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August 4, 2014

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

RE: Position Limits for Derivatives, RIN 3038-AD99

Dear Secretary Jurgens,

The American Petroleum Institute ("API"), on behalf of its members, submits the following comments in response to the CFTC's further request for public comment to the Commodity Futures Trading Commission (the "Commission" or "CFTC")'s notice of proposed rulemaking establishing federal position limits for derivatives ("Position Limits NOPR").[1]

API is a national trade association representing more than 580 oil and natural gas companies. API's members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. The core business of API members is delivering affordable energy to their wholesale and retail consumers. API's members transact in physical and financial, exchange-traded and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business. API members enter into derivative transactions to facilitate physical transactions and to offset related exposures to price risk in such physical markets. Because API members rely on the integrity of markets under the Commission's jurisdiction and are concerned that compliance with the Position Limits NOPR as proposed would be burdensome and complex, they appreciate the opportunity to comment.

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[1] *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 78 Fed. Reg. 75,680 (Dec. 12, 2013) ("Position Limits NOPR"); *Position Limits for Derivatives and Aggregation of Positions,* Notice of Proposed Rulemaking; Reopening of Comment Periods, 79 Fed. Reg. 30,762 (May 29, 2014).

I. Introduction.

On March 13, 2012, API submitted a petition to the CFTC regarding the applicability of the bona fide hedge exemption to certain transactions under Part 151 of the CFTC's regulations.[2] Additionally, on February 10, 2014, API submitted comments generally requesting that the CFTC protect legitimate commercial hedging activity in its attempt to establish position limits that prevent excessive speculation in commodity derivatives markets.[3] The comments presented herein are intended to supplement the content of these submissions and specifically address Question No. 10 from the list of questions issued by the CFTC's Division of Market Oversight in connection with the June 19, 2014 Roundtable on Position Limits for Physical Commodity Derivatives.[4] Question No. 10 provides:

> *Synthetic fixing of un-fixed price forward contracts*. Some commenters have noted that a merchant may have established unfixed-price forward contracts that may expose the commercial enterprise to operational risk of counterparty performance. To ensure the making or taking of delivery, some commenters establish a position in a physical-delivery futures position. Such commenters seek recognition of that position as a bona fide hedge to offset the risk of potential failure by the cash counterparty to perform on an unfixed-price forward contract.
>
> What public policy reasons are there to recognize an exemption for such price fixing uses of derivative contracts?

As further described below, unfixed price physical transactions are quite common in oil markets.[5] Buyers and sellers may prefer to link the price of physical transactions to instruments that rise and fall with the market where they determine such to be the most effective way to price physical purchases and sales, even if a different pricing exposure might present lower risk.[6] Therefore, API requests the Commission to recognize as a bona fide hedge the sale or purchase of Referenced Contracts that (i) are offset by exposure to unfixed price sales or purchases of the contract's underlying cash commodity or (ii) convert the pricing terms of a purchase or sale of a

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[2] *See* API, *Petition for Commission Order Regarding the Applicability of the Bona Fide Hedge Exemption to Certain Transactions* (Mar. 13, 2012) (attached hereto as Attachment 1). Note, on September 28, 2012, the United States District Court for the District of Columbia vacated Part 151 of the CFTC's regulations. *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).

[3] *See* API, Comment Letter on CFTC Position Limits for Derivatives, RIN 3038-AD99 (Feb. 10, 2014) (attached hereto as Attachment 2).

[4] *See* DMO, *Position Limits Roundtable: Staff Questions* (June 12, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/staffquestions061214.pdf.

[5] *See* Platts, *The Structure of Global Oil Markets: Backgrounder*, at 4-5 (June 2010), *available at,* http://www.platts.com/IM.Platts.Content/InsightAnalysis/IndustrySolutionPapers/oilmarkets.pdf.

[6] *Id.*

contract's underlying cash commodity to calendar month average ("CMA") pricing.[7] Further, API requests the Commission to permit market participants to hold these contracts through the spot month. API sets forth below several public policy reasons to support its requests.

II. The Use of Commodity Derivatives Contracts to Hedge the Unfixed-Price Sale or Purchase of a Commodity or to Achieve CMA Pricing is *Not* Speculative.

In energy markets, commodities often are priced by reference to a floating metric, such as the price of the CME Crude Oil Futures contract. As a result, participants in energy markets often will be exposed to price volatility as prices associated with the unfixed price purchase or sale of a commodity fluctuate. Commercial firms may enter into commodity derivatives transactions to hedge these unfixed price sales or purchases.

