



## JUNE 19, 2014 PUBLIC ROUNDTABLE – COMMERCIAL ENTERPRISE HEDGING PANEL

August 1, 2014

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

**Re: Public Roundtable on Position Limits – Supplemental Comments on Hedges of Physical Commodity Risks by Commercial Enterprises, Request for an Entity Exemption and a Swap/Transaction Exemption (RIN 3038-AD99)**

Dear Ms. Jurgens:

The NFP Electric Associations<sup>1</sup> appreciate the Commodity Futures Trading Commission (the “Commission”) staff holding the Public Roundtable on June 19, 2014, and we submit these supplemental comments on topics discussed by the first panel (the “First Panel”): hedges of physical commodity risks by commercial enterprises.

The NFP Electric Associations and other energy industry entities and associations have been active participants throughout the Commission’s rulemakings implementing Title VII of the Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). We submitted comments on the Commission’s speculative position limits rules initially proposed in late 2010 (and later vacated), and on the Commission’s reproposal of such rules in late 2013.<sup>2</sup>

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<sup>1</sup> The National Rural Electric Cooperative Association (“NRECA”), the American Public Power Association (“APPA”) and the Large Public Power Council (“LPPC”) (collectively, the “NFP Electric Associations”). See Attachment A for a description of the members of each NFP Electric Association. The comments contained in this filing represent the comments and recommendations of the NFP Electric Associations, but not necessarily the views of any particular member of any NFP Electric Association on any issue. The NFP Electric Associations are authorized to note the involvement of the following organizations and associated entities to the Commission, and to indicate their full support of these comments and recommendations: ACES and The Energy Authority.

<sup>2</sup> Comment letter on 2010 proposal available on the Commission’s website at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=33909&SearchText=wasson> (the “2011 Speculative Position Limits Comments”). Comment letter on the 2013 reproposal available on the Commission’s website at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59679&SearchText=> (the “2014 Speculative Position Limits Comments”).

The focus of the NFP Electric Associations’ 2011 Speculative Position Limits Comments was broad, because the Commission’s Dodd-Frank Act rulemaking process was at a much earlier stage. When the first version of the post-

The NFP Electric Association comments have focused on whether and how the Commission's proposed speculative position limits rules (and other rulemakings implementing the Dodd-Frank Act) apply to nonfinancial commodity "swaps"<sup>3</sup> that are entered into as bilateral commercial contracts, governed by state law. The NFP Electric Association comments have also focused on whether and how the Commission's rulemakings implementing the Dodd-Frank Act apply to other commercial contracts involving nonfinancial commodities, where the parties intend physical settlement (delivery and receipt of the underlying commodity), including commodity trade options.

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Dodd-Frank Act speculative position limits rules were proposed, the Commission had just recently proposed for comment its rules for the "end-user exception" to clearing and trade execution mandates for swaps entered into by commercial enterprises "to hedge or mitigate commercial risks" (as such phrase is used in CEA Section 2(h)(7)). As a result, the NFP Electric Associations' 2011 Speculative Position Limits Comments attached and cross referenced regulatory concepts from the "end-user exception" rules, and requested exemptions from speculative position limits for entities that acted only as "end-users" or "bona fide hedgers" when entering into nonfinancial commodity swaps. See Section III. The NFP Electric Associations' 2014 Speculative Position Limits Comments reiterated the earlier request for a broad entity exemption, as well as requested a series of transaction exclusions or exemptions from the speculative position limits regime for nonfinancial commodity swaps and other transactions entered into by end-users to hedge or mitigate commercial risks arising from ongoing business operations. See Section II.

<sup>3</sup> The scope of this term, defined in Section 1a(47) of the Commodity Exchange Act (the "CEA") as amended by the Dodd-Frank Act, is unclear. It is also unclear whether certain commercial transactions involving nonfinancial commodities for deferred shipment or delivery where the parties intend physical settlement are or are not "swaps." This fundamental regulatory uncertainty affects, in particular, everyday energy industry transactions involving stand-alone options, or including embedded options or "optionalities," or that may have option-like pricing or other transaction features. In the Dodd-Frank Act, Congress instructed the Commission to further define the term "swap" in rules to be published jointly with the Securities and Exchange Commission. Instead, the Commission has published a series of interpretations, and the staff has published guidance and issued no-action relief. See, "Joint final rule; interpretations; request for comment on an interpretation –Further Definition of 'Swap' Further Definition of 'Swap,' " "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping," 77 Fed. Reg. 48,208 (August 13, 2012) (the "Product Definitions Release") and "Final rule and interim final rule – Commodity Options," 77 Fed. Reg. 25,320 (April 27, 2012) (the "Commodity Option Release"). The Product Definitions Release and the Commodity Option Release contain a variety of significant interpretations of the Dodd-Frank Act amendments to the CEA Section 1a(47). The Commission did not seek public comment in advance on the Commodity Options Release or its interpretations in the Products Definition Release. Instead, comments were sought post-publication. The NFP Electric Associations filed comments on October 12, 2012, including the request for reconsideration of one of the Commission's most-significant interpretations. See Section X of the comment letter, dated October 12, 2012, at:

