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

Dear Ms. Jurgens:

The Electric Power Supply Association ("EPSA") appreciates the opportunity to provide the Commodity Futures Trading Commission ("CFTC" or "Commission") with limited comments set forth below in response to the Commission's extension of the comment period[1] on the Notice of Proposed Rulemaking concerning Position Limits on Derivatives ("NOPR" or "Proposed Rule").[2] EPSA 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"), including submitting comments on prior position limits rules issued by the Commission.[3]

I. Description of EPSA and Its Interest in the Proposed Rule

EPSA is the national trade association representing leading competitive power suppliers, including generators and marketers. These suppliers, who account for nearly 40 percent of the installed generating capacity in the United States, provide reliable and competitively priced electricity from environmentally responsible facilities. EPSA seeks to bring the benefits of competition to all power customers.

EPSA members are not financial entities. Rather, they are physical commodity market participants that rely on referenced contracts to hedge and mitigate their commercial risk.

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[1] Position Limits for Derivatives and Aggregation of Positions, 79 Fed. Reg. 30,762 (May 29, 2014).

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

[3] *See, e.g.*, Letter from EEI and EPSA to David Stawick, Sec'y, CFTC (Mar. 28, 2011) (on file with the CFTC); Letter from EEI to David Stawick, Sec'y, CFTC (Jan. 17, 2012) (on file with the CFTC); Letter from EEI, AGA, and EPSA to David Stawick, Sec'y, CFTC (Mar. 1, 2012) (on file with the CFTC); Letter from EPSA and EEI to Melissa Jurgens, Sec'y, CFTC (Feb. 7, 2014).

Regulations that make effective risk management options more costly for end users of derivatives will likely result in higher and more volatile energy prices for retail, commercial, and industrial customers. As end users of commodity derivatives who hedge commercial risk, EPSA's members have a direct and significant interest in the Commission's proposal to establish speculative position limits.

II. Background and Procedural History

On December 12, 2013 the Commission published a NOPR to establish speculative position limits for 28 exempt and agricultural commodity futures and option contracts and physical commodity swaps that are "economically equivalent" to such contracts. Comments on the NOPR were due February 10, 2014. EPSA, jointly with the Edison Electric Institute ("EEI") filed comments in response to the NOPR. On May 29, 2014, the Commission announced that Commission staff would host a public roundtable to discuss and consider certain issues related to the Proposed Rule regarding position limits for physical commodity derivatives ("Public Roundtable"), to take place on June 19, 2014. In connection with the Public Roundtable, the Commission announced it would allow comments on the Proposed Rule related to discussions at the Public Roundtable for a period of three weeks starting on June 12, 2014 and ending on July 3, 2014. On July 3, 2014, the Commission published an extension of the comment period until August 4, 2014.[4]

EPSA appreciates the Commission hosting the Public Roundtable and reopening the comment period to allow for comments related to the discussions at the Public Roundtable. While many of the points raised at the Public Roundtable echo points raised in EPSA's prior comments filed in February 2014, we will not rehash each point here. Rather, we would like to take this opportunity to reiterate a few key points raised at the Public Roundtable.

III. Comments

A. *The Commission Should Evaluate and Update the Information and Data Used to Establish Position Limits Including Deliverable Supply and Spot Month Limits*

As stated in earlier comments, EPSA encourages the Commission to look at how deliverable supply is currently determined and update that information for purposes of re-establishing and evaluating any proposed position limits. Many panelists at the Public Roundtable echoed the importance of the Commission evaluating the current deliverable supply figures and offered numerous suggestions on how the Commission could go about updating that information.

