish relationships with refiners and producers, respectively. An example of this is the crude oil gathering business that exists in the mid-continent of the United States. Oil is gathered by truck from small producers that do not have the relationships or the volumes to contract with refiners, who themselves have no interest in owning and operating trucks to collect the oil. The oil is often blended by the gatherer to meet pipeline specifications before depositing the oil into the stream of commerce in Cushing, Oklahoma.
- Large producers and refiners may not have relationships with one another. Often, they are in different parts of the world with vastly different credit qualities. Customs, legal, tax and personnel issues may prevent either side from desiring to do business in the jurisdiction of the other.
- The merchandising function bridges those relationships by owning the infrastructure and providing the capital necessary to move the product.

Timing issues are critical on both sides.

- Crude oil producers want to offload their product as it comes ratably from the ground. Refiners want to buy their crude oil ratably based on how their refineries are currently running or expecting to run in the near term. Often, refiners are not interested in committing capital to hold more than the minimum inventory and prefer to buy in the spot (or short-term forward) market.

terminal facilities, as well as the capital, employees, and expertise to manage that infrastructure and operation.<sup>27</sup> The treatment of the merchandising function in the Proposed Rule as different from the role of producers, processors, manufacturers or other owners of physical commodities is misplaced for the following reasons:

*First*, Congress has recognized that reducing the risk of merchandising and anticipated merchandising activity constitutes *bona fide* hedging under CEA Section 4a(c)(2)(A). Specifically, CEA Section 4a(c)(2)(A)(I) contemplates *bona fide* hedging treatment for positions that reduce the risk of the change in value of assets a person merchandises or anticipates merchandising.<sup>28</sup> There is no indication that Congress intended to marginalize merchandising or anticipated merchandising, or differentiate between the treatment of hedges related to producing, processing, and consuming on one hand and merchandising on the other.<sup>29</sup>

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- By using its own storage capabilities and its access to multiple sources of supply, the merchandising function bridges that capital and timing gap to allow producers to offload and refiners to engage in “just in time” inventory policies and to buy crude oil in a ratable manner or a ratable price.

Refiners may choose to pay for the merchant’s expertise and infrastructure.

- Managing the logistics business of a merchandising operation is complex and requires expertise and personnel. Many refiners are too small to support personnel that possess the requisite expertise and related operations. Other refiners may simply choose to outsource and pay for them.
- Refiners’ needs are dynamic. They can change quickly in real-time due to weather, economic conditions, and many other supply disruptions or demand changes. Long-term supply agreements cannot protect against these changes. However, a merchant has the ability to supply product from its own storage or to re-direct vessels or barges to where product is needed.

<sup>27</sup> The role of commodity market participants has evolved significantly over the past thirty years. For example, traditional integrated energy companies, such as producers and processors, often have business units that engage in certain merchandising and mid-market trading activities to optimize their assets and portfolios. The merchandising and mid-market trading activities engaged in by these companies are, in many respects, no different than those activities engaged in by merchants.

<sup>28</sup> CEA Section 4a(c)(2) provides:

For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a *bona fide* hedging transaction or position as a transaction or position that-

(A) (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel;

(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and

(iii) arises from the potential change in the value of-

(I) assets that a person owns, produces, manufactures, processes, or *merchandises* or *anticipates* owning, producing, manufacturing, processing, or *merchandising* . . . .

(emphasis added).

<sup>29</sup> Indeed, in implementing federal speculative position limits under the Vacated Final Rule, former Chairman Gensler stated that the “final rule also implements Congress’s direction to . . . [ensure] that *bona fide* hedge exemptions are available for producers *and merchants*.” Vacated Final Rule at 71,699, App. 2 (emphasis added). *See also Position Limits and the Hedge Exemption, Brief Legislative History*, Testimony of General Counsel Dan M.

*Second*, since the 1970s and 1980s, when long-term supply deals were replaced by shorter-term transactions in the spot and forward markets, energy markets have extensively utilized the merchandising function to bridge the gap between producers and users and to move commodities from regions of excess supply to regions where they are more urgently needed.<sup>30</sup>

*Third*, as the Commission has recognized, the merchant plays a role in price convergence and market equilibrium that is essential to well-functioning markets.<sup>31</sup> Denying merchants the ability to hold *bona fide* hedging positions in excess of speculative limits will not only deprive the market of that important function, but it also will have the perverse effect of having speculative positions reflecting a greater percentage of overall market open interest, including in the spot period.

*Fourth*, the commercial need to reduce risk and lock in margins is no different for a merchandiser, producer or any other owner of a commodity, but is equally critical to the ability of each to sustain its role in the physical supply chain. While different in character, a merchant's commitment of capital, staffing, and expertise is no different in quality or commitment to the efficient and economic movement of commodities to end-users than the wells that the producer has drilled in the ground or the refineries that the processor has built.

The Commission's concerns with merchandising and anticipated merchandising are manifested in several places in the preamble to the Proposed Rule. In addressing Request for Exemptive Relief No. 3 from the BFH Petition, the Commission stated:

Considering the anticipated merchandizing transaction, a merchant may assert her intention, but merchandizing intentions alone are not sufficient to recognize a price risk . . . . The

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Berkovitz, Commodity Futures Trading Commission (July 28, 2009) ("Since it first directed the Commission to establish position limits in 1936, Congress has made it clear that such position limits should not apply to the legitimate use of the futures markets by commodity producers, *merchants*, or end-users to price their goods efficiently or to manage their price risks") (emphasis added).

<sup>30</sup> See Daniel Yergin, *The Prize: The Epic Quest for Oil, Money, and Power* at 721 (Free Press Reissue ed. 2008).

<sup>31</sup> As the Commission noted in its discussion of proposed conditional spot month limits, merchants aid in driving price convergence, an essential function of physical delivery futures contracts. Specifically, the Commission stated:

[P]rior to such adequate convergence, the Commission has observed when a physical-delivery contract is trading at a price above prevailing cash market prices, commercials with inventory tend to sell contracts with the intent of making delivery, causing physical-delivery prices to converge to cash market prices. Similarly, the Commission has observed when a physical-delivery contract is trading at a price below prevailing cash market prices, commercials with a need for the commodity *or merchants active in the cash market* tend to buy the contract with the intent of taking delivery, causing physical-delivery prices to converge to cash market prices.

Proposed Rule at 75,737, n.463 (emphasis added).

Commission is concerned that exempting such a yet-to-be established cash position would make it impossible for the Commission to distinguish hedging from speculation. For example, a trader could maintain a position, exempt from position limits, until the trader enters into a subsequent cash market transaction that results in a book-out of the first unfixed-price cash market transaction. The trader could assert that changed conditions resulted in a change in intentions. Since market prices are continually changing to reflect new information and, thus, changing conditions, the Commission believes an exemption standard based on merchandizing intentions alone would be no standard at all.<sup>32</sup>

There are a variety of reasons why the Commission's concerns are misplaced. *First*, in this context, "intentions" is a synonym for "anticipated activity" and Congress expressly recognized the appropriateness of *bona fide* hedge exemptions for anticipated activity, including merchandising. The possibility that a merchandiser might change its "intentions" is really no different than the possibility that a producer might decide not to produce or that the needs of a processor might change. Yet, that possibility has not prevented the Commission from recognizing exemptions for anticipated unsold production and anticipated unfilled requirements.

*Second*, there are substantial safeguards in place that will prevent the abuse the Commission appears to be concerned about. Most importantly, a person who utilizes a *bona fide* hedge exemption to exceed speculative limits will be required to file a Form 204, explaining its positions. The submission of Form 204 carries with it the potential for substantial penalties for false statements under both the CEA and federal criminal statutes. That alone should provide a sufficient disincentive for anyone falsely to claim *bona fide* hedge treatment for a speculative position.

*Third*, if the person engaged in speculative activity under the guise of hedging with the intent to wrongfully influence price, its conduct would run afoul of the various sets of anti-manipulation statutes and regulations that govern the markets.

*Fourth*, the person will be subject to Regulated Exchange rules in addition to the CFTC regulations implementing federal speculative position limits. Accordingly, there will be additional oversight over the activities of a person claiming an exemption, which should also limit any opportunity for abuse.

*Finally*, there is no evidence of abuse with respect to merchandising or anticipated merchandising activities that has occurred under current speculative position limit rules of the Regulated Exchanges that resulted in excessive speculation that warrant such restrictions on risk-reducing activities.

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<sup>32</sup> See Proposed Rule at 75,719.

Discounting the commercial value of merchandising and anticipated merchandising will have the effect of injecting more risk into the supply chain. Increased risk will result in increased costs, which will ultimately be borne by consumers of energy commodities. This added risk will have no concomitant, positive effect on preventing excessive speculation. With this in mind, the following sections illustrate where the Proposed Rule would inappropriately limit the *bona fide* hedging of merchandising or anticipated merchandising transactions.<sup>33</sup>

1. Certain Floating or Variable Price Commitments.

The Working Group has previously requested *bona fide* hedging treatment where a party has a floating price contract to purchase (sell) a commodity in one location with an expectation to enter into a contract to sell (purchase) the commodity in another location.<sup>34</sup> This is a critically important exemption for commercial hedgers. The Working Group believes that it fits within the proposed general definition of “*bona fide* hedging position,” as it satisfies all of the pertinent tests within that definition. However, should the Commission take a contrary view, the Working Group submits that it would still be appropriate to provide an enumerated hedge exemption for this transaction pursuant to CEA Section 4a(a)(7).

Example 1 - Single-Sided Floating Price Transaction.<sup>35</sup>

*Company A purchases a product in a particular location (“**Location 1**”), and does so at an index price as is customary in that market. Based on its operations in the physical supply chain, Company A is experienced in all of the elements of the movement and storage of physical commodities (e.g., owning ships, chartering vessels, scheduling deliveries, conducting quality inspections).*

*The current market price for the commodity in Location 1 is at a discount to the market price at another location (“**Location 2**”) at the time the product could be delivered there. The discount is sufficiently large to cover the logistical costs of moving the product from Location 1 to Location 2 and to generate a profit to Company A. Based on these market signals, Company A purchases the product in Location 1 at a floating index price. To lock in the economics of the transaction, Company A takes a long position in a commodity derivative contract on the purchase price index (at Location 1) and sells a derivative on the expected sales price index (at Location 2). In industry parlance, it has “locked in the basis.”*

*If Company A fixes its purchase price at Location 1 before selling the product in Location 2, it will liquidate its long-side hedge. At that time, it will have a fixed-price*

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<sup>33</sup> While the preamble of the Proposed Rule reflects the possibility that the Commission might consider anticipated merchandising transactions on a case-by-case basis after evaluating “the particulars of the transaction,” the Working Group submits that this approach is not a practical solution for a party seeking to execute a transaction based on then-existing market conditions. See Proposed Rule at 75,719.

<sup>34</sup> See BFH Petition Request for Exemptive Relief No. 3.

<sup>35</sup> This and other examples provided herein represent a non-exhaustive set of examples developed by the Working Group for purposes of these comments. The Working Group reserves the right to supplement this filing with additional examples as may be required or otherwise appropriate

*purchase contract (or inventory) and a short hedge against it. Alternatively, if it sells the product at a fixed price in Location 2 before fixing its purchase price, it will liquidate its short-side hedge. Or, if it sells the product in Location 2 at a floating price, it will leave its basis hedge in place.*

This type of transaction is routinely conducted in numerous markets and commodities every day. It is the basis by which energy commodities move from the United States to Europe, Asia and Latin America and *vice versa*. Parties enter into one side of a transaction before arranging the other based upon market-based prices and their ability to “lock in the basis” and ensure the economics of the transaction. Such transactions facilitate the requirements of the parties at either end of the physical supply chain. Producers sell on their schedule, for example, and refiners purchase on theirs. Waiting until there is a match of buyers and sellers would ignore this commercial reality. Note that, in this example, Company A has committed to the purchase transaction. Thus, it should not be deemed “naked merchandising,” a phrase that was coined in the Proposed Rule’s preamble to connote speculative activity not tied to a commercial transaction.<sup>36</sup>

If this transaction could not receive *bona fide* hedging treatment and consequently caused Company A to exceed applicable speculative position limits, Company A would be forced to price its risk into the underlying physical transaction. This would result in (i) a higher net price of the commodity to consumers in Location 2, or (ii) the physical market transaction not occurring, leaving consumers in Location 2 to find the commodity less economically priced in a different location. It would not address any concerns about excessive speculation.

**Proposed Solution:** The Commission should expand subsection (3) of the definition of “*bona fide* hedging position” as follows:

**(v) Transactions to lock in basis differentials. Long and short positions in commodity derivative contracts referencing different delivery locations, where the person has entered a non-fixed price purchase or sale commitment to buy or sell a commodity in one location with the expectation of moving it between the two locations.**

## 2. Binding Bids and Offers.

The Commission proposes to deny Request for Exemptive Relief No. 4 in the Working Group’s BFH Petition because, in the Commission’s view, it does not fit within the proposed definition of “*bona fide* hedging position.” Request No. 4 involves hedging binding, irrevocable bids or offers. The Working Group re-submits by reference Request No. 4 from the BFH Petition and submits the additional example below regarding the need for recognition of this transaction.

In providing a fixed-price bid or offer, a market participant must calculate its view of the forward price curve, costs, and profit margin before placing the bid or offer. Often, the market

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<sup>36</sup> Proposed Rule at 75,720.

participant needs to lock in the margin before it commits itself by making the binding bid or offer and before it has a fixed-price commitment to purchase or sell the commodity. The Working Group believes that these transactions meet the proposed definition of a “*bona fide* hedging position” because they protect against price risk in connection with anticipated cash market activity. However, even if the Commission disagrees, it should use its authority under CEA Section 4a(a)(7) and provide an exemption for these transactions.

#### Example 2 - Binding Bids and Offers.

*Municipal Utility X requires power supply for the next planning year starting June 1, 2014. It issues a Request For Proposal (“RFP”) for electric supply averaging 10 MW per hour for 24 hours seven days a week at a fixed price and delivered at the ISO-New England Hub for the term of June 2014 through May 2015. The RFP structure requires the Town Board to approve the offers that Municipal Utility X desires to accept before the utility may execute a final sales agreement with the winning bidder(s). The terms of the RFP require that bids are due by 10:00 am on Tuesday, March 25th and must be held firm until Town Board approval is received. The lowest bidder will be notified by 4:00 pm on Tuesday, March 25th that its offer will be submitted for Town Board approval at its meeting scheduled for Wednesday, March 26th at 7:00 pm. On Thursday March 27th, Municipal Utility X will confirm the results of the Town Board meeting and execute the power sales agreement.*

*On March 25th, several marketers submit offers to Municipal Utility X. Marketer A submits the lowest bid and is notified that its bid will be submitted to the Town Board for approval the next night. Municipal Utility X has obtained Town Board approval in previous RFPs, so Marketer A is confident that it will succeed on the instant RFP and will be the supplier.*

*Before Marketer A prepared its offer, it developed and implemented a hedging strategy. Given the risks associated with holding an irrevocable offer open and the volatility it has seen in the natural gas and power market in New England, Marketer A took a long position in a strip on a natural gas futures contract prior to submitting its bid. The natural gas futures position reduces the risk of an increase in the price of power (for which natural gas serves as a proxy)<sup>37</sup> during the period between the time that the binding bid is submitted and the time that it is accepted.*

As drafted, the Proposed Rule would create significant hurdles to the implementation of the hedging strategies discussed in the example above. The Proposed Rule would not allow for the type of anticipatory hedge engaged in by Marketer A because the hedge would be entered into before the transaction is confirmed by Municipal Utility X as a firm commitment. The same would apply to an electricity futures contract designated as a CRFC (if one existed) subject to federal speculative position limits. This view contradicts industry practice and the correlations that relate to the transactions being hedged.

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<sup>37</sup> The issue of power/gas correlations is generally discussed in in Section VII.A.5 below, and correlations prepared by the Working Group involving the Algonquin Index and ISO-New England’s Mass Hub are specifically addressed in Figure 6.

This example, or a variation on it, is extremely common in the energy industry, and market participants that respond to these types of requests for proposals use a variety of techniques to hedge them. The RFP process discussed in the example above is not unique to municipal utilities, or even investor-owned utilities regulated by state utility commissions. In fact, numerous other governmental organizations, including state agencies, federal authorities, and even private consortiums use similar mechanisms to contract with natural gas and electric power suppliers.

In the Proposed Rule, the Commission appears to be concerned about circumstances in which multiple losing bidders must liquidate their hedge positions roughly contemporaneously.<sup>38</sup> These concerns should not eliminate the availability of a legitimate hedge exemption when there are numerous ways in which the Commission can verify or audit the legitimacy of the hedge transaction entered into as part of a competitive solicitation process for energy commodities.

**Proposed Solution:** The Commission should expand subsection (3) of the definition of “*bona fide* hedging position” as follows:

**(vi) Hedges of Binding Bids and Offers. Long or short positions in commodity derivative contracts that do not exceed in quantity the amount of a commodity that is, or within a reasonable period of time will be, the subject of a binding bid or offer.**

3. The Storage Hedge and the Hedge of Other Assets.

The Commission has not proposed the *bona fide* hedge exemption for storage that had been included in the Vacated Final Rule. The stated basis focuses on a provider of “off-farm storage” and the rents it might collect from its storage, not on the farmer, merchant, or any other producer or processor that has the rights to use the storage. This is not the basis on which the Commission originally approved the hedge, and the Working Group submits that is the incorrect basis on which to reject it. As the examples below demonstrate, a final rule that does not acknowledge this as *bona fide* hedging activity will harm commercial market participants while doing nothing to prevent excessive speculation.

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<sup>38</sup> See Proposed Rule at 75,720. Assuming there were five bidders participating in the RFP process outlined in Example 2, there would be one winning bidder and four losing bidders. Upon the award of the winning bid by Municipal Utility X, the four losing bidders would be required to liquidate their hedge positions. The Working Group submits that any concerns held by the Commission that the concurrent liquidation of such positions by the losing bidders could have a disruptive impact on energy markets is misplaced. Specifically, similar factual circumstances routinely arise in energy markets and the Working Group is unaware of any allegations of (i) market disruptions, (ii) excessive speculation, or (iii) the abuse of hedge exemptions that resulted from the liquidation of positions by losing bidders participating in an RFP process. The Working Group submits that the economic self-interest of the losing bidders, together with existing orderly trading/liquidation rules of the Regulated Exchanges, prevent such a result.

Example 3 - The Storage Hedge.