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59235&SearchText=>. Energy industry representatives have filed dozens of comments, requests for clarification and other relief related to the interpretations. The Commission has not responded to the requests, although the Commission staff has noted several times that the Commission is still considering the issues raised by the Commodity Options Release and the Commission's Product Definitions Release interpretations. See, for example, footnotes 4 and 10 to No-Action Letter 13-08 (April 5, 2013). Most recently, the Commission held a Public Roundtable in April 2014 to continue the discussion of the Commission's interpretations, and the continuing regulatory uncertainty particularly in the energy industry. See <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59822&SearchText=> for the comments filed by the NFP Electric Association on this issue in conjunction with the April 2014 Public Roundtable.

Such swaps and other commercial transactions, including commodity trade options, are almost always executed “off-facility”<sup>4</sup> and are not typically cleared.<sup>5</sup> Often, such swaps and other commercial transactions, including commodity trade options, are entered into between two “commercial end-users”<sup>6</sup> directly as principals and located in the same regional commercial market, without the involvement of a major swap participant and without intermediation by a swap dealer or other entity registered with or regulated by the Commission.<sup>7</sup>

In comments on the Commission’s proposed speculative position limits rules, the NFP Electric Associations’ comments have been from the perspective of their members as non-speculators. Where the Commission’s rules start from the perspective that all positions in Referenced Contracts are speculative, unless a bona fide hedging exemption applies, the NFP Electric Associations’ members start from exactly the opposite perspective. The NFP Electric Association members enter into nonfinancial commodity swaps, and other commercial transactions involving nonfinancial commodities where the parties intend physical settlement, as commercial end-users acting solely “to hedge or mitigate commercial risks”<sup>8</sup> arising from

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<sup>4</sup> There are no Commission exchange trading or clearing mandates for nonfinancial commodity swaps as yet. There is virtually no liquidity for nonfinancial commodity swaps on swap execution facilities.

<sup>5</sup> Many nonfinancial commodity swaps contain customized, non-standard terms related to the local or regional market structures, transportation limitations and other idiosyncratic market fundamentals that are being “hedged or mitigated” using these bilateral contracts. These customized commercial terms make the nonfinancial commodity swaps less fungible and more difficult to margin or clear.

<sup>6</sup> This term is not defined in the CEA or in Commission’s rules. The NFP Electric Associations use the term to mean a commercial enterprise that is not a “financial entity” and that enters into a swap “to hedge or mitigate commercial risks” (as such phrase is explained in new CEA 2(h)(7)) arising from its ongoing business operations. The members of the NFP Electric Associations are not financial entities, and are not registered with the Commission as swap dealers, major swap participants or any other entity registration category. The members are not-for-profit electric cooperatives, and government-owned electric entities and utilities. The NFP Electric Association members do not engage in swap dealing activities, or invest or trade in swaps as financial instruments or investments (seeking profit). The NFP Electric Association members do not engage in any speculative transactions or activities.

<sup>7</sup> Such bilateral nonfinancial commodity swaps are sometimes referred to as “end-user-to-end-user swaps.” Although this small segment of the global swaps markets constitutes less than one-half of one percent of global swaps, it is a critically important segment to those commercial enterprises whose commercial risks relate to one or more nonfinancial commodities underlying such swaps.

<sup>8</sup> As such phrase is used in new CEA 2(h)(7) and more fully explained in Commission Regulation 50.50(c). The NFP Electric Associations respectfully request the Commission to use this definition of hedging whenever the Commission’s rules are applied to nonfinancial (or commercial) entities or enterprises that enter into nonfinancial commodity transactions, including swaps, in order to hedge or mitigate commercial risks arising from ongoing operations (as distinguished from hedging financial investments or financial markets trading activity). Each commercial enterprise whose operations require nonfinancial commodities of various and different types has complex, unique, interdependent and dynamic commercial risks that it hedges to enable its business operations and achieve its commercial objectives. In this sense of “hedging,” commercial end-users do not operate in a manner that is identical to the risk management strategies of investment managers, financial entities or other investors hedging their investments. Commercial end-users’ commercial risk management hedging strategies are correlated to the individual commercial enterprise’s assets, its liabilities and business objectives, as well as its tolerance for accepting (not assuming) and managing the risks that arise from its ongoing business operations.

ongoing electric operations. For purposes of the speculative position limits rules, the NFP Electric Association members can be characterized as commercial end-user only entities -- “CEU-Only Entities.” The NFP Electric Associations respectfully submit that there is no regulatory policy reason to consider whether any of the NFP Electric Association members, as CEU-Only Entities, hold speculative positions that would be subject to the Commission’s speculative position limits.<sup>9</sup>

