



8065 Leesburg Pike, 3rd Floor
Vienna, VA 22182
Phone (703) 962 9800
Fax (703) 962 9850
www.nodalexchange.com

February 10, 2014

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

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

Dear Ms. Jurgens:

Nodal Exchange, LLC (Nodal Exchange or Exchange) appreciates the opportunity to submit comments with respect to the Commodity Futures Trading Commission's (CFTC or Commission) proposed rulemaking concerning *Position Limits for Derivatives*, 78 Fed. Reg. 75680 (Dec. 12, 2013) (Proposed Rule). Nodal Exchange generally supports the comment letter filed on February 6, 2014 by the Futures Industry Association (FIA). Specifically, the FIA's letter addresses the impact of the Proposed Rule on protecting the price discovery and risk-management functions of commodity derivatives markets. The Exchange's comments herein focuses on the role and responsibilities of designated contract markets (DCMs) in implementing and enforcing the Proposed Rule.

As introduction, Nodal Exchange is a newly registered DCM operating as such since September 30, 2013 that serves the electricity markets by offering cash settled futures contracts on power in North America. All Nodal Exchange contracts (Nodal Contracts) are for monthly terms and are central counterparty cleared by LCH.Clearnet. Nodal Exchange also offers natural gas contracts for the benefit of being able to cross-margin power and natural gas open positions. The electric power markets are not like typical commodity markets because electricity cannot be stored economically. Since variations in supply, demand and transmission constraints lead to price differences by location, it is important to be able to hedge with contracts for the price of power at specific locations, leading to a very high number of required contracts to serve the market. Nodal Exchange has become a vital market distinguished by its granularity and is the only cleared market for over 100 locations in the United States.

Since Nodal Contracts enable market participants to hedge their risks at over one hundred locations defined by the power grid, the Exchange submits comments concerning the Proposed Rule and its impact on the Exchange's market.

I. The Definition of *Bona Fide* Hedging Restricts Nodal Exchange's Ability to Service the Hedging Needs of its Market

The Proposed Rule limits the definition of *bona fide* hedging positions to a narrow list of enumerated hedging positions that disregard important commercial risk-management practices. For example, the Proposed Rule limits the market's use of cross-commodity hedges, which is a critical risk reducing mechanism in the energy industry. These limitations may cause market participants to limit their commercial activities or otherwise incur additional risk because risk reducing positions may be subject to speculative limits.

Current exchange rules and procedures governing *bona fide* hedging positions, effectively permit market participants to rely upon cross-commodity hedging positions.¹ Although the Proposed Rule permits cross-commodity hedging based on a qualitative standard similar to its existing speculative position limits rule, the Proposed Rule establishes a quantitative factor that would disqualify a cross-commodity hedge if it does not satisfy a quantitative factor safe harbor test.

The Proposed Rule establishes a quantitative factor 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 (or the price series for the derivative contract used to offset risk) must be at least 0.80 for at least 36 months.² If a cross-commodity hedge does not meet this threshold, the Commission presumes that the hedge does not qualify as a *bona fide* hedge.

Nodal Exchange respectfully disagrees with the Commission's application of this quantitative analysis to conclude that fluctuations in the price of electricity are not substantially related to the fluctuations in the price of natural gas.³ The energy industry has historically used natural gas as an effective cross commodity hedge for electricity and Nodal Exchange provides both contracts for that purpose. About 30%⁴ of electricity in the United States is generated with natural gas, and some regions have a much higher dependence on natural gas for power generation. As natural gas typically is the price setting fuel for power, the forward prices for power and gas are closely correlated, and gas serves as a useful forward cross commodity hedge for power. The proposed quantitative standard only measures the correlation between the spot prices of the target commodity and the spot prices of the commodity underlying a derivative contract, which is not the same analysis that market participants use to make commercial judgments about the appropriateness of cross-commodity hedges. Even though the correlation between spot electricity and spot natural gas prices may be lower, the correlation between forward electricity and forward natural gas prices is high.⁵ The Commission's hedging

¹ See CFTC Rule 1.3(z)(2)(iv).

² Proposed Rule at 75717.

³ Proposed Rule at 75717.

⁴ U.S. Energy Information Administration, Annual Energy Outlook 2014 Early Release Overview Figure 13 on page 14.

⁵ If there is sufficient liquidity and if it is economically appropriate, they may convert their natural gas contract hedges to electricity contract hedges as the spot period approaches.

rules should be sufficiently flexible to enable market participants to enter into cross-commodity hedging transactions when there is a commercially reasonable correlation between the forward prices of related commodities, even if that correlation is substantiated in qualitative terms.

By imposing a correlation factor of 0.80 for cross-commodity hedging, the Commission will significantly restrict the availability of cross-commodity hedging where a commodity derivative contract does not meet the quantitative test. In these circumstances, the Exchange's participants are unlikely to attempt to rebut the presumption that a position is not a *bona fide* cross-commodity hedging position and may instead refrain from hedging entirely to the detriment of consumers of electricity in the United States. In all of these instances, the quantitative factor ultimately makes it more difficult for market participants to hedge the risk of changes in the value of a commodity that they are entitled to hedge under the CEA.

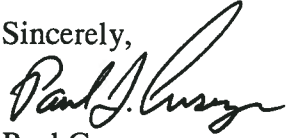
II. The Commission Should Clarify that Basis Contracts Are Excluded from Exchange-Set Position Limits

The Proposed Rule adopts the definition of a "basis contract" in proposed section §150.1 and excludes "basis contract" from the definition of a "Referenced contract".⁶ As a result, basis contracts are not subject to the proposed federal limits. However, it does not appear that the CFTC proposes a similar exclusion for purposes of exchange-set limits. The Commission should clarify that basis contracts are excluded from exchange-set limits in order to provide for consistency between the rules for federal limits compared to exchange-set limits.

III. The Commission Should Allow Exchanges to Determine Appropriate Accountability Levels for Exempt Commodities

The Proposed Rule in section §150.5(b)(ii)(B) should remove the 5,000 contract limit for non-spot or all-months-combined accountability levels for exempt commodities. The 5,000 contract limit on accountability levels may not be appropriate for all markets. Each exempt commodity is its own distinct market (e.g., power is very different than oil which in turn is very different than gold) and has different lot sizes. The Commission should instead rely on the exchanges to set appropriate accountability levels for their respective exempt commodity markets.

Nodal Exchange appreciates the opportunity to comment on this rulemaking and welcomes any questions from the Commission.

Sincerely,

Paul Cusenza
Chief Executive Officer

⁶ Proposed Rule 150.1.