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August 4, 2014

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

Re: Position Limits for Derivatives, RIN No. 3038-AD99

Dear Secretary Jurgens:

The Coalition of Physical Energy Companies ("COPE") appreciates its invitation to participate in the Commodity Futures Trading Commission's ("CFTC" or the "Commission") Staff Roundtable ("Staff Roundtable") held June 19, 2014 regarding the CFTC's proposed position limits rule ("PL NOPR").[1] As the Commission has reopened the comment period for the PL NOPR,[2] COPE offers these comments to supplement those it previously filed in this proceeding.[3]

The Coalition of Physical Energy Companies ("COPE")[4] is comprised of physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members generally use swaps, futures, options, and trade options in conjunction with their physical businesses, most typically for hedging. As physical commercial companies and hedgers in commodity markets, COPE members are among the intended beneficiaries of the proposed position limits regime.

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[1] Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013).

[2] Position Limits for Derivatives and Aggregation of Positions, 79 Fed. Reg. 30762 (May 29, 2014).

[3] COPE Comments Regarding Position Limits for Derivatives, RIN No. 3038-AD99, filed Feb. 10, 2014 ("Prior COPE Position Limits Comments").

[4] The members are: Apache Corporation; EP Energy LLC; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

While COPE will not repeat its prior comments, it will reiterate that the proposed position limits regime appears to be the most burdensome and intrusive element of Dodd-Frank regulation affecting end-users/hedgers. Unlike Swap Dealers, Swap Execution Facilities and other similar entities, end-users/hedges did not make an affirmative decision to get into a CFTC-regulated business with the knowledge of the burdens that would entail. Commercial end-users/hedgers are engaged in physical commercial businesses that require tools to hedge risk. The Commission should recognize this distinction and make an effort to limit the burden it is imposing on end-users. In the PL NOPR, the Commission noted that, although the record was mixed concerning the need for and efficacy of position limits, it was "erring on the side of caution" in proposing them. Similarly, the Commission should err on the side of reducing end-user/hedger burdens when implementing the limits.

In addition to limiting the complexity and burden of the PL NOPR, it is imperative that the Commission not interfere with legitimate hedging by physical companies hedging their risk in its zeal to prevent excessive speculation.

The Staff Roundtable Made Clear That the PL NOPR Does Not Treat All Legitimate Hedging as *Bona Fide* Hedging

COPE believes that the Staff Roundtable was a useful and constructive exercise. The participants were not speculators; rather, they were largely physical companies that hedge their risk using products that are proposed to be made subject to federal positron limits. These companies are the purported beneficiaries of position limits, as logically they would be harmed by the negative effects of "excessive speculation." However, the message of these companies at the Staff Roundtable was not that the Commission should protect them from excessive speculation. Instead, the message was that the Commission should not interfere with legitimate hedging.

COPE believes that the core problem with the PL NPOR, beyond its excessive complexity and corresponding burden, is that it would interfere with and limit legitimate hedging. This is particularly true in the energy space where the proposed enumerated hedge regime is not in effect today and much hedging has historically been accomplished with swaps (which have not generally been subject to position limits). Under the PL NOPR's enumerated hedge provisions, the CFTC will now pre-ordain what is a legitimate *bona fide* hedge and, if a firm does not hedge as proscribed by the rule, it will be deemed to be "speculating" (regardless of the fact that it is using the transaction to hedge its risk and is, in its view, mitigating its risk).

As discussed at the Staff Roundtable, as a general matter, physical energy companies do not speculate – they hedge. They are typically forbidden to speculate by their management, their lenders, or both. On the other hand, management and lenders often require hedging. Such required hedging is undertaken within risk limited parameters, and is managed, reported and documented.

Physical energy companies do not typically speculate because it is not their business model to do so. They are trying to run a profitable physical business and use hedges to limit risk. In contrast,

speculation increases risk. To the degree that some energy companies engage in limited speculation, it is typically for price discovery or other purposes aligned with their physical business and captured in a "Spec Book." The bottom line is that physical energy companies are hedgers and not speculators.