In the 2014 Speculative Position Limits Comment Letter, the NFP Electric Associations characterize nonfinancial commodity swaps used by commercial end-users to hedge or mitigate commercial risks as “CEU Hedging Swaps.”<sup>10</sup> The NFP Electric Associations respectfully submit that there is no regulatory policy reason to consider CEU Hedging Swaps as “Referenced Contracts” under the Commission’s proposed speculative position limits, only to then require commercial end-users to “bucket” and exempt such CEU Hedging Swaps as “bona fide hedging” transactions.<sup>11</sup>

The NFP Electric Associations would like to echo the panelists representing commercial enterprises on the First Panel, who urged the Commission not to apply a “one-size-fits-all” set of speculative position limits rules to nonfinancial commodity markets that are significantly different from one another, and each of which operates well for the benefit of the commercial risk hedgers who rely on such markets. As the energy industry has explained before, and

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<sup>9</sup> See Section III of the NFP Electric Association’s 2014 Speculative Position Limits Comments, linked at footnote 2 above, which seeks an entity exemption from the Commission’s speculative position limits, using a definition of “Exempt NFP Electric Entities” that parallels the definition of “Exempt Entities” in the Commission’s Between NFP Electrics Exemption Order, 78 Fed. Reg. 19,670 (April 2, 2013). In the 2011 Speculative Position Limits Comments, NFP Electric Associations made substantially the same request, characterizing their members as “bona fide hedgers-only,” due to the fact that the Commission’s end-user exception rules in Part 50 (in particular, Regulation 50.50(c)) had not yet been finalized. See footnote 6 above. The entity exemption request remains the same – a non-speculator by definition does not hold speculative positions.

<sup>10</sup> As discussed in the 2014 Speculative Position Limits Comments, depending on whether the Commission clarifies its rules defining the term “swap” prior to issuing its final speculative position limits rule, the NFP Electric Associations must respectfully request that the Commission exclude or exempt from its speculative position limits the following types of commercial transactions, which are not speculative, but used to hedge or mitigate commercial risks of ongoing operations: all commodity trade options, all consumer, commercial or other agreements, contracts or transactions that the Commission has further defined by regulation, interpretation, guidance, order or other action as not intended by Congress to be regulated as “swaps,” and all transactions exempted for the Commission’s swap regulations by means of the Between NFP Electrics Exemption Order, 78 Fed. Reg. 19,670 (April 2, 2013) and the RTO/ISO Exemption Order, 78 Fed. Reg. 19,879 (April 2, 2013). See Section II of the NFP Electric Associations’ 2014 Speculative Position Limits Comments, linked at footnote 2 above.

<sup>11</sup> Such bilateral CEU Hedging Swaps are entered into off-exchange and many are not cleared, due to the non-standardized nature of the commercial terms thereof, which are tailored to the commercial risks being hedged. For this reason, CEU swaps are not “economically equivalent” swaps, as such term is used in new CEA 4a(a)(5), nor do they act as significant price discovery contracts for any Covered Futures Contract.

panelists explained again at the Public Roundtable, it could be very damaging to some or all of the nonfinancial commodity markets (and to commercial risk hedgers) to impose a set of rigid, one-size-fits-all “bona fide hedging” metrics developed to be applied by financial investors holding investments in commodity contracts, and to standardized trading instruments on regulated price discovery markets, to the complex market structures in various regional nonfinancial commodity markets, where myriad commercial enterprises manage their diverse commercial risk using different hedging strategies.<sup>12</sup> The NFP Electric Associations urge the Commission to consider implementing its new speculative position rules to markets relevant to one Referenced Contract at a time, beginning with the legacy agricultural commodity markets with which the Commission is most familiar.

As recommended in our 2014 Speculative Position Limits Comments and specifically in light of the Public Roundtable discussions, the Commission should include in its final rules: (a) an entity exemption for CEU-Only entities (with appropriate conditions), and (b) a nonfinancial commodity transaction exemption for CEU Hedging Swaps (with appropriate conditions), under its authority under Section 4a(a)(7) of the Commodity Exchange Act (the “CEA”). The Commission should focus its limited resources on those entities that may be speculating in Referenced Contracts, not on non-speculators. The Commission should focus its limited resources on those nonfinancial commodity futures contracts, options and standardized, economically-equivalent swaps (that serve a price discovery function in respect of covered futures contracts) that may constitute a speculative position in Referenced Contracts that exceeds a Commission-established limit. Congress intended the Commission to put limits on excessive speculation, not to put limits on the ability of commercial enterprises to hedge or mitigate commercial risks of ongoing business operations.

In Section 3 below, the NFP Electric Associations address the question asked during the first panel at the Public Roundtable as to how a commercial enterprise would assure the Commission that it is entering into nonfinancial commodity swaps for commercial risk-hedging purposes, and not for speculative purposes.<sup>13</sup>

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<sup>12</sup> The NFP Electric Associations agree with the panelists who urged the Commission to focus on “doing no harm” to the markets that provide commercial risk management opportunities and achieve price convergence between futures and cash market prices for the benefit of commercial hedgers and their counterparties.

