Edison Electric Institute
Power by Association

August 4, 2014

Via Electronic Submission

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

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

Dear Ms. Jurgens:

I. INTRODUCTION

The Edison Electric Institute ("EEI")[1] appreciates the Commodity Futures Trading Commission's ("CFTC" or "Commission") decision to hold a public roundtable on June 19, 2014, to discuss end-user issues related to the Notice of Proposed Rulemaking concerning Position Limits on Derivatives ("Proposed Rule").[2] EEI and its members have been active participants in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and filed comments in response to the Proposed Rule.[3] Pursuant to the Notice Re-Opening the Comment Period until August 4,[4] EEI offers the following additional comments on the issue discussed during the June 19, 2014 roundtable.

EEI members are not financial entities. Rather, they are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. If the Commission adopts a definition of *bona fide* hedging that is too narrow or inflexible, it will make important hedging activities more difficult for commercial end users which, as a consequence, may increase the price and volatility of energy for residential, commercial, and industrial customers. The position limits rule as proposed is complex and

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[1] EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 99 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry.

[2] Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013) ("Proposed Rule").

[3] Letter from EEI and EPSA to Jurgens, Sec'y, CFTC (Feb. 7, 2014) (on file with the CFTC)

[4] Position Limits for Derivatives and Aggregation of Positions, 79 Fed. Reg 37,973 (July 3, 2014).

places significant additional burdens on end users as they use transactions to hedge and mitigate commercial risk.

As such, EEI requests that the Commission take affirmative steps to simplify and reduce the burdens placed upon hedgers such as EEI members by the Proposed Rule. As entities that do not engage in speculation and rely upon CFTC regulated markets to hedge their risks, EEI Members are among the intended beneficiaries of the Proposed Rule. However, the complexity and burden of the proposal coupled with the limited and pre-determined set of "enumerated hedges" that are found to represent all *bona fide* hedges under the Proposed Rule renders it highly problematic from the perspective of electric company end-users.

As a general matter, EEI believes the Commission should acknowledge that there are *bona fide* hedges beyond the limited set it has listed. For example, the Commission has found that actions "mitigate or hedge commercial risk" for the purpose of the end-user exemption[5] and Major Swap Participant test[6] are legitimate hedging and not speculation. They are no less *bona fide* then the proposed enumerated hedges. As such, EEI urges the Commission to adopt a definition of *bona fide* hedging that is easily understandable and commercially practicable by incorporating the specific recommendations described below

Further, as discussed at the June 19 roundtable, the energy exchanges (ICE and CME) effectively grant hedge exemptions today for their non-enumerated hedge markets without the constraint to a limited set of hedges. They review facts and circumstances; recognize the legitimacy of hedging and grant a hedge exemption if justified. The Commission should consider building on this existing foundation and integrate this expertise and flexibility into any final rule as ICE and CME appeared to offer at the roundtable.

EEI offers the following additional comments on the issues related to gross hedging, cross-commodity hedging and anticipatory hedging discussed during the June 19, 2014, roundtable.

II. COMMENTS

A. The Commission Should Not Restrict Gross Hedging if Done Under Commercially Acceptable Risk Management Principles

To qualify as a *bona fide* hedging position, a position in a commodity derivative contract must be, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[7] As discussed during the roundtable, portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. As long as a company organizes risk-based portfolios on commercially reasonable risk management principles, market participants should have the flexibility to manage risk and hedge on a

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[5] Rule 50.50
[6] Rule 1.3(kkk)
[7] Proposed Rule 150.1.

portfolio level without regard to other portfolios within the same legal entity. This is especially important to EEI members as energy markets are regional in nature. As a result, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (i.e., it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region. The regional nature of the electric power industry also means that hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions. Moreover, forcing end-users to net positions between regions that may have limited commercial relationship with each other will increase risk, not decrease risk.