Alternatively, market participants may enter into commodity derivatives positions to achieve CMA pricing. Participants may, in accordance with their business model and objectives, conclude that CMA is the pricing term that minimizes risk. Using derivatives to convert non-CMA pricing terms of a physical transaction to CMA pricing is not speculative. Such derivative positions must be both established and unwound according to an orderly pattern to achieve a specific, desired risk-mitigating objective. To achieve CMA, the timing of establishing the hedge is dictated by the timing and pricing terms of the non-CMA physical transaction and does not reflect any speculative assessment of potential future market moves. Likewise, once the hedge has been established, the decision to unwind it on any particular day is driven by the CMA formula and does not reflect any assessment about potential future price movement.

Significantly, the hedging objectives described above apply to all participants in the physical supply chain: (i) producers, (ii) entities that purchase from the producers, (iii) consumers, and (iv) entities that sell to the consumers. Any of these entities may use commodity derivative transactions to hedge unfixed price transactions or to achieve CMA pricing terms. They will do so when they (i) have executed a physical transaction with pricing terms different from those they regard as least risky and (ii) have determined to hedge that risk rather than bear it. As discussed in the following section, any regulatory constraint that limits the ability of any such entity—regardless of its role in the physical supply chain—to hedge in accordance with its perspective on risk has the potential to constrain real economic activity and reduce competition and economic efficiency, contrary to the public interest.

There is therefore no speculative component to these transactions (*i.e.*, those that hedge the unfixed price sale or purchase or those that convert to CMA pricing). Rather, they are risk reducing and simply reflect the manner in which energy market participants buy and sell commodities. Accordingly, the Commission should provide bona fide hedging treatment to commodity derivative transactions that hedge unfixed-price commitments or establish CMA pricing.

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[7] *See* The Commercial Energy Working Group, Comment Letter on CFTC Position Limits for Derivatives, RIN 3038-AD99, at Section IV.G (Feb. 10, 2014) ("Working Group Position Limits Comment Letter") (providing examples describing the use of Referenced Contracts to convert transaction pricing terms to CMA pricing).

III. Providing an Exemption for Referenced Contracts that Hedge the Unfixed Price Purchase or Sale of a Cash Commodity or Achieve CMA Pricing Will Promote Efficiently Functioning Energy Markets.

API members and other commercial energy firms decide what "risk" means within the context of their businesses. Generally, they will scale their real economic activities to fit within a tolerable risk budget, and in some cases they will use hedges to reduce risk and thereby expand the scale of their activity. Restrictions on a commercial energy firm's legitimate hedging activity may require it to reduce its real economic activity, *i.e.,* the production, processing, merchandising, sale, or purchase of energy commodities and investment in key energy infrastructure, to fit within the same risk budget. API submits that allowing commercial energy firms to use Referenced Contracts to hedge according to their identified risks, such as the unfixed-price purchase or sale of energy commodities, or non-CMA purchase or sale, will maximize real economic activity and is therefore in the public interest.

Additionally, given its definition of "risk," an API member will prefer to procure commodities under particular pricing terms. An API member could achieve this goal by restricting its commodity counterparties to the subset of market participants that are willing to contract on those terms. However, if the API member is able to hedge unfixed price exposure, or hedge to convert pricing terms into its preferred form, then it is able to procure commodities on any pricing terms, hedging if necessary to obtain its preferred pricing structure. This approach permits an API member to transact with the entire set of market participants rather than a mere subset. By expanding the pool of suitable counterparties, the availability of hedging will increase competition and efficiency, and thus enable increased real economic activity.

Accordingly, the Commission should permit commercial energy firms to use Referenced Contracts to hedge risks associated with exposure to unfixed price terms or to establish the pricing terms deemed most effective and efficient to their business model and objectives.

IV. The Sale or Purchase of Referenced Contracts that Hedge the Unfixed-Price Purchase or Sale of a Cash Commodity or Achieve CMA Pricing Terms Fall within the Statutory Definition of "Bona Fide Hedging."

Commodity Exchange Act ("CEA") Section 4a(c)(2)(A)(i) states that a bona fide hedging transaction or position is one 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 ....

The use of Referenced Contracts to hedge the unfixed price purchase or sale of a commodity or achieve CMA pricing terms, as described in the Working Group Position Limits Comment Letter, satisfies the statutory definition of bona fide hedging.[8] First, buying or selling Referenced Contracts is 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. For example, once oil is purchased, the sale of the CME Crude Oil Futures contract is a substitute for selling the oil at a later time in a physical marketing channel. Second, the transaction is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." In this regard, API does not seek an exemption that is broader than the quantity of the underlying commodity that has been purchased or sold. Third, the transaction arises from the potential change in the value of an asset—for example, oil—that an API member owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising.

Accordingly, given the statutory definition permits a hedge exemption for a Referenced Contract hedging an unfixed price sale or purchase of a physical commodity or establishing CMA pricing, the CFTC should adopt such exemption in any final rule it adopts in this proceeding.