<sup>13</sup> Mr. McGonagle asked this question of the panelists. Various panelists noted that a commercial enterprise’s risk management policies often either prohibit, or qualitatively and quantitatively limit, speculative trading within parameters tailored to the commercial enterprise’s organizational structure, operations and risk tolerances. Panelists also noted that a commercial enterprise’s employment policies and practices typically include penalties for noncompliance with commercial risk management policies, up to and including termination of employment. The NFP Electric Associations also respectfully call to the Commission’s attention the fact that the formality and sophistication of a commercial enterprise’s corporate risk management and employment policies may vary widely, depending on the size and scope of its business operations and the sophistication of its commercial risk management strategies.

## 1. COMMENTS ON THE PUBLIC ROUNDTABLE DISCUSSION

Throughout the Public Roundtable, the conversational disconnect was obvious between the Commission staff and the panelists representing commercial enterprises.<sup>14</sup> The Commission staff's questions and hypotheticals were about hedging positions, and distinguishing whether an entity was entering into risk-assuming or risk-reducing commodity interest and "cash market" transactions in nonfinancial commodities. The Commission staff was then asking questions about how entities make qualitative and quantitative comparisons between the established and anticipated positions that they are hedging. The panelists representing commercial enterprises were trying to explain the "art, not the science" of entering into commodity interests and cash market transactions "to hedge or mitigate commercial risks" -- risks that arise in the normal course of their ongoing business operations.

From a commercial enterprise perspective, the panelists were all describing transactions entered into to mitigate risks – the ongoing commercial risks that are inherent in each company's business operations – as such commercial risks are perceived on the day the particular transaction is entered into.<sup>15</sup> None of the panelists describing commercial risk hedging practices was talking about entering into a transaction, or establishing a position, in order to initiate or assume new market risk, and thereafter (or in advance) hedging that assumed risk position with a risk-reducing transaction or position. The commercial risks of a particular type of business operation exist by the very nature of the role(s) a commercial enterprise plays in the commercial economy; these risks are not initiated or assumed. Moreover, the commercial risk hedging calculus and efforts to manage commercial risks change dynamically as time passes, nonfinancial commodity and derivatives markets evolve, and as commercial business decisions are made. Opportunities and challenges present themselves due to the changing conditions of commercial businesses, and/or the changing nature of the economic markets within which such

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<sup>14</sup> For this purpose, the NFP Electric Associations call particular attention to the comments on the First Panel made by Ron Oppenheimer representing the Commercial Energy Working Group, Lael Campbell representing the Edison Electric Institute, and David Perlman representing the Coalition of Physical Energy companies, as well as Matthew Jansen of ADM, Mike Ricks of Cargill and Joe Nicosia of Louis Dreyfus. On the Third Panel, Michael Sweeney representing the American Gas Association and the Commercial Energy Working Group, and Charles Cerria representing the Commodity Markets Council, commented from the same perspective.

<sup>15</sup> Each commercial enterprise is exposed to identifiable "commercial risks" arising from, and in many respects unique to, such commercial enterprise's ongoing business operations. Panelists representing commercial enterprises listed some of those risks: supply risk, location risk, delivery risk, weather risk, time risk, execution risk, political risk, counterparty risk, market risk, sovereign risk, regulatory risk, and operational risk. Each commercial enterprise makes ongoing business judgments about the best and most cost-effective way to either manage, hedge or mitigate each of the unique commercial risks that arise from its particular business operations. Any CEU Swap that the commercial enterprise identifies as meeting its internal commercial risk management criteria for being a risk-reducing (not a risk-assuming) transaction should be excluded or exempted from the Commission's speculative position limits regime. That transaction is not speculative.

businesses hedge their commercial risks.<sup>16</sup> Each of the panelists focused on business judgment as they described the ways in which their particular commercial risk managers make decisions about entering into nonfinancial commodity and derivative transactions.

As one panelist noted, commercial enterprises have difficulty “backfitting” the commercial risk management policies, procedures and practices within which they operate when entering into CEU Hedging Swaps into specific “bona fide hedging” exemption buckets, and applying the correlated and calculable risk reduction metrics typically used by financial investment and/or derivatives trading firms. This is particularly difficult to accomplish “in real time” when a commercial enterprise’s employee is deciding whether to enter into a particular CEU Hedging Swap in order to hedge an identified commercial risk using his/her background, experience and business judgment with respect to the enterprise’s ongoing operations, existing and anticipated market conditions, and applicable commercial risk management policies.