There was a discussion during the roundtable regarding how to distinguish hedging from speculating. EEI members have and follow documented risk management procedures to ensure that hedging transactions are designed to manage the risks incurred in their commercial operations. In addition, since the hedges are based on physical commodities, the value of the hedge changes as the market moves. As a result, energy companies have front office commercial operations personnel, supported by middle office risk management policies and back office derivative accounting processes, who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. If a hedge is not effective, these controls will identify it and require a change. As such, the Commission should continue to recognize the industry's risk mitigation practices and permit all forms of *bona fide* hedging regardless of whether those hedges are executed on an enterprise-wide gross or net basis, or at a portfolio level within a single company. So long as hedging practices are "economically appropriate and consistent with sound risk management principles", the Commission should defer to accepted industry practices. The dynamic and complex nature of energy markets, in particular electricity markets, demands that the Commission provide flexibility to those charged with managing risk in these markets.

B. The Commission Should Remove the Quantitative Test for Cross - Commodity Hedging

The Proposed Rule would permit certain cross-commodity hedges to qualify as *bona fide* hedging positions, "provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are *substantially related* to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract."[8] To further elaborate on when a cross-commodity hedge would be considered "substantially related" to a cash-market position, the Commission provided a non-exclusive safe harbor based on two factors: (1) a qualitative factor, requiring a reasonable commercial relationship between the underlying cash commodity and the commodity underlying the commodity derivative contract; and (2) a quantitative factor, requiring a reasonable and

[8] Proposed Rule at 75,824.

measureable correlation in light of available liquid commodity derivative contracts. Under the Proposed Rule, the CFTC would only presume an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[9] Positions that do not satisfy *both* the conditions of the safe harbor are presumed *not* to be *bona fide* hedging positions; however, a person may attempt to rebut this presumption.[10]

EEI strongly opposes the approach to cross-commodity hedges in the Proposed Rule and urges the Commission to remove the quantitative test from the safe harbor when it finalizes the position limits rule. The Commission should recognize that energy markets are different than financial markets and preserve sound risk management practices that have been developed in the industry. As discussed during the roundtable, hedging electric power is both an art and science with the key factors being time and location. Due to the constantly changing nature of electricity markets, a 36-month spot month look back does not work.

As discussed during the roundtable, there is a relationship between the price of the fuel used to generate electricity and the price of electricity. As such, utilities and other power generators have long used natural gas Referenced Contracts and other fuel-based derivatives to hedge the price risk associated with their electricity production. This correlation between natural gas and electricity prices is likely to increase going forward as the number of natural gas-fired generation facilities increases due to, among other factors, EPA rules and low gas prices. Many commonly traded physical products such as Heat Rates, which are discussed in detail in EEI's comments on the Proposed Rule, reflect this correlation.

There are also other significant problems with the Commission's proposed limitations on cross-commodity hedges. Using spot prices to make this determination, as proposed by the CFTC, is inconsistent with actual market practice. Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. In that case, a market participant will often convert its hedges from gas derivatives to electricity derivatives as the risk moves closer to, or into, the spot month. Requiring the proposed correlation in outer months would eliminate all available tools for hedging at illiquid locations which, in turn, would result in higher risks for market participants and higher costs for consumers.

Due to long-established risk manage practices using cross-commodity hedges, EEI would urge the Commission to give discretion to other widely recognized risk management practices used in the industry. As noted at the roundtable, EEI members and other sophisticated market participants in the physical energy space have internal risk controls such as managing value at risk (VAR), and hedge effectiveness monitoring to ensure that risk is being managed properly and effectively. Cross commodity hedges are monitored, and if a correlation breaks down, hedges will be adjusted accordingly. As physical commodity end-users EEI members participate in the futures and swap market first and foremost to hedge and manage risk associated with their

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[9] *Id.* at 75,717.
[10] *Id.*

businesses. Regulations that second guess these accepted industry practices and sound risk management controls will only add risk to the system and ultimately raise costs for energy consumers.

C. Trade Options Should Not be Subject to Position Limits

The proposed definition of "Referenced Contract" would include commodity trade options that technically fall within the definition of a "swap," but that generally are exempt from regulation under Part 32 of the CFTC's rules. Trade options are entered into by commercial market participants and, if exercised, result in the sale of a physical commodity for immediate or deferred shipment or delivery.[11] Trade Options, including physical forward transactions with embedded volumetric optionality, should not be subject to position limits. Trade Options are not transactions that are generally used to manage financial risk relating to changes in prices, but instead are physically settled transactions that are used to manage supply risk. In other words, the primary purpose of trade options is to ensure that the physical commodity itself will be available when needed. Subjecting these physically-settled products to position limits could materially harm the efficient operation of physical commodity markets and increase costs for end-users. This is of particular concern in the electricity sector, where after the polar vortex in January – February 2014, there has been increased focus by the Federal Energy Regulatory Commission and other regulators on electric system reliability during extreme weather events, and ensuring that generators have the fuel available to operate when called upon.