*On July 1st, Company A enters into a one-year lease on 1Bcf of natural gas storage near Chicago Citygate, which it intends to use to store gas to supply to local distribution companies (“LDCs”) over the coming winter season. On July 1st, the price of the October natural gas contract is \$4.32, indicating that Company A could inject natural gas into storage in October at \$4.32 for a total cost of \$4,320,000. Also on July 1st, the December-January-February strip (“December-February Strip”) is priced at \$4.51, indicating that Company A could withdraw natural gas from storage to supply the LDCs at \$4.51 for gross revenue of \$4,510,000. As Company A may not be able to enter into agreements to buy and sell physical natural gas to replicate its expected winter activity, it uses derivatives contracts as a temporary substitute to protect itself against the risk that prices for October move adversely relative to prices for the December-February Strip. It will buy October futures and sell an equal amount of the December-February Strip and lock in the differential and in doing so, hedge the value of the one-year storage lease it has entered into.*

Not only does the transaction in Example 3 reduce Company A’s risk on the purchases and sales it will make, it established (and locked in) the value of the asset Company A holds – the storage lease. The lease is itself transferrable and its market value is largely determined by the calendar spread at that moment. The Federal Energy Regulatory Commission’s (“FERC”) capacity release rules clearly demonstrate this proposition. Regulated storage (and transportation) contracts are initially priced to the lessee at FERC-approved tariff rates. However, FERC allows their transfer as market-priced assets pursuant to well-defined rules governing the release of capacity.<sup>39</sup>

While Example 3 reflects the manner in which one may hedge storage from a static perspective, it should be noted that the holder of a storage lease likely will make dynamic decisions about how and when to hedge its storage capacity based upon a number of factors. These factors include but are not limited to: (i) facility-specific operating characteristics; (ii) weather; (iii) regional storage constraints; (iv) pipeline maintenance; (v) “force majeure” events; and (vi) weekly U.S. Energy Information Administration natural gas storage numbers. If commercial market participants are unable to obtain *bona fide* hedge treatment for storage, many storage facilities could remain unfilled, resulting in greater price volatility in the cash and futures market for natural gas. In turn, this greater price volatility likely will translate into high gas costs for consumers.

The Working Group submits that the Commission’s proposal not to allow a party to treat as a *bona fide* hedging position its activity to protect itself from an adverse change in the prices that determine the asset’s value fails to give recognition to the language of CEA Section 4a(c)(2)(A)(iii)(I), which directs the Commission to define “*bona fide* hedging transaction or position” to include the hedging of the value of assets that a party owns.

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<sup>39</sup> *Promotion of a More Efficient Capacity Release Market*, Order No. 712, 123 FERC ¶ 61,286 (2008), *order on reh’g*, Order No. 712-A, 125 FERC ¶ 61,216 (2008), *order on reh’g and clarification*, Order No. 712-B, 127 FERC ¶ 61,051 (2009); 18 C.F.R. §284 (2013). FERC’s rulemaking, among other things, was “designed to enhance competition in the secondary capacity release market.” Order No. 712 at 2.

This concept is equally pertinent to the ability to take a *bona fide* hedging position to lock in the value of other assets that are critical to growing energy infrastructure. For example, there is a growing need to build pipeline capacity to move the crude oil or natural gas developed in one of the many locations where it is being produced to underutilized refining or processing plants located in a different part of the country. Before such a project can be financed, however, it is likely that the lenders will require a pipeline company to lock in certain revenue streams.

The pipeline company may do that in one of several ways or a combination thereof. One method would be for the pipeline company to conduct an “open season” and seek commitments from third-parties to lease a portion of the capacity. Alternatively, the pipeline company may seek to hedge the value of the capacity itself. That hedge will be a spread of the expected commodity prices at the two different ends of the pipeline at the time it will be operational. The pipeline company will enter into a derivative that represents a purchase of the product at the injection point and a sale of the commodity at the off-take point.<sup>40</sup> For the Commission to deny *bona fide* hedging treatment to this derivative transaction would increase the risk and, therefore, the cost (or, potentially decrease the building) of critical infrastructure needed to bring energy products to consumers at the lowest possible price. Alternatively, if the pipeline company hedged with a swap, but was forced to treat it as a speculative position, its swap counterparty would not be able to claim its side of the transaction as a hedge under the pass-through exemption, limiting the possibility that the pipeline company would find an appropriate universe of counterparties (or price) for its needed transaction.

#### Example 4 - Anticipated Ownership of a Pipeline.

*Company A seeks to build a crude oil pipeline between Point 1 and Point 2, a currently underserved route. Company A seeks bank financing and the bank insists that Company A lock in a percentage of the value of the pipeline, even before Company A begins to market transportation along the pipe. Company A enters into one commodity derivative contract and locks in a price for Point 1 and enters into another commodity derivative contract to lock in a price at Point 2. This differential represents the value of this asset. Knowing that Company A has been able to lock in its value, the bank is willing to provide the financing and this infrastructure project will proceed.*

The storage hedge and the hedge of infrastructure projects represent legitimate risk-reduction activities of commercial enterprises. Not allowing these hedges to be treated as *bona fide* hedges because they are “anticipatory,” “merchandising,” or both, will result in activities, not limited to private or government infrastructure project investments, not being undertaken or at higher costs if taken. Again, however, limiting the use of the *bona fide* exemption for merchandising or anticipated merchandising activity in this manner will do nothing to protect against excessive speculation.

**Proposed Solution:** The Commission should expand subsection (3) of the definition of

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<sup>40</sup> Pipeline customers who commit to lease a portion of the transportation capacity would face similar risks and could hedge them with the same derivative.

the “*bona fide* hedging position” as follows:

**(vii) Hedges of Storage and Transportation. Offsetting long and short positions<sup>41</sup> in commodity derivative contracts representing the differential in either timing or location with respect to storage or transportation of the commodity underlying the commodity derivative contracts.**

**(viii) Hedges of Assets Owned or Anticipated to be Owned. Positions in commodity derivative contracts that hedge the value of an asset used to produce, process, store or transport the commodity underlying the derivative contract owned or anticipated to be owned by the same person.**

### **C. Ongoing, Good-Faith Negotiations.**

The Commission proposed to deny Request for Exemptive Relief No. 5 in the BFH Petition. Request No. 5 seeks an exemption for a Referenced Contract that is used to hedge a physical transaction that is subject to ongoing, good-faith negotiations that the hedging party reasonably expects to conclude. The Proposed Rule states that where a market participant has only a tentative cash transaction, its merchandising activity is not backed by definite exposure to a value change (*e.g.*, “naked merchandising”) and thus cannot be distinguished from speculation.

The Working Group disagrees and submits that if a market participant reasonably believes that a physical transaction will be consummated and fails to hedge that transaction, then it will have failed to reduce its exposure to price risk. Market participants should have the flexibility and discretion to enter into derivatives transactions to reduce price risk associated with certain ongoing, good-faith negotiations to purchase or sell a physical energy commodity and receive *bona fide* hedging treatment for such derivatives transactions.

**Proposed Solution:** The Commission should expand subsection (3) of the definition of the “*bona fide* hedging position” as follows:

**(ix) Hedges of Anticipated Cash Transactions. Long or short positions in commodity derivative contracts that hedge the value of anticipated cash transactions involving the commodity underlying the commodity derivative contract that a person reasonably believes will be consummated and that is subject to on-going, good-faith negotiations.**

### **D. Unfilled Anticipated Requirements and Unsold Anticipated Production.**

The Working Group generally supports the proposed *bona fide* hedging exemption for unfilled anticipated requirements and unsold anticipated production. In a staff interpretation

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<sup>41</sup> The offsetting long and short positions could be created through separate transactions, or could be embedded in a spread contract or an option on a spread contract.

letter issued in 2012,<sup>42</sup> Commission staff stated that unfilled anticipated requirements may be recognized as a *bona fide* hedging position or transaction when a commercial enterprise has entered into a long-term, unfixed price supply or requirements contract.<sup>43</sup> The 2012 Interpretation further stated that the price risk of such “unfilled” anticipated requirements is not offset by an unfixed price forward contract.<sup>44</sup> As such, the price risk remains with the commercial enterprise, even though the commercial enterprise has a contractually ensured supply of the commodity, with continuing price risk until the forward contract’s price is fixed.<sup>45</sup>

**Proposed Solution:** The Commission should codify its guidance and conclusion in the 2012 Interpretation through the following revision to subsections (3)(iii)(A) and (4)(i) of the definition of “*bona fide* hedging position” as follows:

Proposed Revision to CFTC regulation 150.1(3)(iii)(A)

(iii) *Hedges of unfilled or unfixed priced anticipated requirements.*

.....

(A) Long positions in commodity derivative contracts that do not exceed in quantity unfilled or unfixed priced anticipated requirements of the same cash commodity, and that do not exceed twelve months for an agricultural commodity, for processing, manufacturing, or use by the same person; and

Proposed Revision to CFTC regulation 150.1(4)(i):

(i) *Hedges of unsold or unfixed priced anticipated production.* Short positions in commodity derivative contracts that do not exceed in quantity unsold or unfixed priced anticipated production of the same commodity, and that do not exceed twelve months of production for an agricultural commodity, by the same person.

**E. Utility Hedging Unfilled Anticipated Requirements of Customers.**

The Commission proposes to provide an exemption for unfilled anticipated requirements for resale by a utility where the utility is “required or encouraged” to hedge by its public utility commission.<sup>46</sup> While the Working Group appreciates the Commission’s decision to grant Request for Exemptive Relief No. 6 in the BFH Petition, Request No. 6 merely sought a

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<sup>42</sup> CFTC Letter No. 12-07, Interpretation, Division of Market Oversight (Aug. 16, 2012) (providing guidance regarding the meaning of “unfilled anticipated requirements” for purposes of *bona fide* hedging under the Commission’s position limits rules) (“**2012 Interpretation**”).

<sup>43</sup> 2012 Interpretation at 1.

<sup>44</sup> *Id.* at 1-2.

<sup>45</sup> *Id.* at 2.

<sup>46</sup> *See* subsection (3)(iii)(B) of the definition of the “*bona fide* hedging position.”

determination that, in connection with the exemption for unfilled anticipated requirements, the phrase “for use by the same person” not be strictly limited to “consumption by the same person.” Nonetheless, the Working Group believes that an exemption such as that proposed will provide significant value to the public at large, but suggests that the Commission (i) not condition this exemption on instances in which a utility is “required or encouraged” to hedge by its public utility commission, and (ii) expand the applicability of this exemption to other similar entities that have been designated in certain jurisdictions as providers of last resort and therefore have similar obligations to provide natural gas or electricity service to customers as “utilities.”

Most, if not all, state regulators or public utility commissions do not require or encourage utilities to hedge using commodity derivative contracts. In addition, *ex ante* approval of specific hedging programs or strategies is not routinely engaged in by such commissions. Rather, public utility commissions ultimately determine whether to allow or disallow gains or losses from hedging activity to be passed through to customers through rates. In this respect, *ex post* prudence review is the norm. Further, municipal natural gas utilities and public gas agencies generally are not subject to oversight from state public utility commissions with regard to rates; therefore, such entities would not be eligible for the proposed exemption conditioned upon a requirement that they be required or encouraged to hedge by their public utility commissions.

Moreover, the obligation to provide natural gas or electricity to end-use (retail) energy customers is not limited strictly to “utilities.” Under some state laws, municipalities that supply electricity, water or gas to their residents are not officially designated as “utilities.” The same can be true for electric cooperatives. Additionally, it is increasingly common for states to allow retail electric and gas consumers to purchase from competitive energy suppliers and to designate providers of last resort for customers who do not choose to purchase from any particular competitive energy supplier. In these states, utilities provide transmission, transportation and distribution service but no longer sell natural gas or electricity to consumers that have chosen another competitive energy supplier. In fact, utilities may no longer sell natural gas or electricity to any consumers if the state has designated another entity, most likely a competitive energy provider, as provider of last resort. Allowing only “utilities” to have this exemption needlessly discriminates against non-utilities that serve the same role.

**Proposed Solution:** The Commission should revise subsection (3)(iii)(B) of the definition of “*bona fide* hedging position,” as follows:

Long positions in commodity derivative contracts that do not exceed in quantity unfilled **or unfixed priced** 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~~ **or other similar entity designated as sole provider or provider of last resort, to its customers.**

#### **F. Services.**

The Proposed Rule limits the availability of a *bona fide* hedge exemption to services related to production, manufacturing, processing, use, or transportation of the ***commodity underlying the commodity derivative contract***. The Working Group suggests that proposed subsection (4)(iv) of the “other enumerated hedging provision” set forth in proposed CFTC

regulation 150.1 be revised to address situations in which the pricing of a transportation (or other type of service contract) contract is linked, directly or indirectly, to the price of a commodity and not necessarily tied to the commodity actually being transported. A simple example would be a rail contract to transport coal, where the price of the rail contract is partially indexed to the price of diesel fuel. In this example, a market participant may wish to use a Referenced Contract that effectively hedges its exposure to diesel fuel rather than coal since the transportation pricing is partially linked to the index price of diesel.

**Proposed Solution:** The Commission should revise subsection (4)(iv) of the definition of “*bona fide* hedge position,” as follows:

(iv) *Hedges of Services.* Short or long positions in commodity derivative contracts offset by the anticipated change in value of receipts or payments due or expected to be due under an executed contract for services held by the same person, *provided that* the contract for services arises out of the production, manufacturing, processing, use, or transportation of the commodity underlying the commodity derivative contract, **or pricing on such contract for services is directly or indirectly linked to the price of the commodity underlying the commodity derivative contract,** and which may not exceed one year for agricultural commodities.

#### **G. Calendar Month Average Pricing.**

While the Working Group appreciates the Commission’s recognition that CMA pricing could be effectively used in connection with *bona fide* hedging, there are additional factors that the Working Group believes the Commission should consider. The Working Group submits that the use of Referenced Contracts to convert transaction pricing terms to CMA pricing should be recognized as a *bona fide* hedging position that is exempt from speculative position limits.<sup>47</sup>

Additionally, market participants engaged in CMA hedging involving physical delivery Referenced Contracts should be permitted to hold those positions through the spot month.

Market participants that purchase or sell commodities may deem CMA pricing to be the pricing term that minimizes risk. Such firms may therefore wish to use derivatives to convert pricing of physical transactions consummated on other pricing terms to CMA pricing. Such derivatives transactions (i) are substitutes for transactions made or to be made in the physical marketing channel and (ii) reduce risk incurred in the conduct of a commercial enterprise, and therefore meet the statutory definition of “*bona fide* hedging transactions” set forth in CEA Section 4a(c)(2)(A).

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<sup>47</sup> Spot and term oil can be sold on a fixed price basis or on a floating basis. Floating sales are overwhelmingly the norm and buyers and sellers agree to link the price to an instrument that rises and falls with the market. Buyers and sellers generally prefer floating price deals to fixed deals because it is less risky. In this respect, floating price mechanisms generally allow companies more flexibility in risk management and more flexibility in optimizing purchases and sales. *See The Structure of Oil Markets: Background, Platts at 4-5 (June 2010).*

As illustrated in the examples provided below, some of the derivative structures necessary to achieve CMA pricing require holding the derivatives through the spot month. As with other examples provided by the Working Group, if the Commission does not agree that these transactions fall within the definition of “*bona fide* hedging position,” the Working Group requests that the Commission use its authority under CEA Section 4a(a)(7) to exempt them from speculative position limits.

Importantly, a corporate determination that CMA pricing represents the minimum-risk pricing term could apply to either the purchase or the sale of a commodity, or to both. This discussion is therefore applicable to producers and consumers of commodities and to any market participant engaged in the supply chain that joins producers to consumers. The only requirement necessary is that the market participant, in the exercise of its business judgment, has concluded that CMA pricing represents the desired risk-minimizing transaction structure. The risk borne by such an entity is created by the non-CMA transaction itself and does not depend on the presence or absence of any other transactions or holdings.

As noted in one of the examples set forth below, the market participant in question is a refiner with non-CMA priced crude oil purchase contracts. The price risk this entity bears is created by these crude oil purchase contracts. While the refiner naturally also has the production and sales of refined products, the risk from the non-CMA crude purchase contracts is unrelated to this production stream and the pricing terms of any associated sales contracts.<sup>48</sup>

In practice, while crude oil markets typically price crude oil a month or more before the actual time of processing the crude oil, refined products markets price much closer to the actual production date. As a result, the refining industry commonly deems typical industry crude oil pricing to present non-CMA risk, and the industry is less likely to deem typical product pricing to present non-CMA risk. However, the decision about which pricing terms represent risk is a decision properly taken by the entity’s management in the exercise of its business judgment.

The Commission should reconsider what had been labeled as Scenario 1 in the BFH Petition and resubmitted below as Example 5 - Scenario 1, in light of the above explanation. Further, Example 5 - Scenario 1 should be recognized as a *bona fide* hedging position for both the refiner and its supplier (and any similar buyers or sellers in this or an analogous physical supply chain), including the ability to hold the physical delivery Referenced Contracts into the spot month period.

As discussed above, the risk in this example arises whenever there is a party to that transaction that perceives CMA as the least-risky terms for a transaction. As Example 5 - Scenario 1 is structured, that entity is a refiner, but it is neither its character as a refiner that creates the need to hedge, nor is it the inventories of crude or products. Rather, it is the terms of the commercial contract. In other scenarios, the refinery might have been able to purchase from a merchant on CMA terms, but the merchant might then have had a mis-match of terms that

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<sup>48</sup> The sales contracts themselves might also present non-CMA risk issues, but for these refined products, non-CMA risks are separate from the crude oil non-CMA risks, and the two risks do not offset one another because of differences in the structures of the markets for crude oil and the refined products.

required this hedge. Or, as in Example 5 - Scenario 2, the risk might be borne by a producer who would prefer to sell on a CMA price. Regardless of where in the supply chain the mis-match between actual and least-risk pricing terms might occur, the mis-match represents risk, and the transactions necessary to reduce that risk (by converting to the least-risk pricing terms) should be recognized as a *bona fide* hedging position.

Example 5 - Scenario No. 1.

*A refinery will buy crude oil on a CMA basis so that it pays the price of crude oil at the time it receives and runs it. The following presents a typical transaction for a refiner to obtain 63,000 barrels of December crude oil supply:*

*On each trading day from October 19th through November 16th, the refiner purchases three prompt NYMEX Light Sweet Crude Oil futures contracts (“WTI”) (i.e., the December WTI contract). Assume there are twenty-one NYMEX trading days during the period, which would result in sixty-three December WTI contracts being purchased. As a hedge, on each trading day from October 19th through November 16th, the refiner sells (a) two WTI futures contracts of the second nearby month, January (for a total of forty-two contracts), and (b) one WTI futures contract of the third nearby month, February (for a total of twenty-one contracts).*

*Prior to expiration of the permissible period for the December WTI contract, the refiner would execute an Exchange for Physical (“EFP”), converting the sixty-three December WTI crude oil futures contracts to 63,000 barrels of physical supply which will be delivered ratably during the month of December. From December 3rd through December 20th, the refiner would buy back all of the January WTI contracts ratably on each trading day. From December 21st through December 31st, the refiner buys back all of the February WTI contracts ratably on each trading day.*

*The following charts illustrate these transactions:<sup>49</sup>*

DAY	DATE	BUY 3 DEC	SELL 2 JAN	SELL 1 FEB	DIFF
FRIDAY	OCT. 19	89.00	89.15	89.29	0.20
MONDAY	OCT. 22	89.10	89.30	89.35	0.22
TUESDAY	OCT. 23	90.05	90.12	90.14	0.08
WEDNESDAY	OCT. 24	90.04	90.12	90.14	0.09
THURSDAY	OCT. 25	89.93	90.00	90.10	0.10
FRIDAY	OCT. 26	88.00	88.10	88.20	0.13

<sup>49</sup> The differential (in \$ per barrel) at the time the hedge is put in place is equal to the revenue that would be realized by selling two barrels of January and one barrel of February, less the costs to purchase three barrels of December, all divided by three. In this scenario, the differential is positive, reflecting the fact that the January and February contracts that were sold were more expensive than the December contracts that were purchased. That is, the market was “in contango.” Although cash (other than margin) does not change hands until settlement, this differential is now locked in. When the hedges are lifted by buying the January and then the February contracts, the cost locked in (shown here as a positive number, although it reflects the effective price to be paid) is the value of the respective contracts on the day of purchase, offset by the locked in differential.