V. CMA Hedging Might Require Physically-Delivered Referenced Contracts to be Held Through the Spot Month.

As demonstrated by the examples provided in the Working Group Position Limits Comment Letter, commercial energy firms will need to hold commodity derivative transactions through the spot month to achieve CMA pricing.[9] As those examples show, the final step in the CMA hedge requires transacting ratably each trading day for the calendar month in question. These transactions are closing out the derivative positions established previously in the CMA process and must be done each trading day during that month, including the last three trading days of the contract.

API submits that there is no public policy reason to prohibit market participants from holding physically-delivered Referenced Contracts through the spot month. Market participants should be permitted to hold physically-delivered Referenced Contracts through the spot month where doing so is part of a bona fide hedging program routinely used by the firm for managing price risk. Unlike agricultural markets, a commercial energy firm could not be required to fulfill a delivery obligation it is unprepared to fill during the spot month, as energy contracts do not trade during the delivery month. Thus, there is no potential for disruption to the physical energy markets during the spot month by allowing firms to hold physically-delivered Referenced Contracts into the spot month. If commercial energy firms were forced to liquidate such contracts before the spot month, they would be prevented from using the hedging tool they deemed most efficient and effective.

[8] *See* CEA Section 4a(c)(2)(A)(i).

[9] *See* Working Group Position Limits Comment Letter at 29-37.

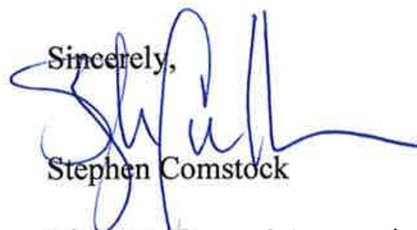
Carrying these physically-delivered Referenced Contracts into the spot month to achieve CMA pricing simply is not speculative (as described above and in the Working Group Position Limits Comment Letter). Accordingly, API requests that the Commission (i) provide bona fide hedging treatment to Referenced Contracts (a) hedging the unfixed price purchase or sale of the contract's underlying cash commodity or (b) achieving CMA pricing terms, and (ii) permit such Referenced Contracts to be held through the spot month.

VI. Conclusion.

For the foregoing reasons, API respectfully requests the Commission to provide in any final rule establishing federal position limits a bona fide hedge exemption for the sale or purchase of a Referenced Contract that (i) does not exceed in quantity the unfixed price purchase or sale of the contract's underlying cash commodity or (ii) converts pricing terms to CMA pricing. Further, API respectfully requests the Commission to permit market participants to hold such Referenced Contracts through the spot month. Alternatively, if the Commission concludes that it would not be appropriate to provide the bona fide hedge exemption as requested above, API requests that the Commission use its statutory authority under CEA Section 4a(a)7 to exempt such Referenced Contracts from any federal speculative position limits. Referenced Contracts used in the manner described herein are not speculative, and their hedging purpose is, and long has been, essential to the normal business practices of numerous physical commodity businesses.

API appreciates the opportunity to provide these comments. Should the CFTC have any questions or concerns regarding these comments, please direct them to Stephen Comstock, at 202-682-8455 or comstocks@api.org.

Sincerely,



Stephen Comstock
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ATTACHMENT 1

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Policy Advisor

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March 13, 2012

Submitted by Email to secretary@cftc.gov
And First-Class Mail

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Petition for Commission Order Regarding the Applicability of the Bona Fide Hedge Exemption to Certain Transactions

Dear Mr. Stawick:

The American Petroleum Institute ("API") hereby petitions for relief from the Commodity Futures Trading Commission (the "Commission"), under Section 4a(a)(7) of the Commodity Exchange Act ("CEA") and Section 151.5(a)(5) of the Commission's regulations,[1] concerning the applicability of the bona fide hedge exemption. Specifically, we ask the Commission, pursuant to its broad exemptive authority in Section 4a(a)(7) of the CEA, to recognize as bone fide hedging transactions routine energy market transactions that are priced at monthly average index prices. We request this relief pursuant to Section 151.5(a)(5) of the Commission's regulations, which permits "[a]ny person engaging in . . . risk-reducing practices commonly used in the market which they believe may not be specifically enumerated [as hedges to] request relief from . . . the Commission under section 4a(a)(7) of the Act concerning the applicability of the bona fide hedging transaction exemption."

Introduction

API is a national trade association representing more than 450 oil and natural gas companies. API's members transact in physical and financial, exchange-traded, and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business of delivering energy to wholesale and retail consumers. API members enter into

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1 Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626, 71,690 (Nov. 18, 2011).

futures, options, and swaps to hedge price risk and facilitate physical transactions. API members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry.