The potential costs to and impact on market participants of speculative position limits on trade options is significant. Trade options are not speculative by definition. Under the CFTC's Interim Final Rule, the offeree to a trade option must "be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such."[12] In other words, because a trade option must be related to the offeree's commercial business, it cannot also be a speculative derivative position (much less a cause of excessive speculation) under the position limits regime. Market participants would be required, for the first time, to develop systems to calculate the futures contract equivalents for these physical-delivery agreements and, for the first time, to associate trade option positions in terms of price risk for compliance with applicable limits, even though that is not the risk these products are primarily designed to manage. Furthermore, a position in a trade option does not share the same risk profile as a position in a future or financially-settled swap because trade options are not used to manage price risk but are instead used to manage supply risk. Therefore, tracking a trade option position in the same manner that you track a financial option will deceptively distort [both speculative and hedging] position sizes by mixing in contracts that primarily manage supply risk with those that manage price risk.

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11 Proposed Rule at 75,711 ("the position limit requirements proposed herein still would be applicable to trade options qualifying under the exemption").

12 Commodity Options, 77 Fed. Reg. 25,320 (April 27, 2012) Interim Final Rule 32.3(a)(2) (emphasis added).

Including trade options in the definition of Referenced Contracts also complicates the ability of market participants to manage risk because they would be precluded from hedging the risks associated with trade option positions given that one Referenced Contract cannot be used to hedge another Referenced Contract and cannot be netted against financially-settled Referenced Contract positions in the spot month. Furthermore, because trade options, as proposed, would be physically-settled Referenced Contracts, a market participant holding a single trade option would be ineligible for the conditional limit on the same financially-settled Referenced Contract. As such, trade options do not fit within the hedging definition put forth in the Proposed Rule. A regulatory outcome that requires market participants to terminate trade options for these reasons is not consistent with the manner in which trade options are used. Due to their customized nature, trade options typically are not liquid products that can be easily traded. They are typically structured as standing agreements between physical commodity market participants, often for longer durations, that are exercised in order to obtain a physical commodity. A regulatory construct that could force market participants to terminate these agreements will act to disrupt the physical supply chain and creates inefficiencies in managing physical supply risk. In addition, since trade options are not easily traded, the transaction must be terminated by mutually agreed negotiations with the other party. This is difficult to accomplish in a timely fashion and may require the party seeking to exit the transaction to pay a premium or penalty. More importantly being forced to terminate a trade option position defeats the purpose it was entered into in the first place which was to obtain physically delivered supply. For all of the above reasons, trade options do not fit any of the conceptual constructs for being included within position limits.

D. The Commission Should Allow Parties to Continue to Engage in Anticipatory Hedging

There are legitimate commercial reasons for anticipatory hedging, and EEI urges the Commission to allow this activity to continue. In some cases, Referenced Contracts are used to hedge ongoing, good faith negotiations, that the hedging party reasonably expects to conclude. Similar to binding and irrevocable bids and offers, a cash transaction that is the subject of ongoing negotiations is anticipated, but not yet a purchase or sale agreement, and therefore would not satisfy the requirements of the proposed definition of *bona fide* hedging position. Examples of this type of hedging include, hedging done in anticipation of the results of a state run standard offer service auction being certified by a state public service commission and buying in advance of renewing existing or enrolling new retail customers. Taking away suppliers' ability to hedge their bid prices will result in the risk being factored into the price which will raise prices for consumers.

III. CONCLUSION

The position limits rule as proposed is complex, creates uncertainty and places additional burdens on end users as they use transactions to hedge and mitigate commercial risk. EEI appreciates the opportunity to submit additional comments on these important issues and the Commission's consideration of these comments as well as its comments on the Proposed Rule. EEI respectfully requests that the Commission adopt the proposed clarifications and allow its members to continue to operate in a commercially reasonable manner in the commodities markets.

Please contact us at the number listed below if you have any questions regarding these comments.

Respectfully submitted,

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