MONDAY	OCT. 29	88.50	88.60	88.70	0.13
TUESDAY	OCT. 30	88.61	88.75	88.90	0.19
WEDNESDAY	OCT. 31	88.67	88.79	88.93	0.17
THURSDAY	NOV. 1	89.10	89.21	89.32	0.15
FRIDAY	NOV. 2	88.95	89.05	89.17	0.14
MONDAY	NOV. 5	89.07	89.18	89.28	0.14
TUESDAY	NOV. 6	89.20	89.30	89.40	0.13
WEDNESDAY	NOV. 7	89.25	89.35	89.45	0.13
THURSDAY	NOV. 8	89.17	89.29	89.41	0.16
FRIDAY	NOV. 9	89.21	89.32	89.43	0.15
MONDAY	NOV. 12	89.40	89.50	89.63	0.14
TUESDAY	NOV. 13	89.60	89.71	89.85	0.16
WEDNESDAY	NOV. 14	89.58	89.70	89.81	0.16
THURSDAY	NOV. 15	89.70	89.82	89.95	0.16
FRIDAY	NOV. 16	90.00	90.15	90.27	0.19
<b>AVERAGE</b>		<b>89.24</b>	<b>89.36</b>	<b>89.46</b>	<b>0.15</b>

<b>DAY</b>	<b>DATE</b>	<b>BUY 3 JAN</b>	<b>BUY 3 FEB</b>	<b>+/- DIFF</b>	<b>DAILY PRICE</b>
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10
FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45
MONDAY	DEC. 31		97.90	(0.15)	97.75
<b>CMA</b>					<b>97.33</b>

*On each day during December, the refiner receives a ratable share of 63,000 barrels under the CMA purchase agreement with his EFP counterparty. The price paid*

*by the refiner is determined on a daily basis using the refiner's repurchase of the then-prompt NYMEX futures contract plus or minus the differential that it had locked in (e.g., December 3 – 97.00 minus 0.15; December 4 – 96.90 minus 0.15; and so on) until at the end of the month, it has paid the CMA price of prompt December barrels.*

The refiner's activity in derivatives falls within the definition of a "*bona fide* hedging position" as the activity (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel, (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (iii) arises from the potential change in value of assets that the refiner owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising. The NYMEX WTI positions reduce the risk of obtaining non-CMA pricing on crude oil purchases. Transforming non-CMA price risk to CMA pricing follows from the same principle that underlies all hedging of price risk: transforming undesirable price risk to desirable price risk (*i.e.*, fixed-price risk to market or floating risk or vice-versa). As long as the hedging is economically appropriate and not risk-increasing, the hedge position should not be treated as a speculative position – either under Section 4a(c)(2) or 4a(a)(7).

Finally, as stated above, the refiner in this example could lock in its December supply of oil and pricing under the facts set forth above or it could, as is often the case, simply buy the oil from a supplier on a CMA basis. To hedge its risk on the sale to the refiner, that supplier would enter into the NYMEX trades identified above. The supplier's hedge transaction would also fall within the definition of a "*bona fide* hedging position" set forth in proposed CFTC regulation 150.1.<sup>50</sup>

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On September 19, 2012, the Working Group submitted a revised version of Request No. 7 - Scenario 2 in the BFH Petition to DMO staff ("**September 19th Submission**"). However, the September 19th Submission is not referenced in the Proposed Rule as materials the Commission considered when considering Scenario No. 2. As such, the Working Group has included the materials contained in the September 19th Submission below for the Commission's review and requests that the Commission consider this revised version of Scenario 2 (now identified as Example 5 - Scenario 2) in determining whether to include this type of hedging activity in its final definition of a "*bona fide* hedging position" for the reasons identified above with respect to Scenario 1.

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<sup>50</sup> Specifically, this hedge meets the definition of a "*bona fide* hedging position" because it (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel, (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (iii) arises from the potential change in value of assets that the supplier owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

Example 5 - Scenario No. 2.

*Energy producer X (“**Producer X**”) produces approximately 2000 barrels of crude oil a day. Producer X wants to receive the daily spot price for crude oil on the day that it extracts the crude oil from the ground. It sells its production monthly and uses CMA pricing to achieve its objective. The following presents a typical transaction for a producer to sell 63,000 barrels of December crude oil at a CMA price:*

*On each trading day from October 19th through November 16th, Producer X would sell three prompt WTI futures contracts (i.e., the December WTI contract). Assume there are twenty-one NYMEX trading days during the period, which would result in sixty-three December WTI contracts being sold. As a hedge, on each trading day from October 19th through November 16th, buy (a) two WTI futures contracts of the second nearby month, January (for a total of forty-two contracts) and (b) one WTI futures contract of the third nearby month, February (for a total twenty-one contracts).*

*Prior to expiration of the permissible period for the December contract, Producer X would EFP the sixty-three December WTI futures contracts to 63,000 barrels of physical sale commitment that will be delivered ratably during the month of December and priced at CMA based upon the activity set forth below. From December 3rd through December 20th, sell all of the January WTI futures contracts ratably on each trading day. From December 21st through December 31st, sell all of the February WTI futures contracts ratably on each trading day.*

*The following charts illustrate these transactions:<sup>51</sup>*

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<sup>51</sup> The differential (in \$ per barrel) at the time the hedge is put in place is equal to the revenue that would be realized by selling three barrels of December, less the costs to purchase two barrels of January and one barrel of February, all divided by three. In this scenario, the differential is negative, reflecting the fact that the January and February contracts that were purchased were more expensive than the December contracts that were sold. That is, the market was “in contango.” Although cash (other than margin) does not change hands until settlement, this differential is now locked in. When the hedges are lifted by selling the January and then the February contracts, the value realized is the value of the respective contracts on the day of sale, less the locked in differential.

DAY	DATE	SELL 3 DEC	BUY 2 JAN	BUY 1 FEB	DIFF
FRIDAY	OCT. 19	89.00	89.15	89.29	(0.20)
MONDAY	OCT. 22	89.10	89.30	89.35	(0.22)
TUESDAY	OCT. 23	90.05	90.12	90.14	(0.08)
WEDNESDAY	OCT. 24	90.04	90.12	90.14	(0.09)
THURSDAY	OCT. 25	89.93	90.00	90.10	(0.10)
FRIDAY	OCT. 26	88.00	88.10	88.20	(0.13)
MONDAY	OCT. 29	88.50	88.60	88.70	(0.13)
TUESDAY	OCT. 30	88.61	88.75	88.90	(0.19)
WEDNESDAY	OCT. 31	88.67	88.79	88.93	(0.17)
THURSDAY	NOV. 1	89.10	89.21	89.32	(0.15)
FRIDAY	NOV. 2	88.95	89.05	89.17	(0.14)
MONDAY	NOV. 5	89.07	89.18	89.28	(0.14)
TUESDAY	NOV. 6	89.20	89.30	89.40	(0.13)
WEDNESDAY	NOV. 7	89.25	89.35	89.45	(0.13)
THURSDAY	NOV. 8	89.17	89.29	89.41	(0.16)
FRIDAY	NOV. 9	89.21	89.32	89.43	(0.15)
MONDAY	NOV. 12	89.40	89.50	89.63	(0.14)
TUESDAY	NOV. 13	89.60	89.71	89.85	(0.16)
WEDNESDAY	NOV. 14	89.58	89.70	89.81	(0.16)
THURSDAY	NOV. 15	89.70	89.82	89.95	(0.16)
FRIDAY	NOV. 16	90.00	90.15	90.27	(0.19)
<b>AVERAGE</b>		<b>89.24</b>	<b>89.36</b>	<b>89.46</b>	<b>(0.15)</b>

DAY	DATE	SELL 3 JAN	SELL 3 FEB	+/- DIFF	DAILY PRICE
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10
FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45

MONDAY	DEC. 31		97.90	(0.15)	97.75
<b>CMA</b>					<b>97.33</b>

*On each day during December, the producer delivers a ratable share of 63,000 barrels under the CMA purchase agreement with its EFP counterparty. The price the producer receives is determined on a daily basis using the producer's sale of the then-prompt NYMEX futures contract plus or minus the differential that it had locked in (e.g., December 3rd – 97.00 minus 0.15; December 4th – 96.90 minus 0.15; and so on) until at the end of the month, it has received the CMA price of prompt December barrels.*

CMA pricing is used in a vast amount of commercial transactions because it allows users to (i) establish a spot price based upon a differential to the forward price when there is no reliable market-established spot price, and (ii) convert “trading month average” pricing (*i.e.*, the expiring NYMEX futures contract does not trade through the calendar month) to CMA pricing. In this scenario, the producer (purchaser) is looking to hedge on a forward basis the differential between (a) the benchmark forward price (NYMEX) and (b) the spot price. The transactions described in this scenario allow them to do that.

The producer's activity in derivatives falls within the definition of a “*bona fide* hedging position” as the activity (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel, (ii) are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (iii) arise from the potential change in value of assets that the producer owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

Finally, as stated above, the producer in this example could lock in its December sale of oil and pricing under the facts set forth above or it could, as is often the case, simply sell the oil to a purchaser on a CMA basis. To hedge its risk on the purchase from the producer, the purchaser will enter into the NYMEX trades identified above. The purchaser's activity in derivatives would also fall within the definition of a “*bona fide* hedging position” as it (i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel, (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and (iii) arises from the potential change in value of assets that the purchaser owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

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### Example 5 - Scenario No. 3.

*Company A buys 300,000 barrels of RBOB from a European supplier at the calendar month average of NYMEX RB prices plus a differential for the month of expected delivery. Each day during that calendar month, 1/20th (assuming 20 trading days during the month) of the purchase price converts from CMA (index) to a fixed price. After the 8th pricing day, it sells the cargo to Company B. As its purchase from its*

*supplier has not fully priced, Company A retains exposure to the CMA pricing formula. Accordingly, Company A buys 180 RB futures to offset the risk that prices will rise during the balance of the pricing period and will liquidate those long positions as the CMA exposure becomes fixed ratably each day through the balance of the month. As pricing will continue during the spot period, Company A needs to hold futures in the spot period to cover its pricing exposure.*

**Proposed Solution:** The Commission should expand subsection (3) of the definition of “*bona fide* hedging position” as follows:<sup>52</sup>

**(x) Calendar Month Average Hedges. Short or long positions in commodity derivative contracts that are offset by exposure to calendar month average pricing obligations or that are designed to achieve calendar month average pricing.**

**V. DIRECT HEDGES OF COMMODITY PRICE TERMS THAT ARE BASED ON A COMMODITY THAT IS DIFFERENT FROM THE UNDERLYING PHYSICAL TRANSACTION.**

The Working Group seeks confirmation with respect to an issue that is not directly addressed by the Proposed Rule. In many cases, a commodity is bought or sold at a floating price that references a different commodity. For example, physical jet fuel is frequently purchased and sold at a price equal to the NYMEX HO contract plus or minus a differential; and physical power and LNG is frequently purchased and sold at a differential to the NYMEX NG contract. The risk to be hedged is expressed in terms of HO or NG and not jet fuel, power or LNG. Accordingly, where the hedge of those obligations is done using Referenced Contracts involving HO or NG,<sup>53</sup> it is not, and should not be deemed, a “cross-commodity” hedge.

**Proposed Solution:** The Commission should clarify that when a physical transaction is priced with reference to the commodity underlying a Referenced Contract and is hedged with that same Referenced Contract, the hedge transaction does not constitute a “cross-commodity” hedge.

**VI. PROPOSED EXEMPTION FOR CROSS-COMMODITY HEDGING.**

Under both existing CFTC regulation 1.3(z)(2)(iv) and the Proposed Rule, market participants may claim an exemption for a *bona fide* hedging position in which the commodity derivative contract was not identical to the commodity being hedged, provided “[t]he fluctuations in value of the position in the commodity derivative contract (or the commodity underlying the commodity derivative contract) are “substantially related” to fluctuations in value of the actual or anticipated cash positions or pass-through swap.”<sup>54</sup> Historically, this has been

<sup>52</sup> This proposed enumerated hedge exemption would permit commodity derivative contracts that function as calendar month average hedges to be held through the spot month as *bona fide* hedging positions.

<sup>53</sup> Assume for these purposes a hedge of offsetting unfixed-price cash commodity purchases and sales under section (4)(ii)(A) of the definition of “*bona fide* hedging position.”

<sup>54</sup> Proposed Rule at 75,716.

addressed by what the Commission refers to in the preamble to the Proposed Rule as the “qualitative test.” However, the Commission proposed to introduce a new “quantitative” test requiring that the correlation between the 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 at least 36 months. If the correlation meets or exceeds the 0.80 standard, it falls within the safe harbor and “[t]he Commission will presume that the appropriate quantitative relationship exists.” If the correlation falls below the 0.80 standard, then “the Commission will presume” that the positions are not *bona fide* cross-commodity hedging positions and a market participant would not be permitted to claim an exemption without first applying for, and receiving, permission under Commission regulation 140.99 (the “**Quantitative Test**”).

**A. The Quantitative Test.**

1. The Use of an Objective Test to Measure “Substantial Relationship”.

The Working Group believes that the use of any “pass/fail” standard is inappropriate as it would deny *bona fide* hedging treatment to many cross-commodity hedges that are commonly used to reduce risk in the energy industry. The Working Group also believes that the determination of which hedges are appropriate for the reduction of physical commodity risk should be left to the sound business judgment of the party doing the hedging.

Moreover, the Working Group submits that the Quantitative Test set forth in the Proposed Rule suffers from a number of defects as set forth below:

- As proposed, the Quantitative Test only measures the relationship between spot month cash prices and spot month commodity derivative contract prices. In reality, a significant amount of cross-commodity hedging takes place on a forward basis and through the use of non-spot month contracts. In addition, the timing difference between a daily spot price for a cash commodity and the nearby futures contract delivery date may be up to two months in certain circumstances. This difference alone can impact correlations.
- The 0.80 standard does not reflect risk management practices in commodity markets and appears to have been selected based upon accounting standards that are intended to serve a different purpose and that are not appropriate for determining if a “substantial relationship” exists between two commodities.
- While a 36 month look-back may be informative, it should not form the basis for an absolute test. It will fail to reflect seasonality in the markets or to adjust for changes in specifications, market disruptions or other temporary events. These factors are commonly taken into account by the process of normalizing price correlations achieved by using sound judgment to exclude the effects of temporary events, anomalies or, where appropriate, by adjusting a look-back period. Use of a 36-month look-back also fails to recognize that hedges are placed on a forward looking basis at a specific moment in time. Historical performance should serve as guidance rather than as part of a bright-line test.

- Correlations may change over time – moving above and below the 0.80 standard – and affecting the status of hedges already in place under the test (or about to be placed).
- There is no reliable cash market series for many commodities for which correlations could be accurately determined. In addition, as new commodity derivative contracts are created, there will be no historical price series available to measure that side of the relationship.
- A hedge based upon a correlation that is less than 0.80 may still be an appropriate hedge where the hedging instrument reduces risk; in fact, in many situations it might be the best hedge available.
- Having to apply in advance of entering into a cross-commodity hedge where the correlation is below 0.80 is impractical and will significantly drain Commission resources and cause undue delay for industry.
- As proposed, the Quantitative Test does not function as a “safe harbor” because of the attached negative presumption of falling outside of it.

The Working Group understands that the Quantitative Test was derived from Generally Accepted Accounting Principles used in the United States (“**U.S. GAAP**”). Specifically, it appears that the Quantitative Test was derived from Accounting Standard Codification Topic 815, *Derivatives and Hedging* (“**ASCT 815**”), which was developed to account for hedges and define how the mark-to-market gain or loss on a derivative should be matched with revenues from the underlying business. This standard and related hedge accounting concepts were not created to for the purpose of determining whether a commodity derivative contract sufficiently reduces risk to qualify for *bona fide* hedge treatment.

The ASCT 815 standard sets a high quantitative standard for correlation by stating that the “hedging relationship is expected to be **highly effective** in achieving offsetting changes in fair value attributable to the hedged risk” (emphasis added). The “highly effective” standard is significantly different from the reasonable and prudent standards and practices currently utilized for risk management in the energy industry. It serves an entirely different purpose from the statutory “substantial relationship” test under CEA Section 4a, and a correlation can be economically appropriate to the reduction of risk without meeting the more restrictive “highly effective” ASCT 815 standard.

The “highly effective” test is not universally accepted in the accounting profession. Due to the restrictive nature and implementation challenges since its inception over fifteen years ago, there has been a strong trend among U.S. GAAP financial statement preparers not to utilize hedge accounting treatment under ASCT 815. At the same time, the international body charged with setting accounting standards – the International Accounting Standards Board (“**IASB**”) – has issued a proposed hedge accounting rule under International Financial Reporting Standard 9 (“**IFRS 9**”), which recognizes that a restrictive quantitative standard does not align with

reasonable risk management practices. In IFRS 9, the IASB proposes a rule that would *not* require a quantitative test to meet the hedge effectiveness standard, but rather allows an entity to utilize a principle-based approach that captures the relevant characteristics of the hedging relationship.

In short, the Working Group believes that the use of any quantitative test is simply not appropriate for determining whether a “substantial relationship” exists sufficient to justify *bona fide* hedging treatment of a cross-commodity hedge. Instead, the Commission should continue to rely on the historically acceptable methodology of the qualitative test that allows market participants to use reasonable and prudent risk management practices and takes into consideration the numerous factors that go into a determination that a particular hedge is appropriate to the reduction of risk. Among the factors that should be considered are whether transactions in the underlying cash commodity are commonly priced at a differential to the Referenced Contract or the commodity underlying the Referenced Contract or are commonly exchanged as the cash leg of an EFP transaction, in addition to the other qualitative factors set forth in the Proposed Rule. Dropping the Quantitative Test in favor of a qualitative test that relies on standard industry practices is consistent with Commission practice in other areas where an objective, one-size-fits-all solution would neither be appropriate nor necessary.<sup>55</sup>

If the Commission nonetheless determines to adopt a Quantitative Test, then the Working Group proposes that such threshold should not be set any higher than 0.50 and the 36 month look-back should be eliminated. A 0.50 threshold is reflective of reasonable risk management practices in the energy industry.