In the discussion of gross vs. net hedging,<sup>17</sup> panelists described how a commercial enterprise analyzes the complex, unique and interdependent commercial risks of its particular

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<sup>16</sup> For example, one panelist described a commodity merchandiser (a commercial enterprise) balancing the commercial risks of grain delivery obligations in the Ukraine vs. the availability of similar, but not exactly the same, grain for purchase in Kansas. The commercial enterprise may seek to hedge those unique commercial risks with a variety of different grain contracts on the Chicago Board of Trade, depending on that commercial enterprise’s business judgment at the time about price correlations and risk reduction strategies based on its commercial business experience. Another described an electric utility with electric generation assets situated in the Midwest, some long term transmission rights and natural gas in storage in different geographic areas, but power delivery obligations in the mid-Atlantic during the polar vortex. That electric utility’s experienced commercial risk managers might decide to hedge those interdependent commercial risks using natural gas contracts deliverable at a liquid hub, or power delivered at locational marginal prices in either the Midwest or the mid-Atlantic. The panelists described the probability calculus that any commodity interest hedging contract (available on a registered trading facility) would be a perfect or imperfectly-correlated hedge, and the importance of respecting the commercial entity’s business judgment as to how best to reduce the aggregated commercial risks of the enterprise, or those commercial risks that the particular employee was charged with hedging. Business judgment, not regulatory mandates, should guide the commercial entity’s decision to hedge, or not to hedge, and with what commercial contract or financial markets instrument.

<sup>17</sup> This discussion was replayed during the last panel, and the Commission staff’s reaction was similar to the staff’s reaction during the First Panel. The energy industry panelists described how, within the same commercial enterprise, one group of commercial risk managers might be charged by management with hedging commercial risks arising from fuel supply requirements for a refinery or an electric generation unit or units. Another group might be charged with simultaneously (and independently) hedging commercial risks of the same refinery’s or generation unit’s output, or the output of a refinery half a world away, or an electric generator in another geographic region. In a financial trading company (a financial, not a commercial, enterprise, whose business it is to enter into financial instruments to assume risk, and then enter into other financial instruments to reduce that assumed risk), it may be unusual for management not to be relatively constantly aware of both the gross, net and aggregated positions held by different traders in the same commodity interests, and correlated “cash market” contract quantities. However, as the panelists representing commercial enterprises explained, this hands-on management of aggregated, day-to-day financial market positions is not typical at all in a commercial enterprise. Each independent commercial risk group is engaged in hedging and mitigates specific commercial risks, and is not in constant touch with the enterprise’s overall aggregated position levels.

business operations. Its Board or senior management establishes broad commercial risk management (or “hedging”) policies and operations-specific procedures. The policies and procedures together articulate that particular commercial enterprise’s appetite for certain identified commercial risks, and the permitted (and prohibited) hedging strategies acceptable to their stakeholders for managing each identified commercial risk. As the panelists discussed, many commercial enterprises, especially small, unsophisticated or not-for-profit consumer-owned enterprises, expressly prohibit speculation or speculative activities. Others may specifically restrict or limit speculative activity at the subsidiary, group (“trading desk”) and/or the specific individual (“trader”) level. Those commercial entities then measure and monitor that subsidiary/trading desk/trader’s ability to enter into, and then manage, “speculative” risk transactions or positions. Commercial risk managers and speculative traders are easily distinguishable at a commercial enterprise. If either of these types of employees violate policies applicable to their business unit, the commercial enterprise’s profitability suffers and the commercial risk managers/speculative traders may be disciplined or lose their jobs.

2. **THE STATUTE DISTINGUISHES BETWEEN A COMMERCIAL ENTERPRISE “HEDGING OR MITIGATING COMMERCIAL RISKS,” AND THE PROCESS BY WHICH AN ENTITY THAT MAY BE INVOLVED IN SPECULATIVE ACTIVITY MEASURES AND BUCKETS ITS “REFERENCED CONTRACTS” INTO SPECIFIC BONA FIDE HEDGING EXEMPTIONS FROM SPECULATIVE POSITION LIMITS.**

In the Dodd-Frank Act amendments to the CEA, Congress expanded the Commission’s jurisdiction to include oversight of “swaps” markets. Concurrently, Congress recognized the difference between the “bona fide hedging” analyses used to identify and measure positions for speculative position limits purposes, and the manner in which commercial enterprises enter into swap transactions to “hedge or mitigate commercial risks” of ongoing business operations. Congress charged the Commission with regulating speculative positions to the extent necessary to diminish the effect of excessive speculation on interstate commerce, not to prevent speculation entirely.

The statutory language referencing commercial entities’ use of nonfinancial commodity swaps is found in new CEA Section 2(h)(7), which articulates the broad “end-user exception” to the Dodd-Frank Act’s presumption that all “swaps” should be cleared and traded on exchanges in new CEA Section 2(h).<sup>18</sup> Congress used the words “hedging or mitigating commercial risks” to recognize the prerogative of a commercial enterprise to identify, manage and hedge or mitigate commercial risks arising from and affecting its unique and ongoing business operations. Congress intended the Commission to respect and defer to a commercial enterprise’s business judgment in deciding whether, when and how to hedge such commercial risks. If the commercial end-user decides to use “swaps,” whether to execute such swaps on a regulated

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<sup>18</sup> The Commission’s Regulation 50.50(c) adds more specificity to the statutory concept.



facility and whether to clear the swap, Congress intended the Commission to preserve the commercial end-users' cost-effective access to such swaps.<sup>19</sup>