As was made clear at the Staff Roundtable, the PL NOPR does not recognize all of today's legitimate hedging as *bona fide* hedging that is exempt from the proposed limits. This fact was pointed out by both agriculture companies and energy companies present at the Staff Roundtable. Several of the participants were representatives of large global agricultural firms that engage in sophisticated transactions to hedge their risk that would not be recognized as *bona fide* hedges by the PL NOPR, but that when described at the Staff Roundtable seemed to be clearly hedging transactions. COPE can assure the Commission that it is not only large global agriculture firms whose hedging transactions are not captured by the PL NOPR's definition of *bona fide* hedge, but many of the rank and file energy firms as well.

The structure of the PL NPOR seems to be predicated upon the existence of a *bona fide* hedge list established up front. That is because the PL NOPR is backward looking (unlike today's hedge exemption regime under which a person that anticipates needing an exemption can seek one from the DCM and, if the risk and associated hedge needs are demonstrated, can receive a hedge exemption for a prospective period). Under the PL NOPR, it is only after-the-fact when a person exceeds a potion limit that *bona fide* hedging issues are triggered. At that point it is too late to consider whether the hedging was legitimate/*bona fide*. The excess is either offset by transactions that are pre-designated as *bona fide* hedges, or the person is in violation. There is no room to evaluate whether hedging transactions that are not on the *bona fide* hedging list are legitimate hedging once a limit is breached. COPE believes the inability to treat these transactions as *bona fide* hedges is a serious flaw in the PL NOPR and is the root cause of much of the angst expressed at the Staff Roundtable.

It is not too late to fix this flaw. The Staff Roundtable was a good example of how public, on-the-record dialogue can shed light on issues and prevent confusion, with the Commission and market participants "talking past each other."[5] If the Commission desires to retain the architecture of the PL NOPR (which COPE does not support), it should hold public meetings in which the enumerated hedges in the PL NOPR together with additional proposals are discussed and real world input is added to the administrative process. It would also be helpful to hear from those who are concerned about excessive speculation in such a process, to see if the PL NOPR addresses such concerns.[6]

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[5] COPE is a supporter of a public, on-the-record process as opposed to one of "one off" un-docketed filings addressing generic issues which are not noticed for comment by the CFTC, which is often used today.

[6] Apparently, although invited, such persons declined to participate in the Staff Roundtable.

Regardless of how the Commission fixes this flaw, the issue needs to be addressed. No pre-ordained list of enumerated hedges will capture all legitimate hedging. COPE believes that the Commission must create a workable and timely process to expand or provide exceptions to any list of enumerated hedges included in any final rule.

If the Commission is to administer such a process, it must provide sufficient staff resources and implement an approach that either recognizes the identified transaction as a hedge until the Commission acts, or assures a very quick turnaround (or both). Given the limited resources of the Commission and the realities of the administrative process, it is questionable whether such a process could be workable. However, as discussed at the Staff Roundtable, a time-sensitive approach that is built upon the existing knowledge of energy business that is used to grant hedge exemptions on DCMs (subject to Commission review) could be workable.

Today, energy companies subject to exchange position limits can inform the DCM upon which they are executing hedges about the nature and scope of their physical business, and the nature and size of the hedging transactions that they believe will help them manage their risks. The DCM will consider the facts and, using its expertise and experience, either grant or reject the requested hedge exemption (of course it can ask for more information or grant a more limited exemption). Assuming that the Commission could integrate this process into the after-the-fact approach proposed in the PL NOPR or otherwise modify its process, the proposal would be significantly improved and the fundamental flaw of disregarding certain legitimate hedging alleviated. At the Staff Roundtable, the representatives of CME and the Intercontinental Exchange stated that they are willing to work with the Commission to create such a process for hedge exemptions.

Regardless of the approach the Commission takes to timely and properly consider further exceptions, COPE believes the PL NOPR must be revised to make sure that the enumerated hedges proposed therein are not the exclusive set of *bona fide* hedges and all legitimate hedging is properly recognized as such.