A commercial hedger ordinarily would prefer the correlation between the hedging instrument and the underlying exposure to be as high as possible. However, for any risk measure that is based on the standard deviation of the portfolio (which would include all Value at Risk (“**VaR**”)-type risk measures), for any non-zero correlation, there exists a scale of derivative positions such that the portfolio of the original exposure plus the derivative has lower risk than the original exposure alone. For correlation greater than 0.50 (or less than -0.50), and assuming equal stand-alone risk in the derivative and the original exposure, the risk of the portfolio of the derivative plus the original exposure is less than the risk of the original exposure. In this respect,

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<sup>55</sup> The Commission’s Final Rule further defining swap dealer and major swap participant recognized that the industry’s judgment in measuring exposure and valuation of collateral was more appropriate than a rigid methodology imposed by the Commission by stating that:

[T]he final rules do not prescribe any particular methodology for measuring current exposure or for valuing collateral posted, but instead require the use of industry standard practices. In this regard we do not concur with commenter requests that we approve or prescribe particular methodologies, or provide a safe harbor for measures or valuations made in good faith. Instead, it is appropriate that the final rules provide market participants with the flexibility to use the same methodologies that they use in connection with their business activities.

*See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”, Joint Final Rule, 77 Fed. Reg. 30,596, 30,667 (May 23, 2012) (citations omitted).*

the 0.50 threshold is a more appropriate guideline than the 0.80 threshold currently being proposed by the Commission.

The Working Group also recommends that, if the Commission adopts a Quantitative Test, correlations below the 0.50 threshold should not be presumed to fail the “substantial relationship” test requiring an application to the Commission before *bona fide* hedge treatment could be taken. Due to common and widespread use of hedging relationships that will not meet any quantitative test, the number of applications will be substantial and will put an unnecessary and inefficient drain on Commission resources, in addition to being highly detrimental to commercial market participants seeking to hedge in a timely fashion. Instead, under these circumstances, a market participant should be permitted to demonstrate, upon the Commission’s request, that a transaction entered into with a price correlation below 0.50 was reasonable and appropriate based on the totality of the circumstances. As an additional matter, if the Commission adopts any quantitative test, it should not require the use of a 36-month look-back period for the reasons stated above.

## 2. Natural Gas and Power.

The Proposed Rule suggests that fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in the value of natural gas.<sup>56</sup> The Working Group strongly disagrees with this conclusion. In relevant part, the Proposed Rule states:

There may not be a substantial relation, [between electricity and natural gas] for example, because the marginal pricing in a spot market may be driven by the price of something other than natural gas, such as nuclear, coal, transmission, outages, or water/hydroelectric power generation.<sup>57</sup>

In fact, gas-fired generation has long been a part of the diverse mix of resources offered as part of the physical supply chain for electric energy and power in the United States. As illustrated in Figures 1 and 2 below, gas-fired generation has become one of the predominant fuel

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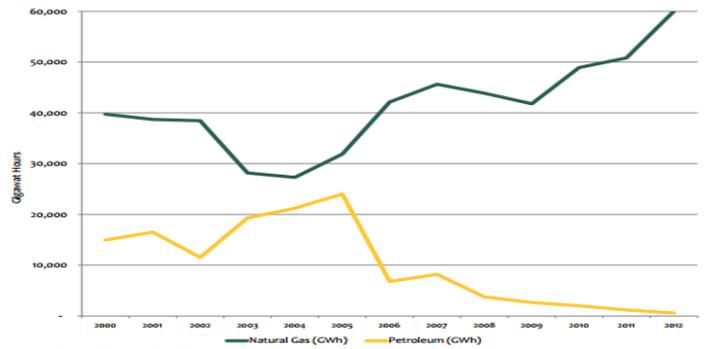
<sup>56</sup> In this respect, the Working Group questions the validity of the correlations set forth in the Proposed Rule because correlations in the spot month may not be relevant to transactions across the forward curve. Many energy products are traded (and hedged) in calendar month strips. The correlation of a one-year forward calendar strip may be substantially different from the correlation in the spot month. Additionally, the Proposed Rule appears to ignore the effects of seasonality, which is an important risk management consideration in the trading and hedging of energy commodities.

<sup>57</sup> Proposed Rule at 75,717.

sources for the production of electric energy and power.<sup>58</sup>

Figure 1

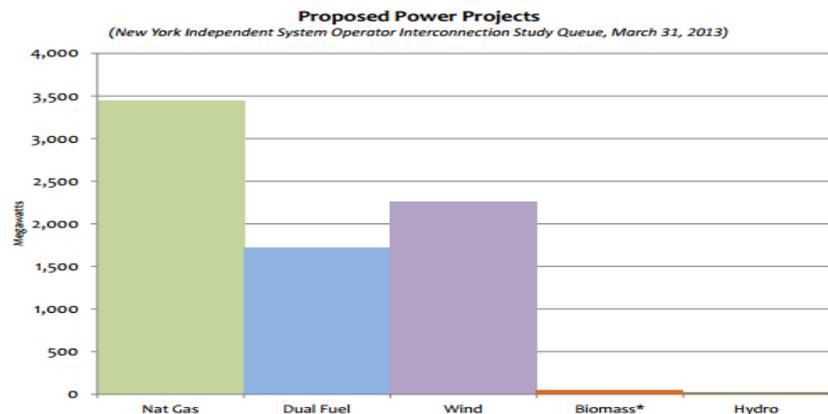
Figure 18: Generation by Natural Gas and Oil: 2000-2012



Data Provided by: U.S. Energy Information Administration  
 Chart: New York ISO Power Trends 2013: Alternating Currents pg. 37

Figure 2

Figure 17. Proposed Generation by Fuel Type – 2013



Source: New York ISO Power Trends 2013: Alternating Currents pg.37

<sup>58</sup> From 2000 through the end of 2012, New York power plants with generating capacity totaling more than 5,000 MW retired or suspended operation. During that same period, New York added more than 10,000 MW of new generation. New power plants are generally more efficient and use cleaner-burning natural gas or renewable resources.

New York Independent System Operator (“ISO”) Power Trends 2013 Alternating Currents, pg. 38 (May 2013) available at: [http://nyssmartgrid.com/wp-content/uploads/2013/05/Power\\_Trends\\_2013\\_May\\_2013\\_FINAL.pdf](http://nyssmartgrid.com/wp-content/uploads/2013/05/Power_Trends_2013_May_2013_FINAL.pdf).

Natural gas has also become the dominant fuel used to produce electricity in New England. Approximately 12,000 of the 14,000 MW of generating capacity built over the past 15 years are natural gas combined cycle units and gas continues to be the fuel of choice for new power plant construction . . . . [T]he increase in natural gas-fired generation has resulted in a significant decrease in both power plant emissions and the wholesale cost of electricity.

ISO New England 2013 Regional Electricity Outlook, pg. 15 available at: [http://www.iso-ne.com/aboutiso/fin/annl\\_reports/2000/2013\\_reo.pdf](http://www.iso-ne.com/aboutiso/fin/annl_reports/2000/2013_reo.pdf).

Due to the dominant role of natural gas-fired generation, particularly the ability to turn on natural gas-fired generation quickly and the ability to modify its output, it is generally the type of generation that sets marginal wholesale power prices. In addition, because natural gas-fired generation generally sets wholesale power prices, market participants often use the expected cost to run natural gas-fired generation to price long-term physical power transactions. Thus, natural gas Referenced Contracts often provide the best available mechanism to hedge price and operational risk associated with long-term power transactions.

For example, because of New England's heavy reliance on this single fuel source, natural gas typically sets the price for wholesale electricity.<sup>59</sup> The status of natural gas as the marginal fuel in New England and the fact there is a strong correlation between natural gas prices and power prices in that region has been acknowledged by the FERC. In its assessment of physical energy markets for the Winter of 2013-2104, FERC staff reported on the relationship between natural gas and power during the winter months. Specifically, FERC staff found that,

Over the last five winters (Dec. – Mar.), the monthly average day-ahead prices have been 99% correlated, as natural gas *has maintained the position as the marginal price-setting fuel during most hours*. There have been no major capacity changes since last winter with the exception of the retirement of 326 MW of oil-fired generation, which ran infrequently last winter. Therefore, we expect this same relationship between natural gas and power prices to continue this winter and believe that power prices should spike if there are high natural gas price events.<sup>60</sup>

The correlation for natural gas and power prices in New England is strong all year. However, the Proposed Rule conflicts with the findings of FERC, a sister agency, that regulates the physical wholesale natural gas and power markets, especially with respect to the winter months in New England. The Working Group submits that it makes no sense to deny *bona fide* hedge treatment in these circumstances and such a finding bears no relationship to the reality of

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<sup>59</sup> See ISO New England 2013 Regional Electricity Outlook at 20. Similarly, in ERCOT, while coal/lignite and nuclear plants operate primarily as base load units, it is the reliance on natural gas resources that drives the high correlation between real-time energy prices and the price of natural gas. See Potomac Economics LTD., 2012 State of the Market Report For The ERCOT Wholesale Electricity Markets (June 2013) available at: [http://www.potomaceconomics.com/uploads/ercot\\_reports/2012\\_ERCOT\\_SOM\\_REPORT.pdf](http://www.potomaceconomics.com/uploads/ercot_reports/2012_ERCOT_SOM_REPORT.pdf).

<sup>60</sup> FERC Staff, Winter 2013-14 Energy Market Assessment Report to the Commission at 13 (Oct. 17, 2013) (emphasis added).

the situation in that region and in other parts of the country.<sup>61</sup>

Figures 3 and 4 set forth immediately below highlight this point.

Figure 3

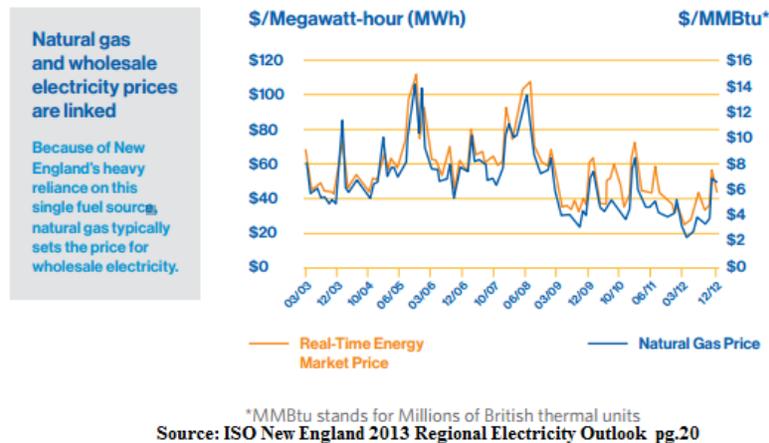
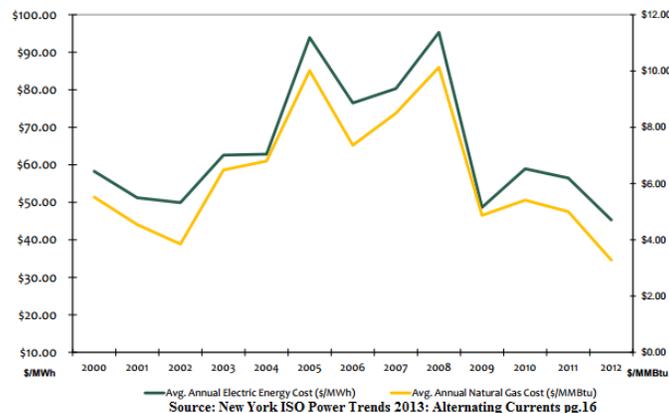


Figure 4

Figure 6. Natural Gas Costs and Electricity Prices: 2000 – 2012



<sup>61</sup> In Docket No. AD12-12-000, FERC has been studying ways to improve the coordination of the natural gas and power industries given the importance of natural gas to the electric generation sector. In a statement made in connection with the start of this proceeding, FERC Commissioner Moeller remarked:

As we have seen over the last few years, natural gas is being used much more heavily in electricity generation. This trend appears likely to accelerate as coal-powered generation is retired, renewable energy resources require more backup by natural gas plants, and low natural gas prices encourage more use of gas. And recent problems, most importantly, the southwest outage in February 2011, suggest that more resources need to be allocated to planning for the increased use of natural gas to generate electricity.

See Commissioner Philip D. Moeller, Request for Comments of Commissioner Moeller on Coordination between the Natural Gas and Electricity Markets, Docket No. AD12-12-000 (Feb. 3, 2012).

The Working Group acknowledges that there may be short-term dislocations in spot market prices. However, the primary hedging relationship used for cross-commodity hedging in the electricity markets is based upon the economic relationship of forward power prices and forward natural gas prices. In preparing these comments, the Working Group ran its own correlation tests based on historic daily observations of forward data and provides the following correlations.

Figure 5

**Calendar Forward Gas/Power Correlations**

	MISO-INDHUB_7X24 HHUB		CAISO-SP15_7X24 HHUB	
	2014	2015	2014	2015
19 month correlation	52%	70%	81%	71%
60 day correlation -- min	25%	56%	42%	35%
60 day correlation -- avg	87%	70%	80%	75%
60 day correlation -- median	90%	72%	83%	77%
60 day correlation -- max	96%	73%	92%	86%

Note: Log-return calculations. 60-day correlations are rolling.

Figure 6

**Calendar Forward Gas/Power Correlations**

	ERCOT_NORTH_ HUB_7x24 HHUB		PJM-WEST HUB_7x24 HHUB		MASS-HUB_7x24 AGT	
	2014	2015	2014	2015	2014	2015
36 month correlation	89%	83%	85%	77%	91%	82%
60 day correlation -- min	58%	46%	62%	42%	63%	49%
60 day correlation -- avg	88%	84%	86%	79%	87%	79%
60 day correlation -- med	91%	85%	88%	83%	91%	85%
60 day correlation -- max	99%	97%	96%	93%	97%	95%

Note: Log-return calculations. 60-day correlations are rolling.

According to the Working Group's data, electricity prices are highly correlated with natural gas futures prices in these markets. The data demonstrate that, in many cases, the correlations meet the proposed 0.80 correlation threshold. However, the Working Group's data also demonstrate that there are certain months in which the 0.80 correlation threshold would not be met.

It should also be noted that the Working Group reviewed the correlations between ERCOT Houston Hub vs. Henry Hub and obtained similar results to the ERCOT North

correlations above. The Working Group decided to use ERCOT North Hub, rather than ERCOT Houston Hub because of the four main trading locations/hubs in the ERCOT region, these locations primarily trade as a spread to ERCOT North Hub.

Given that forward physical and financial power markets have little trading liquidity several years out, commercial hedgers applying prudent risk management practices must find the best available substitute to mitigate exposure to price risk during this period. As discussed in Section IX.A.1, above, faced with a trade-off between (i) not hedging the price risk at all, and (ii) hedging risk with a less than perfect instrument or commodity, commercial hedgers generally will opt to hedge risk with a commodity that is less effective, but provides for a reasonable degree of risk reduction. With this in mind, natural gas generally is the best available substitute commodity that provides a reasonable degree of risk reduction for forward power price exposure.

3. Other Cross-Commodity Relationships Commonly Used in the Energy Industry.

i. *Other Cross-Commodity Relationships.*

Apart from the natural gas/power relationship, the proposed Quantitative Test would cause significant problems in other energy markets, as well. There are literally hundreds of potential “cross-commodity” relationships, all of which would need to be measured against the proposed 0.80 correlation threshold, including relationships between crude streams that are not deliverable on the NYMEX Light Sweet Crude (CL) futures contract, grades of gasoline (including winter and summer, as well as regional, specifications) and blendstocks and the commodity derivative contracts commonly used for hedging them. Attachment No. 1 to this comment letter sets forth a non-exhaustive list of over one hundred (100) cross-commodity relationships that are commonly used by commercial hedgers to reduce their exposure to price risk.<sup>62</sup>

Attachment No. 1 illustrates several key points for the Commission. *First*, approximately 74 percent of the commonly used energy hedges listed in Attachment No. 1 would not satisfy the Quantitative Test. *Second*, there is no reliable cash market price series for eight of the listed relationships. *Third*, even where there is a reliable cash market price series, forward market cash quotes are not readily available. Therefore, the correlations are not relevant to hedging decisions which are generally made on a forward basis. Accordingly, Commission staff will face an unworkable number of requests for interpretive guidance simply to approve cross-commodity relationships that are already commonly used for hedging (*e.g.*, different grades of naphtha to NYMEX RB futures contract).<sup>63</sup>

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<sup>62</sup> The constraint of the 60-day comment period has limited the ability of the Working Group to calculate correlations on all of the “cross-commodity” relationships that exist. The Working Group reserves the right to supplement the list at a later date as deemed necessary and appropriate.

<sup>63</sup> The Working Group submits that this is not the highest and best use of the Commission’s resources, and is not an effective process for market participants looking to hedge their commodity price exposures in a timely manner.

ii. *Gasoline Blendstocks.*

With respect to gasoline blendstocks, there is an additional issue created by the proposed Quantitative Test. For several of these products including, alkylate, butane, raffinate, reformate, toluene, and different grades of naphtha, the correlation to the NYMEX RB futures contract falls well below the 0.80 correlation threshold. Yet, when individual blendstocks are combined together (*e.g.*, in the same tank), they actually are “RBOB.” Accordingly, regardless of their individual correlations to the NYMEX RB futures contract with which they are commonly hedged, they should be deemed to be correlated by virtue of the fact that they are components of RBOB and collectively represent RBOB as a product.

**Proposed Solution:** The Commission should not adopt a Quantitative Test for determining whether a cross-commodity hedge qualifies for *bona fide* hedging treatment. Rather, the Commission should rely, as it has historically, on a qualitative test based on the totality of the circumstances. Alternatively, should the Commission adopt a Quantitative Test, it should adopt the Working Group’s proposal of a 0.50 threshold which is reflective of reasonable and prudent risk management practices in commodity markets. Correlations below the 0.50 threshold should not be presumed to fail. Rather, a market participant should be permitted to claim the exemption and demonstrate, upon the Commission’s request, that a transaction entered into with a price correlation below 0.50 constitutes a *bona fide* hedging position based on the totality of the circumstances. Finally, for the reasons discussed herein, the proposed 36-month look-back period should not be required as part of any Quantitative Test.

**B. The Restriction on the Ability to Hold Physical Delivery Referenced Contracts as Cross-Commodity Hedges into the Spot Month.**

Similar to the Vacated Final Rule, the Commission proposes to retain a blanket restriction that prevents cross-commodity hedging transactions from receiving *bona fide* hedging treatment if they are physically delivered Referenced Contracts held in the spot month as a consequence of the five day rule. However, the Commission has recognized that the five day rule is not appropriate in all circumstances. In adopting its definition of *bona fide* hedging in 1977, including its adoption of the five day rule, the Commission noted that “persons wishing to exceed such limits during the last five trading days may submit materials supporting classification of the position as *bona fide* hedging pursuant to paragraph [1.3(z)](3) of the newly adopted definition.”<sup>64</sup> Based upon the following analysis, the Commission should determine that it would not be appropriate to apply the five day rule to the hedging of cross-commodity relationships in energy products.