On behalf of its members, API respectfully requests that the Commission clarify that the sale or purchase of Referenced Contracts that do not exceed in quantity the unfixed-price purchase or sale of the contract's underlying cash commodity will be treated as enumerated hedging transactions and positions qualifying for the bona fide hedging exemption to position limits.[2] Energy commodities are often priced by reference to a floating metric -- such as, the calendar month average for New York Mercantile Exchange Light Sweet Crude plus or minus a differential -- exposing participants to fluctuating prices. It is critical that participants in energy markets are able to hedge risk associated with these routine unfixed-price purchases and sales. These hedges ultimately reduce risk and volatility in energy markets and facilitate the efficient provision of energy to consumers.

Discussion

I. The Commission should clarify that Referenced Contracts used to hedge risks attendant to the floating-price purchase or sale of an underlying cash commodity qualify as bona fide hedge transactions.

Section 4a of the CEA directs the Commission to set speculative commission limits on positions in futures, options, and economically equivalent contracts "other than bona fide hedge positions." To implement the bona fide hedge exemption, the Commission's rules exempt from position limits a transaction or position in a Referenced Contract that satisfies certain requirements. Among other things, the transaction or position must fall within a list of enumerated hedging transactions and positions.[3]

API seeks bona fide hedging treatment for the purchase or sale of Referenced Contracts that hedge the floating-price purchase or sale of the underlying commodity. API members often do not buy and sell commodities at fixed prices. Rather, as is standard in energy markets, they may buy and sell commodities at calendar-month-average prices. For example, a firm might buy or sell crude oil with the price specified as the average price of NYMEX Light Sweet Crude Oil during the entire spot moth or calendar month. That firm, now exposed to the

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[2] The definition of "Referenced Contract" is set forth in Section 151.1 of the Commission's regulations. *See* Position Limits for Futures and Swaps, 76 Fed. Reg. at 71,685.

[3] *See id.* at 71,689 (Commission Regulation § 151.5(a)(2)).

risk of changing prices, may seek to hedge its exposure to fluctuating prices by buying or selling Referenced Contracts.

API is concerned that these transactions will not fall within the list of enumerated hedging transactions exempt from position limits set by the Commission. Because the underlying commodity is purchased or sold at a monthly average price, rather than at a fixed price, API is concerned that the enumerated hedge exemptions for sales or purchases of referenced contracts that do not exceed the fixed-price purchase or sale, respectively, of the contract's underlying cash commodity will not apply.[4] The Commission has also provided an enumerated hedge exemption for "[o]ffsetting sales and purchases in Referenced Contracts that do not exceed in quantity that amount of the same cash commodity that has been bought and sold by the same person at unfixed prices basis different delivery months."[5] API is concerned that this exception might be too narrow to reach the full scope of routine transactions used by energy companies to hedge risks associated with floating-price transactions in the cash commodity. Accordingly, we ask that the Commission make clear that the transactions in Referenced Contracts that hedge physical commodity transactions priced at calendar or other average index prices, are enumerated bona fide hedging transactions.

In this regard, API fully supports the requests for exemptive relief contained in 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 dated January 20, 2012. In that Petition, the Working Group sought bona fide hedge treatment for, among other things, Referenced Contracts used to lock in a price differential where one leg of the underlying transaction is a floating-price commitment to buy or sell a physical energy commodity and the offsetting sale or purchase has not been completed. As the Working Group explained, a party may enter into a firm, floating-price, physical commitment to buy a commodity because market conditions make it profitable to buy the commodity and move it to a location where it is needed. For example, the party may buy oil at a floating price based on the ICE Brent crude contract and plan to sell it in the United States in the Gulf of Mexico at a sale not yet arranged but often priced off the NYMEX Light Sweet Crude Oil contract. The party must lock in the economics that make this sale profitable by buying ICE Brent futures and selling NYMEX Light Sweet Crude Oil futures. These transactions protect the party from the risk that the price it has agreed to pay for the oil will rise relative to the NYMEX Light Sweet Crude Oil price at which it will sell the oil. Of course, the same is also true in reverse.

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[4] *See id.* (Commission Regulation § 151.5(a)(2)(i)-(ii)).

[5] *See id.* (Commission Regulation § 151.5(a)(2)(iii)).

II. The sale or purchase of Referenced Contracts that hedge the floating-price purchase or sale of a cash commodity conform to the general definition of bona fide hedging.

As the foregoing description makes clear, the use of Referenced Contracts to hedge the floating-price purchase or sale of a commodity satisfies the general definition of bona fide hedging. First, buying or selling Referenced Contracts is 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.[6] For example, once oil is purchased, the sale of NYMEX Light Sweet Crude Oil Referenced Contract is a substitute for selling the oil at a later time in a physical marketing channel.[7] Second, the transaction is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[8] In this regard, API does not seek an exemption that is broader than the quantity of the underlying commodity that has been purchased or sold. Third, the transaction arises from the potential change in the value of an asset -- for example, oil -- that an API member owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising.[9] Alternatively, some such transactions could reduce risks attendant to a position resulting from a swap that qualified for bona fide hedging treatment.[10]

III. Exempting Referenced Contracts that hedge the floating-price purchase or sale of a cash commodity will promote the efficient functioning of energy markets.