The difference in statutory language is also reflected in CEA Section 4a(a)(5). In order to diminish the negative effects of excessive speculation, Congress charged the Commission with establishing speculative position limits not for all "swaps," but for those that are "economically-equivalent" to exchange-traded futures contracts – as fungible, standardized investment or financial instruments. In new Section 4a(a)(6), Congress was even more specific as to which economically-equivalent swaps should be subject to speculative position limits: the Commission is directed to "establish [speculative position] limits (including related hedge exemption provisions [not "bona fide hedge" exemptions])" only for those "swap contracts that perform or affect a significant price discovery function with respect to regulated exchanges." Finally, in Section 4a(a)(7), Congress emphasized that the Commission has broad authority to grant exemptions: it can exempt "any person or class of persons, [an entity exemption], any swaps or class of swaps [a swap exemption]," any futures or exchange-traded options contract or class of such exchange-traded contracts [an exchange-traded contract exemption], "or any transaction or class of transactions [a transaction exemption] from any...[speculative] position limits."

Congress did not intend commercial enterprises to have their business judgment decisions about how best to manage their ongoing operations and to manage, hedge or mitigate commercial risks using nonfinancial commodity swaps, second-guessed or analyzed under the Commission's *speculative* position limits regime. Neither the commercial entities nor the nonfinancial commodity swaps fit the template used by the Commission prior to the Dodd-Frank Act to regulate investors/traders, dealers and speculators in futures contracts and other "economically-equivalent" and standardized, liquid, "significant price discovery" financial instruments. CEU Hedging Swaps in general are neither identifiable as "economically equivalent" to specific nonfinancial commodity futures contracts, nor can they be assumed to perform or affect a significant price discovery function in respect of a regulated futures exchange. If the Commission decides not to grant the transaction exemption, the NFP Electric Associations respectfully request the Commission to explain how and why a non-standardized, off-facility, non-cleared CEU Hedging Swap (where one of the parties is a commercial end-user) is presumed to be economically-equivalent to a Core Referenced Futures Contracts, and how and why such a CEU Hedging Swap can be presumed to play a significant price discovery function in reference to such a Core Referenced Futures Contract.<sup>20</sup>

In summary, the panelists explained at the Public Roundtable how commercial enterprises use strategies to hedge or mitigate commercial risks that differ and are distinguishable from "bona fide hedging" transactions that should be exempt from speculative position limits in a financial markets context. Congress articulated its understanding of the distinction between the two types of hedging in the language of the Dodd-Frank Act "end-user

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<sup>19</sup> Congress has repeatedly stated that its intention in enacting the Dodd-Frank Act amendments to the CEA was not to burden or restrict commercial end-users' access to the swaps required to hedge or mitigate such commercial risks. See the Dodd-Lincoln Letter cited in footnote 7 to the 2014 Speculative Position Limits Comment Letter.

<sup>20</sup> See Section I of the 2014 Speculative Position Limits Comment Letter.

exception” and the Act’s amendments to the CEA’s speculative position limits authority. Both argue strongly in favor of two public policy exemptions from the Commission’s new speculative position limits regime, as permitted under CEA 4a(a)(7): one exemption for commercial enterprises whose policies and procedures prohibit speculation (an “CEU-Only Entity Exemption”), *and* a second exemption for nonfinancial commodity swaps that are entered into by commercial enterprises “to hedge or mitigate commercial risks” arising from ongoing business operations (a “CEU Hedging Swap” Exemption). See Sections I and II of the 2014 Speculative Position Limits Comments.<sup>21</sup>

### **3. DOCUMENTATION REQUIREMENTS FOR RELIANCE ON THE PROPOSED EXEMPTIONS.**

At the Public Roundtable, the panelists representing commercial enterprises described risk management policies and procedures that may either prohibit speculation or, for more sophisticated commercial enterprises, that permit some amount of speculative trading at particular subsidiaries or “trading desks,” or by specific individuals. Commercial risk hedging strategies are calibrated to the particular commercial risks being hedged, and the particular commercial enterprise’s risk tolerances in various areas of its business operations. In those entities that permit speculative trading, the entity establishes carefully-monitored transaction and value-at-risk parameters by commodity or trading instrument, for such permitted speculative trading.<sup>22</sup> The panelists noted that the commercial entity’s employee handbooks or other employment policies typically provide that violation of a risk management prohibition on speculation, exceeding speculative transaction authority (by commodity, qualitative or quantitative measures, depending on the entity) or breaching regulatory “information firewalls” constitutes grounds for discipline up to and including termination.

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<sup>21</sup> This renewed request by the NFP Electric Associations for public policy exemptions under CEA 4a(a)(7) address what was characterized by one of the panelists as a “threshold policy consideration.” Reference the introductory comments by David Perlman on behalf of the Coalition of Physical Energy companies (“COPE”). Although the remainder of the discussion at the Public Roundtable did not focus on this threshold policy consideration, the panelists chosen by the Commission staff for this Public Roundtable were not representative of the large number of smaller commercial enterprises in the energy industry. The NFP Electric Associations’ members and thousands of small commercial enterprises (not represented on the Public Roundtable) would be the entities that would most benefit from these public policy exemptions. See footnote 26 supra.