The Commission has historically raised two concerns related to cross-commodity positions in this context: (i) there was no demonstrated need to hold “cross-commodity” positions into the last five trading days, and (ii) the restriction was necessary to protect orderly

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<sup>64</sup> *Definition of Bona Fide Hedging and Related Reporting Requirements*, Final Rules, 42 Fed. Reg. 42,748, 42,749 (Aug. 24, 1977) (“**1977 Bona Fide Hedging Release**”).

markets.<sup>65</sup>

As to the second concern, the Working Group respectfully submits that the Commission already has adequate, alternative safeguards in place to ensure orderly markets and should not unnecessarily restrict legitimate hedging activity by imposing the five day rule. Specifically, the Commission may ensure orderly markets through its anti-manipulation authority, as supplemented by enhanced anti-manipulation provisions and new anti-disruptive trading practices authority under the Dodd-Frank Act. The Commission would also have the orderly trading requirement of proposed CFTC regulation 150.1. Perhaps most importantly, the Commission has the benefit of the Regulated Exchanges acting as backstops in administering their own speculative position limit rules. The Regulated Exchanges require pre-approval of applications for *bona fide* hedge exemptions, monitor positions up to and through the delivery period, and may require a party to exit positions subject to an exemption for any reason, including, for example, issues with market liquidity.

With respect to the first concern, the Working Group sets forth below several examples demonstrating the commercial need in today's energy markets to hold cross-commodity positions in physical delivery Referenced Contracts into the last five trading days (or last three trading days in energy markets).

Example 6 - Spot Month Cross-Commodity Hedge.

*On April 20, 2014, Party A holds inventory of 550,000 barrels of Alkylate and 265,000 barrels of Naptha in tank in New York Harbor. It is short 815 NYMEX May 2014 RB futures contracts to hedge this exposure. Party A's business plan is to blend the components together and deliver 815,000 barrels of RBOB against its May 2014 RB positions (or via EFP).*

*The spot month period for the NYMEX May 2014 RB futures contract begins at the close of business on Friday, April 25, 2014.*

Under the Proposed Rule, the five day rule would prohibit Party A from claiming this position as a *bona fide* hedging position. If it lacked headroom under the speculative limit, Party A would be required to lift the hedge or roll it to the June contract.

The Working Group notes that companies with storage and gasoline blending operations in the New York Harbor region will determine whether to import and blend components into RBOB and finished grades of gasoline based on factors that include, but are not limited to, the following:

- the value of the spot and second month NYMEX RB futures contracts;

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<sup>65</sup> *Id.*; see also *Bona Fide Hedging Transactions or Positions*, Proposed Rulemaking and Request for Comment, 42 Fed. Reg. 14,832, 14,834 (Mar. 16, 1977).

- the cash values of finished gasoline, RBOB, and other blending components available in New York Harbor;
- the current structures of the NYMEX RB futures and physical gasoline markets (backwardation versus contango); and
- the value of Colonial Pipeline barrels in relation to New York Harbor grades of gasoline.

These and other factors are used by individual market participants to calculate their “blend margins.” Positive blend margins above a certain level mean that certain market participants will maximize their operations to blend RBOB and finished grades of gasoline, while other market participants will do everything possible to transport and sell components or finished grades of gasoline into the New York Harbor region. The following example illustrates these points.

Example 7 - Spot Month Cross-Commodity Hedge.

*On April 20, 2014, Party A has 550,000 barrels of Alkylate in tank in New York Harbor. Party A is currently short 550 RB contracts as a hedge on its Alkylate inventory.*

*That same day, Party A enters into an agreement with Importer to purchase a 265,000 barrel cargo of Naphtha, scheduled to arrive in New York Harbor on May 1, 2014. The contract price is May NYMEX RB -30 cpg, and the pricing term is set by EFP and under this hypothetical at \$3.00, resulting in a cash price of \$2.70 on the cargo. Importer is short 265 May RB as a hedge against the cargo.*

*Also, on April 22, 2014, the RB market is in backwardation by 3 cents and Party A plans to blend the Alkylate and Naphtha into 815,000 barrels of RBOB and deliver it into the New York Harbor market. Blending generally takes two days. If Party A delivers under the NYMEX May RB contract, the first delivery date would not be until May 8, 2014 at the earliest.*

*On April 28, 2014, Party A and Importer enter into an EFP for 265 contracts of May RB (Party A receives Importer’s short futures position as well as the physical cargo of Naphtha). Accordingly, Party A is short 815 May RB.*

*At the close of business on April 28, 2014, Party A is long 550,000 barrels of Alkylate and 265,000 barrels of priced Naphtha. It is short 815 May RB contracts as a hedge. It will blend the Alkylate and Naphtha and either deliver RBOB under the NYMEX May RB contract or EFP and deliver it under a separate contract to another counterparty sometime during the month of May.*

*Decisions related to gasoline blending and making or taking delivery of the NYMEX RB futures contract are typically made very close to expiration of that futures contract, usually within the last day or two leading to expiration. Under these circumstances, if a market participant blends RBOB for NYMEX delivery or finished gasoline to meet other prompt month fixed-price commitments, the market participant*

*needs to be allowed to cross-commodity hedge the components or finished grades of gasoline with NYMEX RB futures contract during the spot period.*

In Example 7 above, due to blending economics dictated by the convergence of the May NYMEX RB futures contract, Party A may decide not to make delivery or make finished gasoline due to changing blend margins or other economic factors. Party A can then exit the hedge in the May NYMEX RB futures contract by rolling it to the next month and subsequently discharging the Naphtha cargo into storage.

Under the Proposed Rule, the limitation on a market participant's ability to hold a cross-commodity hedge for non-RBOB gasoline components in New York Harbor as a *bona fide* hedging position in the spot month will preclude companies from making blending decisions based on economics appropriate for gasoline.

Example 8, below, highlights the adverse impacts that the five day rule will have on market participants that need to hold cross-commodity hedges using physically delivered Referenced Contracts as *bona fide hedging* positions in the spot month. By way of background, the Colonial Pipeline serves as the main conduit to move physical barrels of jet fuel (Colonial Grade JET 54) to staging terminals located between the U.S. Gulf Coast and Linden, New Jersey. The pipeline moves the jet fuel in "batches" that are scheduled in 72 separate, five day cycles throughout each calendar year. The hedging of jet fuel with the NYMEX HO futures contract is considered to be a cross-commodity hedge under the Proposed Rule.

#### Example 8 - Spot Month Cross-Commodity Hedge.

*On January 13, Refiner A decides to sell 200,000 barrels of Colonial Pipeline 54 Grade jet fuel to Counterparty B that intends to take delivery of the physical jet fuel at different terminals adjacent to the Colonial Pipeline. Refiner A sells the jet fuel to Counterparty B on an EFP basis utilizing the FEB14 NYMEX HO futures contract. In this transaction, the premium of +2.50 cents per gallon is fixed at the time of the agreed to transaction (FEB14 NYMEX HO +2.50). The underlying FEB14 NYMEX HO futures contracts will be priced and posted to the exchange sometime between January 13 and January 30 when mutually agreed to by Refiner A and Counterparty B.*

- On January 29, Refiner A and Counterparty B agree to price the underlying 200 FEB14 NYMEX HO futures contracts at \$2.75 per gallon. The futures contracts are posted to the exchange by each party's futures commission merchant and included in each party's active FEB14 NYMEX HO futures position.*
- When the futures contracts are posted to the exchange, Counterparty B, as the purchaser of the jet fuel, obtains a short position, and Refiner A obtains a long position of 200 FEB14 NYMEX HO futures contracts.*
- On January 30, Counterparty B takes possession of the 200,000 barrels of 54 Grade jet fuel at its designated facilities adjacent to the Colonial Pipeline.*
- On January 31, Counterparty B purchases 200 FEB14 NYMEX HO futures contracts to close out its short FEB14 NYMEX HO position and sells 200 MAR14*

*NYMEX HO futures contracts to hedge the exposure associated with the new inventory.*

- *Batches of jet fuel bought and sold for delivery during the last cycle of a given month, from January 27 to January 31, for example, typically will price against and be hedged with the spot month FEB14 NYMEX HO futures contracts.*

The proposed five day rule as applied to cross-commodity hedges would necessitate that a market participant lift its FEB14 NYMEX HO futures hedges on these barrels by close of business on January 28 and roll them to the MAR14 NYMEX HO futures contract. This situation would result in the January Colonial Pipeline barrels being improperly hedged and would create increased exposure to price risk for that market participant.

**Proposed Solution:** The Commission should revise subsection (5) of the definition of “*bona fide* hedging position” as follows:

(5) *Cross-commodity hedges.* Positions in commodity derivative contracts described in paragraph (2)(ii), paragraphs (3)(i) through ~~(iv)~~**(xi)**<sup>66</sup> and paragraphs (4)(i) through (iv) of this definition may also be used to offset the risks arising from a commodity other than the same cash commodity underlying a commodity derivative contract, *provided that* the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are 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, **unless such positions are necessary to hedge the risk of commodities that are being delivered or priced in the five-day period, or where the commodities represent components that if blended together (or in concert with other contracted for components) represent the deliverable grade of the commodity underlying the commodity derivative contract.**

## **VII. THE APPLICATION OF THE FIVE DAY RULE TO ENERGY COMMODITIES; GENERALLY.**

Similar to the Vacated Final Rule, through the proposed five day rule, participants in energy markets are prohibited from engaging in certain commonly used risk-reducing practices that require them to hold hedges involving physical delivery Referenced Contracts into the spot month period. In addition to subsection (5) (Cross-Commodity Hedges) of the definition of “*bona fide* hedging position,” This prohibition applies broadly across the following subsections of this definition:

- (2)(ii)(A) (Pass-Through Swap Offsets)

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<sup>66</sup> The addition of “(xi)” reflects the Working Group’s proposed additions to the enumerated hedge positions in subsection 3 of the definition of “*bona fide* hedging position.”

- (3)(iii) (Hedges of Unfilled Anticipated Requirements)
- (4)(i) (Hedges of Unsold Anticipated Production)
- (4)(ii) (Hedges of Offsetting Unfixed-Price Cash Commodity Sales and Purchases)
- (4)(iii) (Hedges of Anticipated Royalties)
- (4)(iv) (Hedges of Services)

As addressed in Requests for Exemptive Relief Nos. 8-10 in its BFH Petition, the Working Group submits that the provisions identified above prohibiting participants in energy markets from holding physical delivery Referenced Contracts as *bona fide* hedging transactions or positions into the spot month are neither appropriate nor justified given the unique operating characteristics of energy markets. The restrictions against holding a *bona fide* hedging position into the spot month appear to be a carryover from the Commission's historic Part 150 regulations, which apply to Enumerated Agricultural Contracts.

Specifically, in agricultural futures markets, physical delivery Referenced Contracts trade into (and at least partially through) the delivery month. Participants that remain in the CME Group or the Chicago Board of Trade (“**CBOT**”) agricultural futures contracts close to or during the delivery month are potentially subject to a “delivery notice.” The “delivery notice” can occur on the second to last business day of the month preceding the contract month for the prompt futures contract (this is also known as “**First Notice Day**”). Once a market participant holds a position past First Notice Day, from that day forward through expiration of trading in the prompt month futures contract, the exchange may designate them to make or take delivery of the actual commodity. Thus, there is a policy rationale to prohibit market participants from carrying a hedge-exempt sized position in physical delivery agricultural Referenced Contract positions in the last five days of trading when they may not be prepared to make or take delivery. Being served with a delivery notice under such circumstances could be disruptive to the markets.

Energy markets do not operate in this manner. Physical delivery Referenced Contracts for energy commodities do not trade into the delivery month. Rather, these contracts cease trading and settle days, if not weeks, before the delivery month begins. Consequently, the risk that a party could be called upon during the spot period to fulfill a delivery obligation when it is not commercially prepared to do so simply does not exist.

Given this distinction, concerns regarding potential disruptions during the spot period analogous to those in agricultural markets are not applicable to energy markets. Furthermore, there is no apparent economic justification for forcing participants in energy markets to exit the contract that provides the best hedging tool into a different contract month<sup>67</sup> or into a cash-

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<sup>67</sup> This is another key distinction between energy and agricultural markets. As agricultural contracts move toward final expiry, the cash market convention is to begin pricing against the next liquid futures contract month. As energy contracts move into the spot month, the cash market convention is still to price against the spot month futures contract. Thus, the historical requirement pushing agricultural market participants to the next delivery month has less economic impact than it would with respect to energy market participants.

settled contract.<sup>68</sup> Simply put, carrying these hedges into the spot period is not speculative in nature and, as such, these transactions should not be subject to speculative position limits.

The following example illustrates adverse operational impacts and increased exposure that commercial hedgers will be subject to as a result of applying the five day rule to energy markets.<sup>69</sup>

Example 9 - Unsold Anticipated Production – Last Five-day Rule.

*Company A anticipates producing and selling 1,000,000 barrels of crude oil in October. That production is currently unsold. To hedge its risk that the value of those barrels may decline prior to their sale, Company A will sell 1000 October NYMEX Light Sweet Crude Oil futures contracts (“WTI”), which represent delivery ratably during the month of October. The last trading day of the October futures contract is September 22nd. The last day that Company A could hold the position as a bona fide hedging transaction or position under the Proposed Rule would be September 18th. This means that if Company A holds the contract through the spot period, and delivers its oil under the October futures contract, it could not treat those positions as a bona fide hedging transaction or position during that period. Alternatively, in order to maintain bona fide hedge status, Company A would be required to roll its hedge into the October contract on September 17th, taking basis risk on the October/November spread for the additional five days.*

Under the Proposed Rule, the five day rule would prohibit Company A from claiming this position as a *bona fide* hedging position.

**Proposed Solution:** The Commission should amend the subsections of the definition of “*bona fide* hedging position” set forth in proposed CFTC regulation 150.1 that are identified in the bullet points listed above by expressly stating that the five day rule does not prevent a market participant from holding a physical delivery Referenced Contract in an energy commodity as a *bona fide* hedging position in the spot month.

**VIII. “HEAT RATE” TRANSACTIONS IN ELECTRIC MARKETS.**

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 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

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<sup>68</sup> Because cash-settled contracts do not go to delivery and settle at or prior to expiry of physical delivery Referenced Contracts, the five day rule leaves market participants fully exposed to price risk prior to actual physical delivery.

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 (i) forward sales of physical power (either from an electric generator or from a merchant), (ii) forward purchases of physical power, (iii) options on physical power, or (iv) 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 option to hedge electric and gas price risk. Or, a market participant (either a generation owner or merchant) may sell physical electricity priced at a heat rate 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.

The Working Group is 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 these derivatives 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 subsections (3)(i) or (3)(ii) of the definition of “*bona fide* hedging provision” set forth in proposed regulation 150.1 because:

- the enumerated exemptions require the Referenced Contract to reference the same commodity as the cash commodity transaction; and
- the enumerated exemptions require that the cash commodity transaction be a fixed price, but a sale of physical power priced using a heat rate does not fix the price for the sale of power.

Similarly, a heat rate swap or physical heat rate option used by an electric generator does not appear to qualify as a *bona fide* hedging position under the enumerated hedging exemption for unsold anticipated production set forth in subsection (4)(i) of the definition of “*bona fide* hedging position.” 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.

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 only the electricity component satisfying the definition of “*bona fide* hedging position.”

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

**Proposed Solution:** The Commission should (i) as discussed in Section VI above, recognize as an enumerated hedge under subsection (3) of the definition of “*bona fide* hedging position,” a position in a Referenced Contract used to hedge a transaction in a different commodity that is priced by reference to the commodity underlying the Referenced Contract, specifically including physical heat rate transactions, (ii) exclude from position limits heat rate derivatives, which are spread contracts, 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 rate transactions.

## **IX. TRADE OPTIONS.**

The Working Group respectfully identifies several issues that are raised by subjecting trade options to federal speculative position limits.

As an initial matter, for a physical commodity option to qualify as a trade option it must relate to the offeree’s commercial business.<sup>70</sup> Consequently, a trade option cannot function as a speculative derivative or give rise to excessive speculation and should be exempt or otherwise excluded as requested. A trade option is an essential tool used in a variety of ways in markets for many physical energy commodities, including natural gas, crude oil, power, and other energy and energy-related products. It is also common for physical energy forward transactions to have embedded volumetric optionality, which could cause them to be regulated as trade options rather than physical forwards.<sup>71</sup> Trade options may be used to manage supply chain risk (*e.g.*, to ensure availability of the commodity if it is needed or if another source of supply fails), price risk, or both. The Proposed Rule fails to consider a number of issues associated with subjecting trade options to federal speculative position limits.

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<sup>70</sup> See *Commodity Options*, Final Rule and Interim Final Rule, 77 Fed. Reg. 25,320, 25,338 (Apr. 27, 2012) (“The offeree 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 *is offered or entering into the commodity option transaction solely for purposes related to its business as such*”) (emphasis added).

<sup>71</sup> See *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps, Security-Based Swap Agreement Recordkeeping*, Joint Final Rule, 77 Fed. Reg. 48,208, 48,238 (Aug. 13, 2012) (setting forth a seven-part test for a forward transaction with embedded volumetric optionality to qualify for the forward contract exclusion from the definition of “swap”).

**A. Trade Options Are Physical Supply Contracts that Often Will Not Satisfy the Proposed Definition of “*Bona Fide Hedging Position.*”**

The primary purpose of trade options in the energy industry is to ensure that commercial market participants have access to physical commodities. The Commission noted in the Interim Rule on the Trade Option Exemption that trade options are “commonly used as hedging instruments or in connection with some commercial function, [and will] normally qualify as hedges, exempt from the speculative position limits.”<sup>72</sup> Although some trade options could qualify as a *bona fide* hedging position under the Proposed Rule, many, if not most, likely would not.<sup>73</sup>

For example, trade options often have a floating strike price and are used to ensure that a market participant has access to a physical commodity. This type of trade option may, for example, provide access to additional physical supply of a commodity in the event of an unexpected increase in demand or in the event another source of supply fails.<sup>74</sup> However, such a transaction, if priced at an index, does not offset price risk incidental to a commercial operation. Also, as further discussed below, a physical option may not be a substitute for a transaction in the physical marketing channel because the physical option itself may be the transaction taken, or to be taken, in the physical marketing channel.

The issues associated with trade options that manage supply risk are made even more complex for physical forward transactions with volumetric optionality that are regulated as trade options.<sup>75</sup> Embedded volumetric optionality most often exists in physical agreements to facilitate efficient contracting and operational planning in physical markets. Such agreements allow market participants to secure commercial terms for supply and demand of a volumetric range, for what is an unknown finite future requirement, at the time of execution. Federal speculative position limits likely will impede the use of such agreements, which will lead to contracting inefficiencies, spot physical supply volatility, and increased costs for many energy companies. In addition, if a firm’s physical contracts utilize all or part of its federal speculative position limit in a commodity, then that firm may be unable to create financial positions,

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<sup>72</sup> See *Commodity Options*, Final Rule and Interim Final Rule, 77 Fed. Reg. 25,320, 25,328 n.50 (Apr. 27, 2012).

<sup>73</sup> Trade options are physical delivery contracts entered into by commercial entities. The Working Group submits that, under no circumstances, should speculative position limits or *bona fide* hedge exemptions deter cash market activities. See generally 1977 Bona Fide Hedging Release; see also *Definition of Bona Fide Hedging and Related Reporting Requirements*, Notice of Proposed Rulemaking, 42 Fed. Reg. 14,832 (1977).

<sup>74</sup> Some illustrative examples are as follows (i) an owner of power generation that uses fuel oil may want to ensure it has access to additional fuel for a variety of reasons, including unexpected increases in electricity demand, outages of other generation or transmission that make it economical to run more than normal, or decreased operating efficiency that causes the generator to use more fuel than normal, (ii) a refiner may need access to additional crude oil if demand for refined products is higher than normal, and (iii) a merchandiser may need to ensure it has backup sources of a physical commodity supply in order to meet firm sales obligations.