It is critical that participants in energy markets are able to hedge risk. Given the prevalence of floating-price contracts for energy commodities -- such as, standard NYMEX Light Sweet Crude Oil calendar-month-average pricing -- participants in energy markets will often be exposed to fluctuating prices associated with the floating-price purchase or sale of commodities. These transactions are not speculative; they are simply how energy market participants buy and sell commodities. For example, a refinery processes crude seven days a week, but most crude pricing only occurs five days a week. This can lead to a timing imbalance that can be accounted for with calendar-month-average pricing. And participants in energy markets need to be able to hedge risk associated with floating-price transactions without worrying that they will exceed speculative position limits.

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6 *See id.* (Commission Regulation § 151.5(a)(1)(i)).

7 *Cf. id.* at 71,696 (Appendix B to Part 151, Example 3) ("Selling NYMEX Light Sweet Crude Oil Referenced Contracts is a substitute for transactions to be taken at a later time in the physical marketing channel once the oil is produced.").

8 *Id.* at 71,689 (Commission Regulation § 151.5(a)(1)(ii)).

9 *See id.* (Commission Regulation § 151.5(a)(1)(iii)).

10 *See id.* (Commission Regulation § 151.5(a)(1)(iv)).

The use of Referenced Contracts to hedge risk associated with the floating-price purchase or sale of energy commodities is also critical to the effective functioning of energy markets. Energy providers depend on the ability to lock in favorable economic conditions that make it profitable for them to move energy from where it exists to where it is needed. The Commission's position limits regime should not threaten these transactions that facilitate the efficient flow of energy to American consumers. Nor should the regime unnecessarily classify hedging transactions as speculative, so as to raise the costs of energy to American consumers.

Conclusion

For the foregoing reasons, API respectfully requests that the Commission clarify that the sale or purchase of Referenced Contracts that do not exceed in quantity the unfixed-price purchase or sale of the contract's underlying cash commodity will be treated as enumerated hedging transactions and positions qualifying for the bona fide hedging exemption to position limits.

Should you have any questions, please do not hesitate to contact me.

Respectfully submitted,

Brian Knapp

Policy Advisor,
American Petroleum Institute

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Honorable Mark P. Wetjen, Commissioner

ATTACHMENT 2

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February 10, 2014

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

RE: Position Limits for Derivatives, RIN 3038-AD99

Dear Secretary Jurgens,

The American Petroleum Institute ("API"), on behalf of its members, submits the following comments to the notice of proposed rulemaking ("NOPR") issued by the Commodity Futures Trading Commission (the "Commission" or "CFTC") concerning federal position limits for commodity derivative transactions under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1]

API is a national trade association representing more than 580 oil and natural gas companies. API's members range from the largest major oil company to the smallest of independents. They are producers, refiners, suppliers, pipeline operators, and marine transporters, as well as service and supply companies that support all segments of the industry. The core business of API members is delivering affordable energy to their wholesale and retail consumers. API's members transact in physical and financial, exchange-traded and over-the-counter markets primarily to hedge or mitigate commercial risks associated with their core business. API members enter into derivative transactions to facilitate physical transactions and to offset related exposures to price risk in such physical markets. Because API members rely on the integrity of markets under the Commission's jurisdiction, it appreciates the opportunity to comment.

I. INTRODUCTION.

API supports the goals of the Dodd-Frank Act to reduce systemic risk and enhance market integrity in the U.S. financial system. While our members appreciate the Commission's efforts to implement the regulations required by the Dodd-Frank Act in a timely manner, it is

[1] *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 78 Fed. Reg. 75,680 (Dec. 12, 2013) ("Position Limits NOPR" or the "NOPR").

important that the Commission implement tailored regulations that achieve the goals of the Dodd-Frank Act without unnecessarily disrupting the efficient operation of physical commodity and derivatives markets upon which API members rely to hedge risk. API believes that any final rule adopted by the Commission to establish federal position limits should balance the prevention of "excessive speculation" with the preservation of liquidity in the commodity derivatives markets and avoid unnecessarily restraining commercial risk-reducing activities. With this threshold policy concern in mind, API offers the following suggestions, which we discuss in greater length below:

- The CFTC should engage in a rigorous cost-benefit analysis that considers the impact to various market segments before implementing federal position limits.

- The CFTC should not adopt an overly restrictive definition of bona fide hedging.

- The CFTC should permit a market participant to identify and mitigate its risks according to its own business needs and goals. The CFTC should not effectively supplant a market participant's business judgment with its own view of commercial risk.

- The CFTC should grant a bona fide hedging exemption for anticipated merchandising activity.

- The CFTC should not adopt an arbitrary test for allowing cross-commodity hedging exemptions.