Any Enumerated *Bona Fide* Hedges Adopted By The Commission Must Be Broad Enough To Capture All Legitimate Hedging Associated With Real-World Risk

In the Prior COPE Position Limits Comments, COPE requested that if the Commission retains an enumerated hedge regime, the Commission reinstitute the *bona fide* hedge for anticipatory merchandising associated with unfilled storage capacity it had included in its original proposed rules for position limits for derivatives.[7] Upon reflection, it is clear that limiting such a *bona fide* hedge to unfilled storage capacity is insufficient to capture the true scope of legitimate hedging that physical market participants employ in this logistical category. That is, the legitimate commodity hedging activities associated with commitments to reserve and pay for the physical infrastructure necessary to source, store and deliver commodities required for the on-going

[7] Prior COPE Position Limits Comments at 14-15

business needs of a physical merchandizer must be recognized as *bona fide*. These commitments are a necessary and material element of the commodity business and are the core components of the logistical aspects of a merchandizing business. Like storage, these infrastructure commitments put the merchandizer in a position that allows it to effectively access the commodity market and, if the commodity risk relating to these commitments can be properly hedged, to do so profitably.

The example below illustrates this risk and the benefits of hedging.

Company A regularly buys crude oil from South Texas producers at WTI-related prices. It holds capacity in pipelines and tanks to transport the crude oil from South Texas to coastal locations and has made commitments for vessels to ship the oil to U.S. Atlantic Coast refineries where it is sold at Brent-based prices. Company A has not purchased all of its crude needs for the coming months and has not sold any of such crude to its refinery customers. However, Company A has an established history of transacting on the basis described above. Moreover, it has committed physical and financial resources (commitments in pipelines, tanks, vessels, staff, front and back office systems, capital, etc.) for such anticipated transactions. The return on such resources/capital will be correlated to, and be a function of, in this example, the spread between WTI and Brent. If the spread narrows, Company A runs the risk of not making a return on its commitments. In order to hedge this risk, Company A may decide to enter into NYMEX CL futures contracts and Brent futures contracts (or comparable over-the-counter financial transactions) to manage the price exposure that arises from the nature of its commercial activity and committed resources.

As can be seen from the above, Company A is not speculating, but rather, hedging the risk of its on-going merchandizing business. It is doing more than hedging unfilled storage capacity. It is hedging the logistical delivery chain and spread (receipt point and delivery point) that its business profitability is based upon. If it cannot hedge the spread that its logistical commitments permit, it cannot address a core risk. The inability to hedge due to the Commission failing to treat the hedge as *bona fide* puts the entire business model at risk. There is simply no reason such legitimate hedging should not be recognized in any final rule issued by the Commission.

This example further illustrates the core problem with the PL NOPR's attempt to preordain all *bona fide* hedges for all affected commodity market participants and their businesses. There is no question that the proposed enumerated *bona fide* hedges do not capture all legitimate hedging and will have unforeseen negative impacts on physical businesses. COPE expects that under an exchange-based hedge exemption process, hedging the spread as described above would be accepted as *bona fide*.

However, assuming that the Commission does go forward with its enumerated hedge regime, it must not only include "Unfilled Storage Capacity," but it must also expand the concept to capture the real world elements of risk emanating from infrastructure logistical capabilities that underlie a physical business. Failure to permit legitimate hedging such as that described above will incentivize physical market participants to avoid investing resources in transactions that cannot be hedged, decrease liquidity and increase customer prices.

Cross Commodity Hedging Is Not Properly Addressed In The PL NOPR

Significant attention at the Staff Roundtable was devoted to the manner in which cross-commodity hedging is treated in the PL NOPR. The conversation around this topic was particularly informative to demonstrate why the limited nature of the PL NOPR's pre-ordained list of enumerated hedges does not cover all legitimate hedging.

The PL NOPR, *inter alia*, restricts *bona hedge* status to cross commodity hedges with a correlation of 80%.[8] Such arbitrary hair splitting has no place in the real word of hedging. If a physical firm desires to hedge its risk, it will seek a liquid product with 100% correlation. Unfortunately such products do not always exist. In such a case, assuming it wants to hedge, it will have to find the next best tool to do so. In looking at the issue a firm will consider liquidity/pricing, correlation,[9] industry practice and other hedge and business specific issues. It will then make a judgment as to the best product to best hedge its risk in the absence of a liquid 100% correlated product. The key is that the firm is hedging and it is using the judgment of its staff to select the hedge based upon multiple valid factors.