<sup>75</sup> The uncertainty surrounding the application of the seven-part test for physical forwards with volumetric optionality further complicates matters and will result in market participants taking inconsistent views on what transactions are considered trade options and, therefore, included in federal speculative position limits.

including hedges that may not qualify as an enumerated hedge and, in certain circumstances, physical delivery Referenced Contracts that cannot be held as a *bona fide* hedging position during the spot month.

Further, the proposed definition of “*bona fide* hedging position” requires a commodity derivative contract to “represent a substitute for transactions made or to be made, or positions taken or to be taken, at a later time in a physical marketing channel.”<sup>76</sup> Even if a trade option is used to hedge price risk there are critical questions when analyzing trade options under the “temporary substitute” test that need to be answered.

- *First*, is a trade option the actual transaction or position in the physical marketing channel, rather than a substitute for such transaction or position?
- *Second*, because a trade option might not be exercised, is it a substitute for a transaction or position to be taken at a later time in a physical marketing channel?

The very nature of a trade option reflects that the option holder may not have a transaction or position at a later time in a physical marketing channel. Consequently, trade options likely would not receive *bona fide* hedging treatment under the Proposed Rule.

## **B. Prohibitions on Holding a *Bona Fide* Hedging Position in the Spot Month.**

Assuming *arguendo* that a trade option met the general criteria of the definition of “*bona fide* hedging position,” several of the enumerated *bona fide* hedging positions would not permit a market participant to hold the trade option in the spot month.<sup>77</sup> Many trade options are longer than one month (some are many years) and require physical delivery during or after the spot month, which is a concept relevant only to physical futures.<sup>78</sup>

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<sup>76</sup> Proposed CFTC regulation 150.1(2).

<sup>77</sup> Specifically, this prohibition applies to the following subsections of the definition of “*bona fide* hedging position:”

- (2)(ii)(A) (Pass-Through Swap Offsets);
- (4) (Other Enumerated Hedging Positions); and
- (5) (Cross-commodity hedges).

<sup>78</sup> The Working Group acknowledges that many trade options will not be priced based upon the current list of CRFCs. However, the definitions and rules in the Proposed Rule are relevant for all derivatives because, in the Proposed Rule, the Commission stated its intention to expand federal speculative position limits to all commodities. Therefore, the Commission must take a principle-based approach to the entire speculative position limits regime and craft rules that can be applied to any and all commodities and physical commodity derivatives. The Commission cannot simply rely on historical statistics for a very limited number of commodities as a rationale for taking, or for not taking, a particular approach. *See, e.g.*, Proposed Rule at 75,726-27 (stating that the Commission will defer consideration of speculative position limits for agricultural and exempt commodities other than those CFRCs proposed therein because the Commission will consider the adoption of additional speculative position limits in subsequent rulemakings).

For example, a common transaction in the electric industry is a daily exercisable option for physical energy at a price based upon the product of a heat rate<sup>79</sup> and the Henry Hub gas index.<sup>80</sup> These transactions typically last more than one month and may run many years. The person holding the optionality on the electricity may exercise the option each business day for delivery during the next day(s). This type of transaction would be in the spot month every month.

Trade options like the transaction in the above example do not trade like physical futures and cannot simply be traded out of, or unwound, prior to the spot month.<sup>81</sup> This creates two issues for a commercial hedger. *First*, the commercial hedger will be disqualified from claiming a *bona fide* hedge exemption under any such exemption that is subject to the requirements of the five day rule. *Second*, the commercial hedger will be disqualified from availing itself of conditional spot month limits. These negative impacts on commercial hedgers would appear to have no benefit in preventing excessive speculation.

**Proposed Solution:** The Commission should exempt trade options from federal speculative position limits.<sup>82</sup> Alternatively, the CFTC should expressly exclude trade options (*i.e.*, physical options) from the Reference Contract definition. Finally, clarify that, even though trade options are considered to be swaps as a legal matter, any commodity derivative contract used to hedge the risks associated with trade options should be granted *bona fide* hedging treatment.

## X. **SPOT MONTH LIMITS.**

### A. **Deliverable Supply.**

The Working Group supports the Commission's proposal to adopt alternative spot month speculative position limit levels as set forth in Table 9 of the Proposed Rule. As the CME has demonstrated, deliverable supply estimates currently used to determine spot month limits are based upon stale data and should be replaced by more up-to-date estimates. Accordingly, the

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<sup>79</sup> "Heat rate" is the efficiency at which a plant converts fuel into electricity. Davis W. Edwards, *Energy Trading & Investing: Trading, Risk Management, and Structuring Deals in the Energy Market* 9 (2010) (hereinafter "**Edwards**"); see also Betty Simkins and Russell Simkins, *Energy Finance: Analysis and Valuation, Risk Management, and the Future of Energy* 141 (2013) (describing "heat rate" as "the efficiency in converting the chemical energy of a fuel source into electrical energy"). Typically, heat rate is "expressed as a ratio of heat input to work output (for example, Btu/kWh or MMBtu/MWh)." Edwards at 9.

<sup>80</sup> The gas price may also include a basis to convert the Henry Hub price to a delivery point closer to the delivery location of the electricity.

<sup>81</sup> A particularly troubling situation would result if one party to a trade option faced a restriction on holding the transaction in the spot month, but its counterparty did not. Because the position cannot simply be traded out of, the parties would have to unwind, modify, or terminate the transaction. If only one party faced a speculative position limits compliance issue, then that party would be at a severe disadvantage in trying to unwind the transaction and likely would suffer economic harm as a result.

<sup>82</sup> Separately, the Working Group submits that the Commission should, when it finalizes its Interim Final Rule under Part 32, remove from Part 32 the cross-reference that makes trade options subject to federal speculative position limits.

Working Group requests the Commission to rely on CME's revised estimates of deliverable supply.

Pursuant to proposed CFTC regulation 150.2(e)(3), DCMs that list physical delivery Referenced Contracts would be required to submit to the Commission every two years deliverable supply estimates for those physical commodities. The Proposed Rule notes that the Commission will rely on a DCM's deliverable supply estimate unless it "determines to rely on its own estimate."<sup>83</sup> Given the importance of the deliverable supply determination in establishing workable spot month speculative position limits under the Proposed Rule, the process for determining deliverable supply should be fully transparent. The Working Group requests that the Commission provide any deliverable supply proposals for notice and comment.

### **B. Proposed Conditional Spot Month Limits.**

The Working Group supports the Proposed Rule's adoption of a higher spot month limit for cash-settled Referenced Contracts, as these contracts are clearly at a lower risk of manipulation. However, the Working Group believes it is important for the Commission to reconsider its proposal to condition this higher limit on a party holding no positions in physical delivery Referenced Contracts. This condition unfairly and inappropriately impacts commercial hedgers more than speculators.

- *First*, this condition would result in moving liquidity from the spot month period in the relevant physical delivery Referenced Contract to the cash-settled contract. To the extent this liquidity drain is harmful to energy and other commodity markets it will be disproportionately harmful to the hedgers that remain in the spot month contract to hedge legitimate commercial risk. Any drain in liquidity of the spot month contract threatens price convergence and the utility of the physical delivery Referenced Contract as a pricing tool.
- *Second*, commercial hedgers would have two choices: (i) they could move out of the spot month physical delivery Referenced Contract, leaving only speculators in that contract, or (ii) they could forego using the conditional limit, leaving speculators with a far greater percentage of the open interest. Neither result appears to prevent excessive speculation.
- *Third*, under the Proposed Rule, a commercial hedger that is a party to a trade option would not meet the conditional exemption as a trade option is a physical delivery Referenced Contract. The Working Group believes that this is an unintended consequence of the Proposed Rule.<sup>84</sup>

**Proposed Solution.** The Commission should impose an aggregate limit for spot month physical delivery and cash-settled CRFC equal to five times the spot month limit for the relevant

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<sup>83</sup> See proposed CFTC regulation 150.2(e)(3)(i).

<sup>84</sup> For further discussion of trade options see Section IX.

physical delivery CRFC (provided that a person could hold no greater than the spot month speculative limit in the physical delivery Referenced Contract). This limit should be applicable to all CRFCs.

## **XI. PROPOSED ANY AND ALL MONTH LIMITS.**

### **A. Before Implementing Non-Spot Month Limits, the Commission Should Find That They Are Necessary.**

The Proposed Rule states that no person may hold or control positions, net long or net short, in Referenced Contracts when such positions, in all months combined (including the spot month) or in a single, non-spot month, are in excess of specified position limits.<sup>85</sup> The Working Group submits that the Commission should determine whether Any and All Month Limits are necessary and whether they are justified under a cost-benefit analysis before it imposes them upon commodity markets.<sup>86</sup>

The historical issues that have been offered as a basis for proposing Any and All Month Limits have been addressed in other ways. Both the Farm Bill of 2008<sup>87</sup> and the Dodd-Frank Act eliminate the risk of the conduct of Amaranth Advisors L.L.C. liquidating regulated futures contracts and re-establishing an OTC position without limits. Moreover, exchange accountability levels provide for careful monitoring of any and all month positions. Finally, many agricultural products have operated without all month limits and without issue for many years. The Commission should re-evaluate whether Any and All Month Limits are truly necessary.

The Commission should also re-evaluate whether the Proposed Rule can satisfy a cost-benefit analysis. Under the Proposed Rule, Any and All Month Limits for the NYMEX NY Harbor ULSD (HO) and NYMEX RBOB Gasoline (RB) futures contracts are too low.<sup>88</sup> To justify these levels, the Commission states that, during 2011 and 2012 “[f]ew persons held positions over the levels of the proposed position limits . . . as illustrated in Table 11” (emphasis added).<sup>89</sup> Yet, in fact, in the HO contract, five unique entities would have exceeded the proposed

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<sup>85</sup> All months combined and single non-spot month limits are hereinafter referred to as the “**Any and All Month Limits.**”

<sup>86</sup> The Commission did not even include swap data in establishing the open interest figures that it used to calculate Any and All Month Limits even though those swap positions will be included in the limits. Swap data is available to the Commission and there is no justification for establishing a limit without including this data.

<sup>87</sup> See Food, Conservation, and Energy Act of 2008, Pub.L. 110-234, H.R. 2419, 122 Stat. 923 (May 22, 2008).

<sup>88</sup> Although the Proposed Rule does not establish federal speculative position limits for contracts in electricity, the Proposed Rule states that the Commission anticipates at a future date establishing federal limits applicable to such contracts. See Proposed Rule at 75,726. Because electricity contracts are less liquid, open interest for them consequently will be low. If the Commission determines to set Any and All Month Limits based on open interest, such limits likely will be set at inappropriately low levels.

<sup>89</sup> Proposed Rule at 75,731.

single month limit, and eight would have exceeded the proposed all month limit. In the NYMEX RB contract, seven unique entities would have exceeded the proposed single month limit, and eleven would have exceeded the proposed all month limit. In the context of the Proposed Rule, the Commission is obligated to do a more rigorous analysis before characterizing this as “few persons.”

Further, the Proposed Rule does not state how often these market participants would have exceeded those levels or by how much. The Proposed Rule also does not say how those potential exceedances were distributed along the price curve. Accordingly, there is no way to know how significant a reduction in liquidity would have occurred had those positions been removed from the market.<sup>90</sup> Without such information, market participants must conservatively assume that such a reduction in liquidity would be significant. The Proposed Rule also does not address whether the positions were calendar spreads, which have a lower risk profile than outright positions. Finally, the Proposed Rule does not suggest that there was any problem in market pricing as a result of those positions and, therefore, any benefit from prohibiting them.<sup>91</sup>

On the other hand, the Proposed Rule imposes three significant costs. *First*, the parties that carried those positions will lose the market opportunity experienced in holding the positions. *Second*, there will be an immediate reduction in liquidity along the curve if those parties must reduce their positions. There is a significant risk that the lost liquidity will have a material impact on efficient market operations as, in many energy products, liquidity across the curve is limited. *Third*, requiring a reduction in the positions of the affected market participants will reduce open interest, effectively reducing subsequent Any and All Month Limits. Such a scenario would generate a continuous downward cycle, each step of which will draw liquidity from the markets. The drawn liquidity is liquidity that will no longer exist to absorb the risk that commercial hedgers need to shed.

There are other issues with the proposed Any and All Month Limits. A common transaction in energy markets is a strip—a position in equal amounts, in the same market direction, across a period of time (often a calendar year). Under the Proposed Rule, a person could hold a speculative position in the spot month in the NYMEX RB futures contract of 1,000 lots (*i.e.*, the period of most concern from a speculative position limit perspective), but it could not hold a calendar strip of 1,000 lots (*i.e.*, positions in the spot month plus 11 other months across the curve) because the 12,000 lot position would exceed the all months combined limit. This conflict is exacerbated when one considers the alternative deliverable supply data offered by the CME for establishing spot month limits. If accepted, the spot month limit for the NYMEX RB futures contract could increase to 7,300 contracts, but a party could not maintain a position of that size in two non-spot months without exceeding the all months limit. Clearly this would be a restraint on non-spot month liquidity which would have an unnecessary impact on the

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<sup>90</sup> Table 11 provided in the Proposed Rule refers to “Unique Persons”. It is unclear whether that phrase refers to legal entities or aggregated affiliates. If the former, the data may be further understated. See Proposed Rule at 75,733.

<sup>91</sup> The CFTC notes that the “fundamental tenant in the Commission’s setting of speculative position limits is that such limits must be ‘based on the individual characteristics of a specific contract market . . . .’” *Revision of Federal Speculative Position Limits*, Proposed Rule, 57 Fed. Reg. at 12,770 (citing 52 Fed. Reg. at 6,815).

ability of commercial market participants to hedge their risk in non-spot months.

**B. The Commission Should Consider OTC Swap Data in Establishing Any Non-Spot Month Limits.**

The Proposed Rule sets initial non-spot month limits based on open interest for calendar years 2011 and 2012 in futures contracts, options thereon, and significant price discovery swap contracts.<sup>92</sup> The Proposed Rule states that the Commission is considering whether it should use swap data submitted under Part 20 of the CFTC's regulations or to the swap data repositories ("SDRs").<sup>93</sup>

The Commission notes in the Proposed Rule that any open interest in OTC swap Referenced Contracts would serve to increase the levels of the initial non-spot month limits.<sup>94</sup> Given speculative position limits will be applicable to Referenced Contracts in futures, options, and all swaps (which include trade options), the Working Group believes it is critical to use data submitted to the Commission or SDRs under Parts 20, 43, and 45 of its regulations on positions in cleared and uncleared swaps to set initial non-spot month limits.<sup>95</sup> The Commission recognized the importance of waiting for reliable OTC swap data when it adopted the Vacated Final Rule. There is no apparent reason why it should not have that data before finalizing the Proposed Rule.

**Proposed Solution:** The Commission should monitor any and all month positions through the use of accountability levels and not adopt the proposed Any and All Month Limits.

Alternatively, if the Commission re-evaluates the necessity of Any and All Month Limits and they survive a rigorous necessity and cost-benefit analysis, the Commission should adopt "any month limits" and not "all month limits." The any month limit could employ the "10, 2.5 percent formula" with an exception that for spread positions, a party could hold up to a limit calculated using a "10, 5 formula." This alternative has been successfully employed in several agricultural markets for years.

As a second alternative, if the Commission re-evaluates the necessity of Any and All Month Limits and determines to apply them, the Commission should adopt Any and All Month Limits that would include an any month limit calculated as in the first alternative above and an all month limit based on a "10, 5 formula." This alternative has also been successfully employed in several agricultural markets for years.

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<sup>92</sup> Proposed Rule at 75,730.

<sup>93</sup> *Id.* at 75,734.

<sup>94</sup> *Id.* at 75,730 n.423; *see* 17 C.F.R. §§ 20, 43 & 45 (2013).

<sup>95</sup> Such data also should include data on transactions entered into on foreign boards of trade.

## **XII. PROPOSED APPENDIX C, EXAMPLE 7 – AGGREGATION.**

Example 7 of Appendix C to the Proposed Rule addresses a “Sovereign hedge of unsold anticipated production,” but it raises an issue of aggregation that is of serious concern to the Working Group.

In short, the fact pattern of Example 7 to Appendix C is as follows: the Sovereign wants farmer to sell forward its anticipated production to User A at a fixed price. To encourage the farmer to do so, the sovereign provides the farmer with an option that will pay the farmer the excess, if any, of the market price at the time of delivery over the fixed price of the farmer’s contract with User A. The Sovereign then hedges its risk on the option with CBOT futures contracts and seeks to treat those futures contracts as a *bona fide* hedging position.

The narrative to Example 7 of Appendix C states that “[b]ecause the Sovereign 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.”<sup>96</sup> This statement suggests that one party to a transaction may need to aggregate its derivatives for position limit purposes with those of its *counterparty* because they may be deemed to be trading pursuant to an express or implied agreement. The Working Group disagrees with the Proposed Rule’s conclusion that the Sovereign and the farmer are “acting together pursuant to an express agreement,” and consequently does not believe the aggregation provisions should apply.

In this particular example, a Sovereign “induced” a farmer to sell forward to a third-party his expected production at a fixed price. To hedge its risk on the fixed-price sale, the farmer entered into an option with the Sovereign whereby the Sovereign agreed to pay the farmer the difference between the fixed-price under the sale contract and the market price at harvest (if that price was greater than the contract price). The Working Group submits that the Sovereign’s futures contracts constitute a *bona fide* hedging position under the pass-through exemption – the farmer entered into an option with the Sovereign that was a hedge against the farmer’s fixed-price contract with User A and the Sovereign hedged its risk on the option with futures contracts. In reality, this example has nothing to do with anticipated production.

More importantly, Example 7 of Appendix C does not identify any express or implied agreement by the Sovereign and the farmer to act together. The fact pattern describes bilateral transactions between: (1) the farmer and User A; (2) the farmer and the Sovereign; and (3) the Sovereign and CME Group (the clearinghouse for CBOT). The Sovereign and the farmer appear to have agreed to a bilateral option transaction as counterparties. Nothing in the fact pattern suggests the existence of any agreement – express or implied – that the farmer and the Sovereign will act together.

If this fact pattern was deemed to be sufficient to require aggregation, then there would be significant adverse consequences to routine commercial activities and it would do nothing to further the objective of preventing excessive speculation. At its extreme, Example 7 would

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<sup>96</sup> See Appendix C to proposed Part 150; Proposed Rule at 75,837.

suggest that any bilateral swap transaction between counterparties would constitute “acting pursuant to an express or implied agreement” and would require the parties to aggregate all of their respective derivative positions.<sup>97</sup> Guidance set forth under Example 7 of Appendix C would also seem to require aggregation in the following standard commercial situations.