<sup>22</sup> For example, one desk (or subsidiary or department) might be charged with hedging a utility subsidiary’s need for natural gas to fuel generation located in California. Another desk might hedge the commercial risk that the enterprise’s wind energy facilities in New England may not produce enough power to fulfill its contractual obligations to wholesale power customers during an extended calm weather period in that region. A third desk might be authorized to engage in a limited amount of speculative activity around a natural gas storage facility in Texas and/or Pennsylvania. All three desks might enter into natural gas transactions that would fit within the overall enterprise’s commercial risk management procedures. The first two desks’ natural gas transactions would qualify as CEU Hedging Swaps, whereas the third desk would run periodic VAR calculations to verify that it was within the commercial risk management policy parameters. But none of the three desks would necessarily speak to the others during the course of a trading day, or perhaps at all due to regulatory restrictions.

The NFP Electric Associations respectfully recommend a streamlined set of documentation requirements to assist the Commission in monitoring the proposed exemptions. The streamlined documentation would only be available to entities that are not otherwise registered with the Commission in another capacity (“non-registrants”), and as a result the exemptions would be effectively self-administered.

Upon request by the Commission based on reasonable grounds to believe the non-registrant is engaged in speculative activity related to a particular Covered Futures Contract,<sup>23</sup> a non-registrant would be required to file either: (a) a notice that it does not speculate or enter into speculative transactions in nonfinancial commodity interests, and that the entity maintains policies and procedures that prohibit speculation, or, alternatively, (b) a notice of the Covered Futures Contract(s) in respect of which it enters into Referenced Contracts that are not “CEU Hedging Swaps.” For those entities that have a “no-speculation policy, the one-time “CEU-Only Entity Exemption” filing would fulfill its regulatory reporting obligations under the speculative position limits rules, unless the Commission has reasonable grounds to challenge the entity’s representation.

For a non-registrant that engages in some speculative transactions (alternative (b) above), the entity would thereafter nonetheless be entitled to a presumption that any nonfinancial commodity swap,<sup>24</sup> identified in ordinary course business records at the time the transaction is executed as intended “to hedge or mitigate commercial risks,” is a valid CEU Hedging Swap.<sup>25</sup> This self-administered CEU Hedging Swap exemption is consistent with the deference that Congress expected the Commission to give to the business judgment of commercial end-users. The presumption would apply to all “CEU Hedging Swaps.” Moreover, a representation by the non-registrant to its counterparty that a nonfinancial commodity swap is a CEU Hedging Swap should serve as a sufficient basis for a pass-through exemption for registrants or counterparties to CEU Hedging Swaps that are not, themselves, commercial end-users utilizing such swap to hedge or mitigate commercial risks. Because swaps are not anonymous financial instruments (as

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<sup>23</sup> The Commission may base such a request on information that it obtains through its swap transaction reporting rules, through its Large Trader Reporting rules, through market surveillance activity or enforcement investigations.

<sup>24</sup> There should be a presumption that a commercial enterprise is entering into primarily “CEU Hedging Swaps,” and is not typically acting as a speculator in commodity derivatives as trading instruments. In the 2014 Speculative Position Limits Comments, the NFP Electric Associations proposed that the Commission implement such an exemption as an exclusion from the definition of Referenced Contract, rather than a separate exemption order, to provide regulatory certainty. In addition, the NFP Electric Associations respectfully request that the Commission consider the need to broaden the exemption/exclusion to cover other commercial transactions involving nonfinancial commodities, where the parties intend physical settlement (including commodity trade options).. See Section II of the 2014 Speculative Position Limits Comments.

<sup>25</sup> This recommendation relates back to the fundamental principle that the Commission should not interpret its new authority to impose regulatory limits on speculative positions in certain non-financial commodity swaps, and apply that new authority, based on an unstated and erroneous assumption that every nonfinancial commodity swap that a commercial end-user enters into is speculative, unless that commercial end-user can prove otherwise. See footnotes 8-11, and the related text.

futures contracts are), the Commission would be able to see in the swap transaction data whether a swap had been identified to the swap data repository as a CEU Hedging Swap.

The NFP Electric Associations respectfully request that the Commission build such exemptions and presumptions into its speculative position limits rules, providing assurance to non-registrant commercial end-users and their counterparties that such entities and their transactions will not be unintentionally caught up in the Commission's efforts to measure or monitor speculative positions in Referenced Contracts.

Such streamlined reporting for non-registrants should be sufficient for purposes of the Commission's speculative position limits rules, without new and burdensome reporting obligations for CEU-Only Entities or for commercial enterprises whose speculative activities are a limited and well-managed portion of its overall commercial business activities. If the Commission has reason to believe that a specific non-registrant is misrepresenting its policies or that a specific non-registrant is entering into Referenced Contracts for speculative purposes, the Commission would have the right to review the commercial enterprise's commercial risk management policies in order to verify compliance with either the CEU-Only Entity Exemption or the CEU Hedging Swap Exemption. The Commission staff could also investigate the commercial risk management and employment policies to assure that any speculative activity is kept separate from commercial risk hedging activity.