- The CFTC should exempt trade options from federal position limits.

- The CFTC should expand the definition of bona fide hedge to include commodity transactions priced as differentials.

- The CFTC should adopt the CME Group's estimated levels of deliverable supply.

As a general matter, API supports the comments submitted by the Commercial Energy Working Group ("CEWG") in this proceeding and believes the CEWG addresses API's concerns in addition to others. API offers the comments herein to echo the CEWG's comments and highlight the specific concerns that are most significant to API.

II. The Implementation of Federal Position Limits Should Not Unnecessarily Harm Energy Commodity Markets.

For energy market participants, the NOPR represents a significant shift from the existing framework in which regulated exchanges have the primary responsibility for implementing, monitoring and enforcing speculative position limits and granting related exemptions. The exchanges have the necessary resources, personnel and infrastructure to monitor positions in the market. API is concerned that the Commission's proposed regulatory framework (i) adopts a "one-size-fits-all" approach to position limits that is based, in large part, on the Commission's existing Part 150 regulations, which are applicable to certain futures contracts for agricultural products, and (ii) unnecessarily establishes overly prescriptive bright line rules.[2]

Energy markets have distinct operational differences from the agricultural markets, which historically have been subject to federal position limits.[3] These differences require consideration by the Commission and any new framework for federal position limits adopted in this proceeding must be specifically tailored to reflect the operational characteristics and risk management practices employed in each of the markets.

In light of the above, API believes that the Commission should not operate on the assumption that a historical paradigm for federal position limits in one commodity market can be readily applied across all commodity markets. Thus, the Commission ought to engage in a cost-benefit analysis that considers the impact to various market segments before implementing a new regulatory framework that unnecessarily harms commercial hedging activity.

The Commission should consider an approach to implementing and monitoring federal position limits that continues to utilize the resources and expertise of the exchanges in respect of energy commodities. API submits a paradigm in which both the exchanges and Commission engage in largely duplicative efforts offers no immediate benefit to the Commission or market participants and possibly constrains liquidity in the markets.

III. The Definition of "Bona Fide Hedging Position" Must Not Be Overly Restrictive.

A. Market Participants Must Be Permitted to Identify and Mitigate Commercial Risks in Accordance with their Own Business Judgment.

The definition of "bona fide hedging position" set forth in proposed CFTC regulation 150.1 requires that a commodity derivative contract be "economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise" (the "economically appropriate test"). API requests that the Commission confirm that this requirement permits each

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[2] For example, as discussed below, the NOPR attempts to enumerate positions that would qualify for bona fide hedging treatment and attempts to restrict bona fide hedging treatment to hedges reducing fixed price risk only.

[3] API recognizes that the proposed federal position limits under the NOPR represent significant changes to the agricultural and softs markets, particularly in the context of bona fide hedging, and that all commodity markets, regardless of the underlying commodities are negatively affected by many of the proposals in the NOPR.

market participant to identify risks in connection with its own business judgment and risk management policies. More specifically, this requirement must provide each market participant with the flexibility and discretion to identify and manage its risk as it deems appropriate be it across an entire corporate entity, or by legal entity, desk, book or business unit. Regulation should not constrain any market participant's view of what is economically appropriate in risk management.

Market participants in the energy commodity markets have different hedging goals and objectives and may identify or evaluate risks differently. Energy markets are dynamic and complex and present a variety of factors, such as delivery locations or product grades, which can be considered in achieving risk mitigation goals. Moreover, different commercial firms accept different risks and use a variety of effective business processes to achieve commercial objectives.[4] There are numerous circumstances in which it is economically appropriate to hedge specific risks in isolation or in the aggregate.

The Commission must avoid effectively supplanting a market participant's own judgment with regulations that direct a market participant to take a specific view of what is "economically appropriate" to its own business. The NOPR, in allowing certain positions to qualify for bona fide hedging treatment but not other equally risk-reducing positions, constrains the hedging objectives of commercial entities. This constraint will unnecessarily restrict the energy commodity markets and harm commercial hedging activity. Accordingly, the CFTC should clarify that, so long as a business can reasonably demonstrate that a hedging activity reduces or mitigates one or more specific, identifiable risks related to individual or aggregated positions or transactions, such activity should be deemed "economically appropriate."

B. The CFTC Should Retain Its Current Framework for Granting Bona Fide Hedging Treatment to Non-Enumerated Positions.

The NOPR provides that bona fide hedging exemptions will be granted only to positions enumerated in proposed CFTC regulation 150.1.[5] Unlike existing CFTC regulation 1.3(z), the

[4] For example, firms may use different approaches on whether supply chain costs might be managed on a fixed-price or floating-price basis.