- Transactions by Commercial Entities with Swap Dealers. The example would suggest that, where a commercial firm employs the services of a swap dealer to construct a swap transaction to hedge the commercial firm’s risk, the commercial firm would need to aggregate its positions with those of the swap dealer.
- Infrastructure Project Development. In a standard infrastructure project a lender may require the project developer to hedge commodity prices and interest rates. If the lender or its affiliate provides the hedge, Example 7 seems to suggest that it is acting pursuant to an express or implied agreement with the project developer and that they would be obliged to aggregate their positions.
- Asset Management Agreements (“AMA”). An AMA that is structured in accordance with FERC requirements in which Utility A releases storage, transportation, and supply contracts to Marketer B will typically provide that (i) Marketer B will provide all of Utility A’s commodity requirements, (ii) Marketer B will engage in commercial transactions (selected without the knowledge of or approval from Utility A) involving the released storage, transportation, and supply contracts, and (iii) the profit (if any) generated from those commercial transactions will be shared between Marketer B and Utility A. Example 7 seems to suggest that Utility A and Marketer B are acting pursuant to an express or implied agreement and that they would be obliged to aggregate their positions.
- Energy Management Service (“EMS”) Agreements. An EMS where the EMS provider, in addition to providing traditional energy management services such as scheduling and load forecasting, enters into bilateral swaps with the EMS customer, at the customer’s request, to hedge the customer’s commodity price risk.

**Proposed Solution:** The Commission should clarify that the parties’ positions in Example 7 of Appendix C and in the other examples set forth above do not constitute acting pursuant to an express or implied agreement and do not require aggregation of the derivatives in question.

### **XIII. REPORTING REQUIREMENTS.**

The Working Group appreciates the Commission’s determination to include the proposed

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<sup>97</sup> Importantly, the proposed aggregation rules do not recognize any type of limited aggregation such as pro rata aggregation, so it appears that the two parties would have to aggregate *all* derivative positions that each holds along with any positions held by other entities with which each party is required to aggregate. The Working Group submits that the Commission could not have intended this result.

“Series ‘04” reports (*i.e.*, Forms 204, 304, 504, 604, and 704) (“**Forms**”) in the Proposed Rule. Because market participants have an opportunity to review the proposed Forms, they are better equipped to provide appropriate and meaningful comment on such Forms.

**A. Form 204.**

The Working Group supports the Form 204 requirement to file *bona fide* hedging positions and related cash market activity on a monthly rather than daily basis. However, Form 204 requests specific information relating to a market participant’s *bona fide* hedges and related cash market activity. When verifying the accuracy of the specific information requested by Form 204, a market participant may need to report a “best efforts” estimate of actual physical stocks and fixed-price contracts at a given point in time, since the actual data may be difficult, if not impossible, to discern due to the dynamic nature of physical energy commodities. If this estimate of physical activity does not otherwise impact a market participant’s *bona fide* hedge exemption (*i.e.*, cause the market participant to lose the exemption), the market participant should not be penalized for its effort to provide the closest approximation of actual physical product.

**Proposed Solution:** The Commission should adopt a good-faith standard that provides market participants with a reasonable degree of flexibility when verifying the accuracy of Form 204 submissions.

Further, Section A (first column) of Form 204 requires a market participant to identify a particular enumerated *bona fide* hedging position that would apply to the participant’s positions in Referenced Contracts needing *bona fide* hedging treatment. The Working Group submits that participants in the energy commodity markets often hedge on a portfolio basis, and would not be able to identify a particular enumerated *bona fide* hedging position.

**Proposed Solution:** The Working Group recommends that the Commission (i) eliminate the first column in Section A, (ii) make it optional, or (iii) as stated above, adopt a good-faith standard that provides market participants with a reasonable degree of flexibility when verifying the accuracy of Form 204 submissions.

Finally, Section A (third column) of Form 204 also requires a market participant to submit the “commodity derivative contract or Referenced Contract used for hedging.” The proposed federal speculative position limits apply only to a commodity derivative contract that is a Referenced Contract. Thus, the exemption for *bona fide* hedging positions would not be necessary for commodity derivative contracts that are not Referenced Contracts.

**Proposed Solution:** The Working Group recommends the language in the third column of Section A of Form 204 be revised as follows:

~~Commodity Derivative Contract (CDC) or~~ Referenced Contract (RC) used for Hedging.

**B. Form 504.**

A person claiming a conditional spot month limit exemption must report purchases and

sales contracts through the delivery area for the CRFC and inventory in the delivery area on Form 504 daily, by 9 AM Eastern Time on the next business day, for each day that the person exceeds the spot month limit.<sup>98</sup> Form 504 also requires a market participant to submit data on cash market data. The Working Group submits that this requirement is inappropriate as (i) such data is similar to the data required by Form 204, and (ii) commercial hedgers would be disproportionately burdened compared to speculators who would have no cash market positions to report. Thus, if such requirement was adopted, the costs and burdens associated with the requirement would outweigh the benefits, if any.

**Proposed Solution:** The Working Group initially notes that it has recommended that the Commission drop the condition to the proposed spot month limit.<sup>99</sup> Should the Commission adopt the Working Group's recommendation, Form 504 would no longer be required.

However, if the Commission determines to adopt the condition exemption as proposed, the Working Group recommends that Form 504 simply require an affirmative representation from market participants availing themselves of the conditional exemption that they do not hold any physical delivery Referenced Contracts.

The Working Group reserves its right to supplement its comments addressing the proposed Forms as it deems necessary and appropriate.

#### **XIV. OTHER DEFINITIONAL CONCERNS.**

##### **A. Eligible Affiliates.**

The Commission has requested comment on the proposed definition of "eligible affiliate" set forth in proposed CFTC regulation 150.1. As the Commission notes, the Proposed Rule's definition of eligible affiliate differs from the definition under CFTC regulation 50.52(a).<sup>100</sup> The

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<sup>98</sup> Initially, the CFTC proposes to require reporting on proposed Form 504 for a conditional spot month limit exemption only in the natural gas commodity derivative contracts. The CFTC at a later date may require reporting on Form 504 for other commodity derivative contracts. The Working Group's concerns and proposed solution apply in the natural gas context as well as in the context of other commodities.

<sup>99</sup> See Section VII.B, above, for a more thorough discussion of the Working Group's recommendation to establish an aggregate limit for spot month physical delivery and cash-settled Referenced Contracts rather than a conditional exemption for cash-settled Referenced Contracts.

<sup>100</sup> CFTC regulation 50.52(a) provides:

§ 50.52 Exemption for swaps between affiliates.

(a) *Eligible affiliate counterparty status.* Subject to the conditions in paragraph (b) of this section:

(1) Counterparties to a swap may elect not to clear a swap subject to the clearing requirement of section 2(h)(1)(A) of the Act and this part if:

(i) One counterparty, directly or indirectly, holds a majority ownership interest in the other counterparty, and the counterparty that holds the majority interest in the other counterparty reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of the majority-owned counterparty; or

principal difference in the two rules is that while CFTC regulation 50.52(a) includes as eligible affiliates two subsidiaries of a common parent (“**Sister Companies**”), the Proposed Rule would not. In as much as holding company structures commonly include Sister Companies that would be aggregated for position limit purposes under proposed Commission Regulation 150.4, the Working Group sees no regulatory benefit or other reason to exclude them from the definition of eligible affiliate under the Proposed Rule.

**Proposed Solution:** The Commission should adopt the definition of “eligible affiliate” contained in CFTC regulation 50.52(a).

## **B. Referenced Contracts.**

At the CFTC public meeting on November 5, 2013, addressing the adoption of the Proposed Rule, senior DMO staff testified that staff had identified approximately 464 cleared Referenced Contracts subject to the proposed federal speculative position limits.<sup>101</sup> The Commission subsequently published on its web site DMO’s list of cleared Referenced Contracts. The Working Group appreciates the Commission’s efforts and decision to make publically available this list of Referenced Contracts.

In order to effectively implement and comply with the requirements of the Proposed Rule, the Working Group believes that both the Commission and market participants should have a common understanding of the universe of Referenced Contracts subject to federal speculative position limits. Without a common understanding, the broad and vague language defining the term “Referenced Contract” could lead to subjective and inconsistent interpretations by market participants seeking to comply with the Proposed Rule and similarly inconsistent enforcement actions by the Commission. Lack of uniformity is not in the public interest.

**Proposed Solution:** To facilitate a common understanding and uniformity among industry participants and the Commission, the Working Group requests that the Commission publish a comprehensive and exclusive list of exchange-listed contracts that specifically identifies which of the exchange-listed contracts are Referenced Contracts for purposes of the

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(ii) A third party, directly or indirectly, holds a majority ownership interest in both counterparties, and the third party reports its financial statements on a consolidated basis under Generally Accepted Accounting Principles or International Financial Reporting Standards, and such consolidated financial statements include the financial results of both of the swap counterparties.

(2) For purposes of this section:

(i) A counterparty or third party directly or indirectly holds a majority ownership interest if it directly or indirectly holds a majority of the equity securities of an entity, or the right to receive upon dissolution, or the contribution of, a majority of the capital of a partnership; and

(ii) The term “eligible affiliate counterparty” means an entity that meets the requirements of this paragraph.

<sup>101</sup> Public Meeting, CFTC Transcript at p. 48-49, Nov. 5, 2013, (testimony of Steve Sherrod, DMO), *available at* [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission\\_110513-trans.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfs submission/dfs submission_110513-trans.pdf). The Working Group recognizes that Commission staff is unable to identify bespoke, uncleared commodity derivative contracts transacted in privately-negotiated markets that would fall within the Referenced Contract definition.

federal speculative position limits.

### **C. Basis Contracts.**

The Working Group generally supports the Proposed Rule's definition of basis contract<sup>102</sup> and the Commission's determination to exempt these contracts from the Referenced Contract definition (and consequently the federal speculative position limits). Further, the Working Group appreciates the Commission's decision to include an appendix listing commodities that it believes are substantially the same for purposes of the basis contract definition.

The Working Group reserves the right to supplement these comments and submit any additional comments on the scope of Appendix B and the definition of basis contract.

## **XV. COMMODITY TRANSACTIONS PRICED AS A DIFFERENTIAL TO A REFERENCE PRICE.**

Energy commodities are bought and sold at fixed price far less frequently than at an index or floating price.<sup>103</sup> Very frequently, differences in location, grade and quality are embedded in the pricing term of the transaction as differentials to a liquid and reliable index or floating price. For example, sour crude may be transacted at a price based on an index of sour crude prices or at a price of NYMEX CL futures contract plus or minus a fixed differential; finished gasoline may be transacted at a price based on an index of finished gasoline prices or at a price of NYMEX RB futures contract plus or minus a fixed differential; and power may be transacted at a price based on an index of power prices or at a price of NYMEX NG futures contract multiplied by a fixed factor. While the reference price floats and, therefore, would not generally present a price risk that would qualify for a *bona fide* hedge exemption under the Proposed Rule, the fixed differential is, in fact, fixed and the parties to the transaction are at risk of the market value of the differential increasing or decreasing prior to delivery. In such cases the parties may justifiably seek to hedge that risk even as they allow the floating portion of the price (*i.e.*, the index) to continue to float. The hedged risk of the differential changing should be considered a *bona fide* hedge position.

<sup>102</sup> Proposed CFTC regulation 150.1 defines "basis contract" as—

A commodity derivative contract that is cash-settled based on the difference in: (1) the price, directly or indirectly, of: (a) a particular core referenced futures contract; or (b) a commodity deliverable on a particular core referenced futures contract, whether at par, a fixed discount to par, or a premium to par; and (2) the price, at a different delivery location or pricing point than that of the same particular core referenced futures contract, directly or indirectly, of: (i) a commodity deliverable on the same particular core referenced futures contract, whether at par, a fixed discount to par, or a premium to par; or (ii) a commodity that is listed in Appendix B to part 150 as substantially the same as a commodity underlying the same core referenced futures contract.

Proposed Rule at 75,823.

<sup>103</sup> Spot and term oil can be sold on a fixed price basis or on a floating basis. Floating sales are overwhelmingly the norm and buyers and sellers agree to link the price to an instrument that rises and falls with the market. Buyers and sellers generally prefer floating price deals to fixed because it is less risky. In this respect, floating price mechanisms generally allow companies more flexibility in risk management, and more flexibility in optimizing purchases and sales. *See The Structure of Oil Markets: Background*, Platts at 4-5 (June 2010).

The Commission generally recognizes the principle described above. In the context of a location differential, the Commission recognizes the right to use a basis contract to hedge the differential. Because basis contracts are excluded in the context of position limits, even where one leg of the basis contract is a Referenced Contract and the other is not, neither would count against position limits. Likewise, in the context of a timing differential, subsection (4)(ii) of the proposed definition of “*bona fide* hedging position” would allow the market participant to claim a hedge exemption for the differential between the timing of the purchase and the sale.

However, in certain situations common to the energy industry, the Proposed Rule would require a commercial market participant to treat as a speculative position a leg of a transaction that hedged a fixed price differential. Continuing the examples from above:

- a market participant that bought sour crude oil at a fixed differential to NYMEX CL futures contract would have an opportunity to hedge the differential by entering into a short position in a commodity derivative contract on an index of sour crude prices and a long position in the NYMEX CL futures;
- a market participant that bought finished gasoline at a fixed differential to NYMEX RB futures contract would have an opportunity to hedge the differential by entering into a short position in a commodity derivative contract on an index of finished gasoline prices and a long position in NYMEX RB futures contract; and
- a market participant that bought power at a fixed differential to NYMEX NG futures contract would be able to hedge the differential by entering into a short position in a commodity derivative contract on a power index and a long position in NYMEX NG futures contract.

The Working Group believes that each such hedge should be exempt from, or should not count against, speculative position limits, whether done as a single transaction (which under the Proposed Rule would not be a basis contract, but would be an intercommodity spread with one Referenced Contract leg) or as two transactions (one of which would be a Referenced Contract). The single-transaction hedge can be given appropriate treatment and not count against speculative position limits by treating it as a basis contract is treated – *i.e.*, not included in position limits. The two-transaction hedge can be given appropriate treatment and not count against position limits by allowing the Referenced Contract transaction to be treated as a *bona fide* hedging exemption from the speculative position limits.

In a similar manner, a market participant may need to enter two transactions to hedge a location differential where no basis contract exists or has sufficient liquidity to satisfy its needs. In such a case, for example, a market participant may need to enter a long position in the NYMEX NG futures contract and a short commodity derivative contract reflecting an index of Transco Zone 6 pricing. While there would be no speculative position limits impact if the market participant had entered a Transco Zone 6 basis transaction, by doing two legs the market participant would have a long position in NYMEX NG futures contract which is not offset by the commodity derivative contract position reflecting an index of Transco Zone 6 pricing (which is

not a Referenced Contract). The Working Group believes any final speculative position limits rule should rectify this anomaly.

**Proposed Solution:** The Commission should expand subsection (3) of the definition of “*bona fide* hedging position” set forth in proposed CFTC regulation 150.1, as follows:

**(xi) Commodity Transactions Priced as Differentials. Long and short positions in Referenced Contracts (including long and short positions embedded in a single spread contract) that hedge a differential between locations, grades or qualities of two or more commodities, or, in the case of electricity commodities, a differential between the electricity commodity and a fuel source such as natural gas, that arises from a fixed price differential in one or more transactions in a commodity.**

## **XVI. OTHER ISSUES.**

### **A. Timing of Implementation.**

The Working Group requests that the Commission establish a compliance date for any final speculative position limits rule adopted in this proceeding nine months from the date that such rule is published in the *Federal Register*. The vacated Part 151 regulations were finalized on November 18, 2011, but would not have gone into effect until October 12, 2012. Most commercial firms were nearing full readiness for implementation when the Part 151 regulations were vacated on September 28, 2012 (over 10 months after adoption). Although the Proposed Rule has many similarities with the vacated Part 151 regulations, there are significant differences which will require systems and other operational work that is quite different from those previously undertaken.

Additionally, the Working Group submits that implementing the new position limits even on an “end of day” basis will prove challenging for market participants, and intraday limits will be even more difficult to implement. Under the proposed rule, for the first time, position limits will be applied to uncleared transactions. The aggregation of the positions of multiple affiliates for position limits monitoring poses significant technical issues as well, especially if the monitoring has to be virtually instantaneous. Intraday compliance for spot month exchange-set limits on cleared transactions is feasible when the rule becomes effective. However, the Commission should not require intraday compliance with any speculative position limits, other than exchange-set spot month limits, for at least twelve months from the date the final rule is published in the *Federal Register*. This will provide market participants with adequate time to test and develop systems.

**Proposed Solution:** The Commission should, at the earliest, establish a compliance date nine months after the date on which the final rule is published in the *Federal Register* for the general position limits regime and intraday compliance for spot month cleared transactions. Intraday compliance with any speculative position limits, other than exchange-set spot month limits, should be required, at the earliest, twelve months from the date the final rule is published in the *Federal Register*.

## **B. SEF Limits.**

Under the Proposed Rule, Regulated Exchanges must adopt and enforce spot month and non-spot month speculative position limits for all contracts traded thereon. DCM limits work because all of a DCM's contracts are cleared and they are all cleared at a single DCO. The Working Group questions how this would operate in the SEF context. Specifically, SEFs are essentially execution platforms and not repositories of trades. Some trades executed on a SEF could be cleared and others not cleared. In addition, virtually all voice brokers are now SEFs. It is unclear what limit a SEF, particularly a voice broker SEF, could effectively establish. It is also unclear how the execution limit would work if a party had offsetting existing positions that had been established through another SEF. If the Commission establishes swap limits at the DCO level, it will face the added complication that cleared swaps may be offset by uncleared swaps.

**Proposed Solution:** The Commission should exercise its authority under CEA Section 4a(a)(7) to exempt SEFs, particularly voice broker SEFs, from the requirement to implement speculative position limits.

## **C. Pass-Through Exemption.**

### **1. Central Hedging Affiliate.**

The pass-through exemption, as proposed, allows an entity that serves as counterparty to an end-user entering into a *bona fide* hedging position an exemption for both the swap executed by the end-user and the instrument that the counterparty uses to hedge that risk. In some cases, the end-user's counterparty may be a member of a corporate family that uses a central hedging affiliate to manage and hedge all of its risks. In this case the entity that serves as counterparty to the end-user might transfer that risk to its hedging affiliate, who in turn would hedge the risk in the market (perhaps through a futures contract). In this situation, it is not clear that the central hedging affiliate's futures transaction would qualify for the pass-through exemption. However, it should qualify because the net result on the market is no different than if the original counterparty had hedged the risk in the market itself.

**Proposed Solution:** The Commission should clarify that within an aggregated group of companies, the pass-through exemption will remain intact and will be applicable to inter-affiliate transactions as well as transactions in which some member of the aggregated group hedges the risk with a third-party counterparty.

### **2. Good-Faith Representation.**

Like the Vacated Final Rule, a market participant relying on a *bona fide* hedge exemption under a pass-through swap must obtain from its counterparty a representation that the swap, in the counterparty's good-faith belief, qualifies as a "*bona fide* hedging position" as defined in proposed CFTC regulation 150.1. This written representation may be, for example, in the form of a field or other representation contained in an executed trade confirmation. Additionally, the representation must be obtained at the inception (*i.e.*, execution) of the swap.

Melissa Jurgens, Secretary

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The Working Group generally supports the exemption for pass-through swaps as proposed. More specifically, the Working Group supports the requirement that a *bona fide* hedger must make only a good-faith representation that a particular swap qualifies as a *bona fide* hedging position.