These limited entity and transaction exemptions (from speculative position limits rules only) would have no effect on a CEU-Only Entity's obligations under the Commission's swap transaction reporting rules. Nor would these exemptions change a commercial enterprise's obligations under the Commission's large trader reporting rules, or the Commission staff's right to investigate market activity should the Commission have reason to believe that such an entity was involved in potential market manipulation or anti-disruptive practices or other rule violations.<sup>26</sup>

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<sup>26</sup> The vast majority of the NFP Electric Associations' members are "small entities" that, in order to hedge or mitigate the commercial risks arising from ongoing electric operations, execute nonfinancial commodity swaps and commercial transactions involving nonfinancial energy and energy-related commodities for deferred shipment or delivery, some with embedded options and "optionalities." The NFP Electric Association members are, therefore, "CEU-Only Entities." The NFP Electric Associations reserve the right to require that the Commission fulfill its statutory requirements under the Regulatory Flexibility Act, SBREFA and the Paperwork Reduction Act to show the steps it has taken, and the alternatives it has considered (including the alternatives proposed by the NFP Electric Associations), to reduce costs and regulatory burdens that its regulations and interpretations impose on "small entities." It is not within the Commission's authority to ignore those definitions, or to assume away its obligations under SBREFA to "small entities" in general, or to more than 2500 NFP Electric Associations' members that are "small entities" in particular. The Commission is respectfully requested to demonstrate that the costs and burdens of its speculative position limits impose on the members of the NFP Electric Associations and other commercial enterprises that are "small entities" are necessary to accomplish an identified regulatory objective, and that such regulatory objectives cannot otherwise be achieved by alternative regulatory approaches that commenters recommend, while reducing the costs and regulatory burdens imposed on "small entities."

The NFP Electric Associations respectfully reserve the right, on behalf of their members, to request that the Commission evaluate the aggregate costs and benefits of its rules as well as its interpretations, no-action letters and

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Melissa D. Jurgens, Secretary

August 1, 2014

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The NFP Electric Associations are available to assist the Commission and Commission staff as they develop final speculative position limits rules. Our members need workable entity and transaction exemptions to these rules, as Congress authorized the Commission to provide under CEA Section 4a(a)(7). The NFP Electric Associations are also available to assist in developing reporting rules that will allow the Commission to monitor reliance on such exemptions without creating unnecessary transaction documentation steps or delays, or burdensome ongoing reporting requirements.

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Please contact any of the NFP Electric Associations' undersigned representatives or Patricia Dondanville, Reed Smith LLP, 10 South Wacker Drive, 40<sup>th</sup> Floor, Chicago, Illinois 60606, telephone (312) 207-3911 or at [pdondanville@reedsmith.com](mailto:pdondanville@reedsmith.com) for more information or assistance.

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guidance provided in other forms, to the extent that such statements of regulatory policy have the effect of rules and impose significant costs and burdens on "small entities" (even if the Commission does not give notice or seek public comments in respect of such statements of regulatory policy as required by the Administrative Procedures Act).

**JUNE 19, 2014 PUBLIC ROUNDTABLE –  
COMMERCIAL ENTERPRISE HEDGING PANEL**

Respectfully submitted,

**NATIONAL RURAL ELECTRIC  
COOPERATIVE ASSOCIATION**

*Russ Wasson*

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Riva Spear Adriance, Senior Special Counsel  
Kenneth Danger, Senior Economist  
Stephen Sherrod, Senior Economist

## **ATTACHMENT A - DESCRIPTION OF THE NFP ELECTRIC ASSOCIATIONS**

NRECA is the national service organization for more than nine hundred rural electric utilities and public power districts that provide electric energy to approximately forty-two million consumers in forty-seven states or thirteen percent of the nation's population. Kilowatt-hour sales by rural electric cooperatives account for approximately eleven percent of all electric energy sold in the United States. Because an electric cooperative's electric service customers are also members of the cooperative, the cooperative operates on a not-for-profit basis and all the costs of the cooperative are directly borne by its consumer-members.

APPA is the national service organization representing the interests of government-owned electric utilities in the United States. More than two thousand public power systems provide over fifteen percent of all kilowatt-hour sales to ultimate electric customers. APPA's member utilities are not-for-profit utility systems that were created by state or local governments to serve the public interest. Some government-owned electric utilities generate, transmit, and sell power at wholesale and retail, while others purchase power and distribute it to retail customers, and still others perform all or a combination of these functions. Government-owned utilities are accountable to elected and/or appointed officials and, ultimately, the American public. The focus of a government-owned electric utility is to provide reliable and safe electricity service, keeping costs low and predictable for its customers, while practicing good environmental stewardship.

LPPC is an organization representing 26 of the largest government-owned electric utilities in the nation. LPPC members own and operate over 86,000 megawatts of generation capacity and nearly 35,000 circuit miles of high voltage transmission lines, representing nearly 90% of the transmission investment owned by non-Federal government-owned electric utilities in the United States.