[5] 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:

(A) Such position:

(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;

(II) liabilities that a person owns or anticipates incurring; or

NOPR excludes a provision that permits market participants to claim an exemption from applicable position limits for non-enumerated hedging positions. The ability of market participants to use a non-enumerated hedge under CFTC regulation 1.3(z) has worked well for many years. There is no substantive basis to eliminate the existing framework for non-enumerated hedges.

The Commission should preserve the framework for non-enumerated hedging positions that exists under CFTC regulation 1.3(z). As a threshold matter, API submits that, given the dynamic nature of energy commodity markets, the Commission cannot, and should not attempt to, identify and limit bona fide hedging treatment to a list of enumerated positions. While the NOPR allows market participants to receive staff interpretive guidance under CFTC regulation 140.99 or exemptive relief under Commodity Exchange Act ("CEA") Section 4a(a)(7) for positions not enumerated in CFTC regulation 150.1, the proposed framework under CFTC regulation 140.99 and CEA Section 4a(a)(7) for obtaining relief is impracticable and ill equipped to respond as rapidly as is often required by commercial hedgers, resulting in accumulation of costs and lost opportunities.

Given the restrictive nature and narrow definition of the enumerated bona fide hedging positions set forth in proposed CFTC regulation 150.1, there likely will be several petitions or requests seeking bona fide hedging treatment for non-enumerated hedging positions. However, the NOPR, CFTC regulation 140.99, and CEA Section 4a(a)(7) do not set forth specific timelines within which the Commission must deny or grant such petitions or requests. Further, these avenues for seeking bona fide hedging relief do not clarify the type of showing that must be made for a non-enumerated position to qualify for bona fide hedging treatment.

API requests that the Commission retain its framework for non-enumerated hedging positions that currently exists under CFTC regulation 1.3(z) and permit the exchanges to continue administering exemptions for such positions in real time. A non-enumerated hedge category would provide market participants with a real-time ability to hedge, but also would permit such hedging positions to be subject to review and scrutiny should trading activity be questioned by the Commission.

C. The CFTC's Definition of "Bona Fide Hedging Position" Should Include an Exemption for Anticipated Merchandising.

At a minimum, the CFTC must provide an enumerated bona fide hedging position for anticipated merchandising activity. In a distinct departure from vacated CFTC regulation 151.5 and Congressional intent, the NOPR does not allow anticipated merchandising positions to qualify as bona fide hedging positions. The Commission reasons in the NOPR that where a

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(III) services that a person provides, purchases, or anticipates providing or purchasing; ***and***

(iv) ***Is enumerated in paragraph (3) [(Enumerated hedging positions), (4) [(Other enumerated hedging positions)] or (5) [(Cross-commodity hedges)] of this definition . . . .***

(emphasis added).

merchant anticipates purchasing or selling a commodity without having acquired inventory or fixed-price purchase or sale contracts, price risk has yet to be assumed, and therefore, a commodity derivative contract would not reduce this "yet-to-be-assumed" risk.[6] This view reflects a very narrow perspective of risk. Such a view is contrary to sound and customary risk management and the plain language of the statute, and ultimately lessens the ability of commercial firms to hedge.

Merchandising is critical to the physical supply chain from the production to the consumption of commodities. API members hold real and significant price risk associated with their merchandising positions even before the underlying physical purchase or sale is finalized. The ability of commercial firms to hedge foreseeable risks is often a necessary condition to entering into the physical transaction.

It is doubtful that Congress intended to marginalize merchandising activity or treat differently the hedges related to producing, processing and consuming on one hand and anticipated merchandising on the other.[7] In fact, a plain reading of the CEA would suggest the opposite—that Congress intended hedges placed for anticipated merchandising to qualify for bona fide hedging treatment. API submits that the economically appropriate test does not require the Commission to establish a bright line interpretation or requirement that a market participant have fixed-price risk to qualify for bona fide hedging treatment. Therefore, the Commission should adopt a provision in its enumerated bona fide hedging definition that would allow anticipated merchandising positions to be given bona fide hedging treatment.

IV. Cross-Commodity Hedging.

Proposed CFTC regulation 150.1 would provide a cross-commodity hedging position an exemption from speculative position limits if the "fluctuations in value of the position for future delivery are substantially related to fluctuations in value of the actual or anticipated cash positions." The NOPR, however, establishes a safe harbor for cross-commodity positions wherein 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 .80 for at least 36 months (the "safe harbor"). Without any empirical data, API is uncertain how the Commission

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[6] NOPR at 75,718

[7] 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-
>
> . . .
>
> (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).

established its .80 correlation factor. API believes that this safe harbor is arbitrary and inconsistent with risk management practices utilized in the crude oil and other energy commodity markets. Moreover, the safe harbor (i) addresses economic relationships for cross-commodity hedging between spot market prices even though cross-commodity hedging typically occurs outside the spot month, (ii) applies an inappropriate look-back period, and (iii) sets a correlation factor that is too high, disqualifying hedges that legitimately reduce risk.