**Proposed Solution:** The Working Group requests the Commission to confirm that if a swap qualifies as a *bona fide* hedging position and is subsequently determined not to be a *bona fide* hedging position, the counterparty transacting opposite the *bona fide* hedger and relying on such good-faith representation will not be penalized for violating an applicable position limit as a result of the mischaracterization of the swap.

**XVII. CONCLUSION.**

The Working Group supports appropriate regulation that brings transparency and stability to the physical commodity and derivatives markets. The Working Group appreciates this opportunity to provide comments on the Proposed Rule and requests that the Commission consider the comments and adopt the proposed solutions set forth herein as it develops any final rules in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate. If you have any questions, please contact the undersigned.

Respectfully submitted,

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**ATTACHMENT NO. 1**

Attachment No. 1  
Comments of The Commercial Energy Working Group  
February 10, 2014

Names of Individual Grades or Commodities	Physical Pricing Series	NYMEX CL Futures (WTI)	Correlation Percentage	ICE Brent Futures (B)	Correlation Percentage	Product is deliverable against a NYMEX Physically Settled Futures Contract? Y/N
<b>Commodity Group: Crude Oil 33 Grades</b>						
ALASKAN NORTH SLOPE CRUDE OIL	Crudes Platts ANS (Calif.) Mid Daily bbl Dollars PCAAD00c Mid	x	92.9%	x	79.2%	NO
AZERI CRUDE OIL	Crudes Argus Azeri Light Mid Daily bbl Dollars GCAZLTCLC Mid	x	61.0%	x	71.7%	NO
BAKKEN NORTH DAKOTA	Crudes Platts Bakken Blend Ex-Clearbrook Mid Daily bbl Dollars AASRU00c Mid	x	79.2%	x	63.7%	NO
BASRAH LIGHT CRUDE OIL	Crudes Argus USG Basrah Light Houston close Mid Daily bbl Dollars GCBASLTHC Mid	x	63.5%	x	69.7%	NO
BONGA	Crudes Argus Bonga Mid Daily bbl Dollars GC5577A0C Mid	x	61.4%	x	72.0%	NO
BONITO CRUDE OIL	Crudes Platts Bonito Mid Daily bbl Dollars PCAIE00c Mid	x	81.3%	x	81.8%	NO
CAN COLD LAKE	Crudes Platts Canadian Cold Lake Blend Mid Daily bbl Dollars AASZX00c Mid	x	69.6%	x	59.1%	NO
CAN LLOYD BLEND	Crudes Platts Canadian Lloyd Blend Mid Daily bbl Dollars AALRK00c Mid	x	70.3%	x	59.8%	NO
CAN MIXED SWEET BLEND	Crudes Platts Canadian Mixed Sweet Mid Daily bbl Dollars AALRR00c Mid	x	75.2%	x	62.9%	NO
CAN SYNCRUDE	Crudes Platts Canadian Syncrude Sweet Blend Mid Daily bbl Dollars AASOK00c Mid	x	67.7%	x	56.2%	NO
CAN WESTERN CANADIAN SELECT	Crudes Platts WCS Hardisty Canada Mid Daily bbl Dollars AAPPN00c Mid	x	70.2%	x	59.8%	NO
CASTILLA BLEND CRUDE OIL	Crudes Platts Castilla Blend Mid Daily bbl Dollars AAVEQ00c Mid	x	88.2%	x	84.9%	NO
EKOFISK CRUDE OIL	Crudes Argus Ekofisk London 17:30 Mid Daily bbl Dollars GC073\$A\$C Mid	x	61.2%	x	72.2%	NO
ENTERPRISE EAGLE FORD CRUDE OIL	<b>Not Available for 36 Months</b>	x	NA	x	NA	NO
ESCALANTE CRUDE OIL	Crudes Platts Escalante Mid Daily bbl Dollars PCAGC00c Mid	x	88.4%	x	84.1%	NO
ESCRAVOS CRUDE OIL	Crudes Argus Escravos London 17:30 Mid Daily bbl Dollars GC119L1\$C Mid	x	61.5%	x	72.1%	NO
EUGENE ISLAND CRUDE OIL	Crudes Platts Eugene Island Mid Daily bbl Dollars PCAFC00c Mid	x	81.1%	x	81.5	NO
FLINT HILLS SOUTH TEXAS SWEET	<b>No Reliable Pricing Series Available</b>	x	NA	x	NA	NO
FORTIES CRUDE OIL	Crudes Argus Forties London 17:30 Mid Daily bbl Dollars GC074\$A\$C Mid	x	60.0%	x	70.8%	NO
HEAVY LOUISIANA SWEET	Crudes Argus USG HLS Houston close FIP 1st month Mid Daily bbl Dollars GC019E1\$C Mid	x	83.6%	x	80.6%	NO
KIRKUK CRUDE OIL	Crudes Platts Kirkuk Mid Daily bbl Dollars AAEJD00c Mid	x	61.0%	x	71.7%	NO
LOUISIANA LIGHT SWEET	Crudes Argus USG LLS Houston close FIP 1st month Mid Daily bbl Dollars GC028J1\$C Mid	x	85.3%	x	81.5%	NO
MARS CRUDE OIL	Crudes Argus USG Mars Houston close FIP 1st month Mid Daily bbl Dollars GCMARS1\$C Mid	x	86.6%	x	84.4%	NO
ORIENTE CRUDE OIL	Crudes Argus Oriente Houston Mid bbl Dollars GC071EC\$C Mid	x	91.5%	x	79.6%	NO
OSEBERG CRUDEOIL	Crudes Argus Oseberg London 17:30 Mid Daily bbl Dollars GC211\$A\$C Mid	x	61.2%	x	72.1%	NO
POSEIDON CRUDE OIL	Crudes Argus Poseidon Mid Daily bbl Dollars GCPOSE1\$C Mid	x	83.7%	x	81.5%	NO
QUA IBOE CRUDE OIL	Crudes Argus Qua Iboe London 17:30 Mid Daily bbl dollars GC206&TGC Mid	x	61.5%	x	72.2%	NO
SAHARAN CRUDE OIL	Crudes Platts Saharan Blend Mid Daily bbl Dollars AAGZY00c Mid	x	61.9%	x	72.6%	NO
SOUTHERN GREEN CANYON	Crudes Argus USG Southern Green Canyon Houston close FIP 1st month Mid Daily bbl Dollars GCDHC551C Mid	x	83.9%	x	81.6%	NO
THUNDER HORSE CRUDE OIL	<b>Not Available for 36 Months</b>	x	NA	x	NA	NO
URALS CRUDE OIL	Crudes Argus Urals Med London 17:30 Mid Daily bbl Dollars GC043\$A\$C Mid	x	60.8%	x	71.4%	NO
VASCONIA CRUDE OIL	Crudes Platts Vasconia Mid Daily bbl Dollars PCAGI00c Mid	x	87.8%	x	85.9%	NO
WEST TEXAS SOUR MIDLAND	Crudes Argus US Midcontinent WTS Houston close FIP 1st month Mid Daily bbl Dollars GC046C1\$C Mid	x	81.5%	x	64.8%	NO

The correlations for Crude Oil and Refined Products are based on the closing prices of the CRFCs compared to the midpoints of the daily physical price assessments from Platts, Argus and OPIS over a 36 month period.

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Comments of The Commercial Energy Working Group  
February 10, 2014

Names of Individual Grades or Commodities	Physical Pricing Series	NYMEX CL Futures (WTI)	Correlation Percentage	ICE Brent Futures (B)	Correlation Percentage	NYMEX RBOB (RB)	Correlation Percentage	NYMEX Heating Oil (HO)	Correlation Percentage	Product is deliverable against a NYMEX Physically Settled Futures Contract? Y/N
<b>Commodity Group: Residual Fuel Oil and Vacuum Gas Oil 13 Grades</b>										
FUEL OIL 180 CST	Bunkers Argus HSFO 180 CST Houston Mid Daily MT Dollars GPFCHOSHC Mid	x	39.5%	x	36.1%					NO
FUEL OIL 380 CST	Bunkers Platts FO-380 CST Houston Mid Weekly MT Dollars PUAES00c Mid	x	68.7%	x	69.3%					NO
FUEL OIL BLEND	<b>No Reliable Pricing Series Available</b>	x	NA	x	NA					NO
fuel oil max S 1.0% RMG 380	Bunkers Platts FO-380 CST (1%) Rotterdam Mid Daily MT Dollars AASTY00c Mid	x	52.4%	x	60.7%					NO
HIGH SULPHUR VGO - GENERIC.	Products OPIS Gulf Coast VGO (HS) Cargo Mid Daily GAL Cents Gulf Coast/VGO (HS) Cargo/M Mid	x	84.6%	x	76.7%	x	63.7%	x	74.9%	NO
HSFO 180 CST	Bunkers Platts HSFO 180 CST Rotterdam Mid Weekly MT Dollars PUADN00c Mid	x	55.4%	x	64.2%					NO
LOW SULFUR STRAIGHT RUN FUEL OIL	<b>No Reliable Pricing Series Available</b>	x	NA	x	NA	x	NA	x	NA	NO
LOW SULPHUR VGO - GENERIC	Products OPIS Gulf Coast VGO (LS) Cargo Mid Daily GAL Cents Gulf Coast/VGO (LS) Cargo/M Mid	x	86.3%	x	79.1%	x	66.5%	x	77.8%	NO
M-100 HIGH SULPHUR FUEL OIL	<b>No Reliable Pricing Series Available</b>	x	NA	x	NA	x	NA	x	NA	NO
NO. 6 OIL 1.0	Products Platts NYH No.6 1% Cargoes Mid Daily bbl Dollars PUAEO00c Mid	x	76.3%	x	84.5%					NO
NO. 6 OIL 3.0	Products Platts USG No.6 3.0% Mid Daily bbl Dollars PUAFZ00c Mid	x	77.4%	x	85.7%					NO
No. 6 Oil 3.5	Products Platts USG No.6 3.5% Mid Daily bbl Dollars PUBDM00c Mid		77.2%		85.4%					NO
SLURRY OIL	Products Platts USG No.6 Slurry Oil Mid Daily bbl Dollars PPAPW00c Mid	x	77.4%	x	85.2%					NO
<b>Commodity Group: Petrochemicals 3 Grades</b>										
Benzene	Chemicals Platts Benzene USGC (Prompt) Mid Daily gal Cents PHAAE00c Mid	x	37.9%	x	34.8%	x	29.0%			NO
Toluene	Chemicals Platts Toluene (NITN) USGC (prompt) Mid Weekly gal Cents PHAAR00c Mid	x	34.3%	x	34.4%	x	30.0%			NO
Xylenes	Chemicals Platts Xylene (Virgin) Rotterdam Spot Mid Weekly MT Dollars PHABD00c Mid	x	3.9%	x	4.3%	x	1.7%			NO
<b>Commodity Group: Distillates Including Jet Fuel 7 Grades</b>										
CARB DIESEL	Products OPIS Los Angeles Carb No2 Mid Daily GAL Cents Los Angeles/Carb No2/M Mid							x	92.4%	NO
JET 54	Products Platts USG Jet/Kero (54 grade) Pipeline Mid Daily gal Cents PJABO00c Mid							x	92.2%	NO
JET 55	Products Platts USG Jet/Kero (55 grade) Pipeline Mid Daily gal Cents PJABP00c Mid							x	92%	NO
LIGHT CYCLE OIL	Products Argus USG Light Cycle Oil 0.5% Mid Daily gal Cents GP5488A0C Mid							x	92.7%	NO
NO. 2 OIL	Products Platts USG No.2 Pipeline Mid Daily gal Cents POAED00c Mid							x	93.5%	NO
OFF ROAD DSL LOW SULPHUR	Products Platts USG LS Diesel (off-road) Pipeline Mid Daily gal Cents AATGS00c Mid							x	76.0%	NO
ULSD	Products Argus USG ULSD Pipeline Mid Daily gal Cents GPUSP319C Mid							x	97%	NO
<b>Commodity Group: Naphtha 5 Grades</b>										
Naphtha	Products Platts USG Naphtha Mid Daily gal Cents PAAAC00c Mid	x	46.0%	x	53.1%	x	58.4%			NO
Northwest Europe Naphtha	Products Platts NWE Naphtha CIF ARA Mid Daily MT Dollars PAAAL00c Mid			x	63.3%	x	51.5%			NO
Northwest Europe Paraffinic Naphtha	Products Argus NWE Naphtha 65 para FOB Barges Mid Daily MT Dollars GPNANESBC Mid	x	52.3%	x	60.8%	x	49.3%			NO
Rotterdam Barges Naphtha	Products Platts Rotterdam Naphtha FOB Barges Mid Daily MT Dollars PAAAM00c Mid	x	55.0%	x	63.3%	x	51.5%			NO
USGC Paraffinic Naphtha	Products Argus USG Naphtha 70 min Paraffin Mid Daily MT Dollars GPNAGCLBC Mid	x	59.4%	x	63.5%	x	56.2%			NO

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Names of Individual Grades or Commodities	Physical Pricing Series	NYMEX RBOB (RB)	Correlation Percentage	Product is deliverable against a NYMEX Physically Settled Futures Contract? Y/N
<b>Commodity Group: Gasoline &amp; Components</b>	<b>44 Grades</b>			
PBOB-H1 Premium RBOB	Products Argus New York Harbor Pbob Gasoline 91.3 RBOB NYH barge Houston close BARGE Mid Daily gal Cents GPUSP213C Mid	x	85.7%	YES
PBOB-H2	Products Argus New York Harbor Pbob Gasoline 91.3 RBOB NYH barge Houston close BARGE Mid Daily gal Cents GPUSP213C Mid	x	85.7%	YES
PBOB-H3	Products Argus New York Harbor Pbob Gasoline 91.3 RBOB NYH barge Houston close BARGE Mid Daily gal Cents GPUSP213C Mid	x	85.7%	YES
PBOB-H4	Products Argus New York Harbor Pbob Gasoline 91.3 RBOB NYH barge Houston close BARGE Mid Daily gal Cents GPUSP213C Mid	x	85.7%	YES
PBOB-H5	Products Argus New York Harbor Pbob Gasoline 91.3 RBOB NYH barge Houston close BARGE Mid Daily gal Cents GPUSP213C Mid	x	85.7%	YES
CBOB	Products Platts NYH cbob 9.0 RVP Barges Mid Daily gal Cents AAWBL00c Mid	x	83.1%	NO
CBOB-A1 Regular CBOB	Products Platts USG cbob 87 7.8 Mid Daily gal Cents AARQU00c Mid	x	74.8%	NO
CBOB-A2	Products Platts USG cbob 87 7.8 Mid Daily gal Cents AARQU00c Mid	x	74.8%	NO
CBOB-A3	Products Platts USG cbob 87 7.8 Mid Daily gal Cents AARQU00c Mid	x	74.8%	NO
CBOB-A4	Products Platts USG cbob 87 7.8 Mid Daily gal Cents AARQU00c Mid	x	74.8%	NO
CBOB-A5	Products Platts USG cbob 87 7.8 Mid Daily gal Cents AARQU00c Mid	x	74.8%	NO
CBOB-D2 Premium CBOB	Products Platts USG cbob 93 7.8 Mid Daily gal Cents AARQV00c Mid	x	62.9%	NO
CBOB-D2	Products Platts USG cbob 93 7.8 Mid Daily gal Cents AARQV00c Mid	x	62.9%	NO
CBOB-D3	Products Platts USG cbob 93 7.8 Mid Daily gal Cents AARQV00c Mid	x	62.9%	NO
CBOB-D4	Products Platts USG cbob 93 7.8 Mid Daily gal Cents AARQV00c Mid	x	62.9%	NO
CARBOB	Products OPIS Los Angeles CARBOB-R Mid Daily GAL Cents Los Angeles CARBOB-R M Mic	x	56.4%	NO
RBOB-F1 RBOB	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F1	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F2	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F2	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F3	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F4	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F4	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
RBOB-F5	Products Platts USG rbob 83.7 7.0 Mid Daily gal Cents AAMFB00c Mid	x	74.8%	YES
UNL 87 OCT M1 Colonial Regular Gasoline	Platts USG UNL 87 7.8 Pipeline Mid Daily gal Cents PGACT00c Mid	x	74.7%	NO
UNL 87 OCT M2	Platts USG UNL 87 7.8 Pipeline Mid Daily gal Cents PGACT00c Mid	x	74.7%	NO
UNL 87 OCT M3	Platts USG UNL 87 7.8 Pipeline Mid Daily gal Cents PGACT00c Mid	x	74.7%	NO
UNL 87 OCT M4	Platts USG UNL 87 7.8 Pipeline Mid Daily gal Cents PGACT00c Mid	x	74.7%	NO
UNL 93 OCT. CONV. - V1 Colonial Premium Gasoline	Platts USG UNL93 Pipeline Mid Daily gal Cents PGAJB00c Mid	x	65.0%	NO
UNL 93 OCT. CONV. - V2	Platts USG UNL93 Pipeline Mid Daily gal Cents PGAJB00c Mid	x	65.0%	NO
UNL 93 OCT. CONV. - V3	Platts USG UNL93 Pipeline Mid Daily gal Cents PGAJB00c Mid	x	65.0%	NO
UNL 93 OCT. CONV. - V4	Platts USG UNL93 Pipeline Mid Daily gal Cents PGAJB00c Mid	x	65.0%	NO
CAT GAS	<b>No Reliable Pricing Series Available</b>	x	NA	NO
93 OCT. CONV. - V	Products Argus USG 93 Oct. Conv. - V Gasoline 93 V conv Colonial cycle Houston close PIPELINE Mid Daily gal Cents GPOACP7PC Mid	x	65.8%	NO
ALKYLATE	Products Argus USG Alkylate Mid Daily gal Cents GPUSP238C Mid	x	69.4%	NO
BUTANE	Products OPIS Mont Belvieu TET N. Butane Mid Daily GAL Cents Mont Belvieu TET N. Butane M Mid	x	34.3%	NO
C5	Products OPIS Mont Belvieu TET N.Gasoline Mid Daily GAL Cents Mont Belvieu TET N.Gasoline M Mid	x	56.0%	NO
CARBOB PREMIUM	Products OPIS Los Angeles CARBOB-P Mid Daily GAL Cents Los Angeles CARBOB-P M Mid	x	54.5%	NO
CUMENE	<b>No Reliable Pricing Series Available</b>	x	NA	NO
ETHANOL	Products Platts Chicago Ethanol Mid Daily gal Cents AALRI00c Mid	x	22.5%	NO
RAFFINATE	Products Argus USG Raffinate Raffinate USGC barge Houston close BARGE Mid Daily gal Cents GP5481A0C Mid	x	73.3%	NO
REFORMATE	Products Argus USG Reformate Mid Daily gal Cents GP5482A0C Mid	x	70.3%	NO
SUB OCTANE PREMIUM	Products OPIS Pacific NW Seattle Sub-octane Pre Mid Daily GAL Cents Pacific NW Seattle Sub-octane Pre M Mid	x	68.2%	NO
TOLUENE (COMM)	Chemicals Platts Toluene (COMM) USGC (prompt) Mid Weekly gal Cents PHAAO00c Mid	x	2.7%	NO

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