The PL NOPR does not recognize this reality. Instead, in many cross-commodity instances it will label such hedging as not *bona fide* and therefore speculation. Taking steps to acquire the best imperfect hedge available, with all things considered, simply cannot lead to excessive speculation. As the participants at the Staff Roundtable uniformly agreed, such legitimate hedging must be recognized as such in any final rules.

Additional Observations From the Staff Roundtable

Participants at the Staff Roundtable asked that the Commission take steps to clearly tie the requirements of the PL NOPR to the potential negative effects of "excessive speculation." The complex and burdensome process proposed in the PL NOPR is focused on excessive speculation and speculators, but instead seems to create a process that limits legitimate hedging. Any final rule issued by the Commission must make clear the specifics of excessive speculation that are targeted together with clear explanation as to why the regulations prevent it. It is not enough to mandate an extremely complicated regime that bars persons from holding certain positions at certain times. The Commission must show a meaningful nexus between the purported harm of some type of identifiable excessive speculation with the burdensome remedy of the PL NOPR.

Similarly, it appears to COPE that the manner in which excessive speculation could potentially cause negative impacts on commodity markets is by distorting price discovery. However, the PL

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[8] *See* PL NOPR at 75717.

[9] Further, as pointed out at the Staff Roundtable, due to dynamic market conditions, correlations do not always hold but will often fluctuate.

NOPR is not limited to price discovery contracts. It includes over-the-counter swaps[10] and trade options[11] as referenced contracts that are not used in any way for price discovery. Under the PL NOPR, a person could be barred from holding positions in over-the-counter swaps and trade options that play no part in price discovery or price formation. The proposal offers no rationale to include such contracts.

Further, the PL NOPR mechanically assigns the label of "economically equivalent" to any swap that employs a core referenced contract as part of its settlement terms.[12] Labeling a transaction as "economically equivalent" does not make the transaction actually economically equivalent. For example, as shown in comments filed in this proceeding, an electricity heat rate swap that employs a natural gas core referenced contract as a settlement component is not economically equivalent to a natural gas futures contract.[13] If the Commission finds otherwise, it must support its finding with compelling facts.

Thus, any final rule issued by the Commission must tie a meaningful risk of excessive speculation to the remedy proposed in the PL NOPR. The contracts that are subject to the limits must be those that could be employed to create the harm that would result from excessive speculation. The Commission must accomplish these goals without preventing or excessively burdening legitimate hedging. In order to meet the foregoing criteria, the PL NOPR should be fundamentally revamped. If the Commission can show a meaningful nexus the between the potential for harmful excessive speculation and its proposed position limits regime that is adequate to go forward, it must, at a minimum, revise its proposal to remove contracts that do not play a role in price discovery and adjust the resulting regime to assure it is flexible enough to recognize all legitimate hedging as *bone fide*.

Conclusion

COPE respectfully requests that the Commission carefully review the comments it has received and information from forums like the Staff Roundtable. In such a review, the Commission

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[10] *See* PL NOPR at 75825 (proposed § 150.1, definition of "Referenced contract") ("*Reference contract* means, on a futures equivalent basis with respect to a particular core reference futures contract, a . . . swap . . . [t[hat is . . . [d]irectly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular core referenced futures contract . . . .").

[11] *See* 17 C.F.R. § 32.3(c)(2) (providing that trade options are to be subject to position limits); *see also* PL NOPR at 75711 (explaining that the Commission is proposing to clarify in Section 32.3(c) that the newly proposed position limits would apply to trade options).

[12] *See infra* note 10.

[13] Prior COPE Position Limits Comments at p. 7 ("While these are different commodities than that covered by the core referenced futures contract and the price expressed for such commodities is the product of multiple inputs, the Position Limits NOPR deems them *per se* economically equivalent to the core referenced futures contract.")

should consider what it means by "excessive speculation" and how, if at all, the PL NOPR properly combats it. Assuming the Commission chooses to go forward with a final rule, it should: limit the burden of such final rule on hedgers; carefully target the rule to attack the specifics of the excessive speculation it is contemplating; and, make sure it is not disrupting or incorrectly classifying legitimate hedging.

Very truly yours,

/s/ David M. Perlman
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