Accordingly, the Commission should adopt a facts and circumstances test to determine whether a cross-commodity position should be granted hedging treatment. There are derivative positions that represent a correlation less than .80 that are risk-reducing and reflect the most appropriate hedge available. A market participant engaging in legitimate hedging activity will ordinarily prefer the correlation between the hedging instrument and the underlying exposure to be as high as possible. However, in the absence of highly correlated instruments, firms might feel it prudent to hedge risk with an instrument with a moderate correlation with the underlying exposure, particularly if the alternative is not to hedge at all.

The Commission should not apply its five-day rule to cross-commodity hedging positions. If the Commission retains this restriction, market participants who own stocks of physical products that are hedged on a cross-commodity basis using physical-delivery Referenced Contracts will have to remain completely exposed to price risk during the spot month or replace their hedges with less effective hedges. The petroleum industry, in particular, would be impacted given the large number of varying crude grades and types of refined products involved. Ultimately, it must be recognized that these positions are not speculative in nature and, thus, should not be subject to speculative position limits.

V. THE COMMISSION SHOULD EXEMPT TRADE OPTIONS FROM POSITION LIMITS.

Physical forward contracts with embedded volumetric optionality are prevalent in crude oil and other energy commodity markets. API members enter into such transactions to meet their supply chain needs and manage risk.[8] More specifically, physical forward contracts with embedded volumetric optionality allow API members, at the time of execution, to ensure the supply of a physical commodity in unexpected circumstances, such as an increase in demand or a supply source becoming unavailable. The NOPR must consider the operational and risk-reducing benefits these contracts provide to market participants.

If trade options were subject to federal position limits, it would lessen the ability of commercial firms to use the futures and swaps markets to meet their physical supply or sale needs because the futures equivalent of the trade options would be applied when determining if a firm holds a position below the limit. In some instances, market participants *with no* derivatives positions other than trade options could find themselves in violation of position limits. Ultimately, the Commission has not proffered sufficient justification for subjecting trade options to federal position limits.

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[8] It's important to note here that volumetric options are more likely to be managing *volume* risk, rather than *price* risk.

API is concerned that trade options would not meet the definition of "bona fide hedging position." Proposed CFTC regulation 150.1 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." However, because some trade options function as pure physical purchases or sales, it is unclear whether such transactions would be considered the substitute, or the actual, position taken in the physical marketing channel and meet this prong of the bona fide hedging definition.

Additionally, several of the enumerated bona fide hedging positions would not allow a market participant to carry a physically-delivered Referenced Contract (*e.g.*, a trade option) into the spot month. Given many trade options require physical delivery during or after the spot month, market participants would not receive bona fide hedging treatment for such positions.[9] Thus, those market participants would have to abandon their trade options even though they may be the right instrument to manage their supply chain needs.

In light of the above, the Commission must exempt trade options from federal position limits. Subjecting these products to federal position limits will unnecessarily reduce liquidity and harm the efficient operation of physical commodity markets.

VI. The Commission Should Expand the Definition of Bona Fide Hedge to Include Commodity Transactions Priced as Differentials.

The CEWG describes in their comment several types of hedging where prices of physical commodities are set on a differential from a core reference contract or mitigate risks associated with pricing differentials between different grades of the same or similar commodities. These exposures are real and a market participant's ability to hedge them is critical. The types of hedging described by the CEWG are not unusual in the petroleum industry, and are significant to members of API. Accordingly, to the extent the Commission elects to adopt enumerated bona-fide hedge categories, API recommends that it provide a category for transactions that hedge a differential between locations, grades or qualities of two or more commodities.

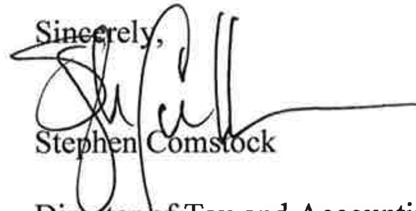
VII. Conclusion.

For the reasons described in these comments, API is concerned that the NOPR is too restrictive and could impair market liquidity in the energy commodity markets. In implementing final rules establishing federal position limits, the Commission should seek to curb excessive speculation while preserving liquidity in the derivatives markets that API members rely on to hedge their physical risk.

[9] Market participants holding trade options also would not qualify for the conditional spot month exemption for cash-settled Referenced Contracts as the exemption requires market participants to hold no physically-delivered Referenced Contracts.

API appreciates the opportunity to provide these comments. API members are pleased to provide any additional information regarding their views on the NOPR and welcome the opportunity to work with the Commission as it develops its final rule.

Should you have any questions or concerns regarding this comment, please direct them to Stephen Comstock at (202) 682-8455 or comstocks@api.org.



Sincerely,

Stephen Comstock

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