EPSA previously urged the Commission to adopt spot month position limits based upon the CME Group's estimates of deliverable supply. We note that since the adoption of the Dodd-Frank Act, the market has changed significantly and the deliverable supply figure the Commission currently uses does not accurately reflect the markets as they exist today. As explained in our February 2014 comments, we believe the CME Group's estimates of deliverable

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[4] 79 Fed. Reg. 37973 (July 3, 2014).

supply represent the most current and accurate data regarding the size of the markets for the commodities that underlie each core referenced futures contract. Commission reliance upon out-of-date statistics will likely result in imposing limits that are unnecessarily restrictive and will harm the liquidity of the derivatives markets. Since all futures transactions occur on an exchange, we believe the exchanges are in the best position to provide accurate and current information on the market. EPSA therefore encourages the Commission to follow its established practice of deferring to the exchanges' expertise and adopt position limits based upon the most current and complete information available.

As noted in the Proposed Rule, the Commission relied solely upon open interest data from calendar years 2011 to 2012 for futures contracts, options on futures contracts, and significant price discovery contracts that are traded on exempt commercial markets to calculate some proposed limits.[5] The Commission excluded open interest data derived from the CFTC's Part 20 large trader reporting rule and data derived from swaps reported to swap data repositories pursuant to the Commissions swap reporting rules from its calculation due to potential inaccuracies and other concerns.[6]

Given the incomplete and inaccurate information upon which the Commission proposes to establish Position Limits, EPSA argues that the Commission should allow the individual exchanges to establish the appropriate limits. At a minimum, EPSA argues that, if the Commission seeks to establish position limits across the board and across exchanges, it should ensure that the information upon which those limits are based is the most current, up-to-date information available. As previously stated, one way to accomplish this is to rely upon the information from CME Group.

B. *The Commission Should Consider Market Participant's Expertise and Commercial Risk Management Activity In Establishing Position Limits and Exemptions*

EPSA members are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. If the Commission adopts a Final Rule that is too narrow or inflexible, including an unworkable definition of *bona fide* hedging, it will make important hedging activities more difficult for commercial end users which, as a consequence, will likely increase the volatility and price of energy for residential, commercial, and industrial customers. Accordingly, EPSA urges the Commission to give careful consideration to the extensive experience market participants, including EPSA members, bring to bear and the extensive comments submitted throughout the Position Limits Rulemaking process. EPSA stresses the importance of adopting and implementing a Final Rule that is easily understandable, commercially practicable, and does not hinder the ability of market participants to effectively manage risk.

One issue discussed at the Public Roundtable related to the Commission's proposed qualification of certain cross-commodity hedges as *bona fide* hedging positions. Under the current Proposed Rule, the Commission would permit certain cross-commodity hedges to qualify

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[5] Proposed Rule at 75,730.

[6] *See* Proposed Rule at 75,733-34.

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."[7] 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 measureable correlation in light of available liquid commodity derivative contracts. 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."[8] This creates a rebuttable presumption that positions that do not satisfy both the conditions of the safe harbor are presumed not to be *bona fide* hedging positions.[9]

As previously explained, utilities and other power generators, including EPSA members, have long used natural gas futures contracts to hedge the price risk associated with electricity production. This hedging activity is a successful risk-management practice that has been employed for decades based upon EPSA members' commercial experience and reasonable business judgment. However, the Commission stated in the Proposed Rule that fluctuations in the value of electricity contracts are not considered substantially related to fluctuations in the value of natural gas.[10] EPSA disputes this determination and requests that the Commission should not attempt to substitute its administrative judgment for the commercially reasonable business judgment of market participants.

Contrary to the Commission's stated belief about the correlation between power and natural gas prices, there is substantial evidence in the assessments done by the Federal Energy Regulatory Commission ("FERC") as well as the system operators responsible for maintaining reliability in the electricity markets about the correlation between electricity contracts and natural gas contacts.[11] In fact, electricity prices and natural gas prices are so interrelated that the FERC

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[7] Proposed Rule at 75,824 (emphasis added).

[8] Proposed Rule at 75,717.

[9] *Id.*

[10] *Id.*

[11] *See e.g.* Winter 2013 -14 Energy Market Assessment, FERC Staff Report to the Commission (slide 11 illustrates correlation between natural gas and electricity prices in New England); 2013 Special Reliability Assessment: Accommodating an Increased Dependence on Natural Gas for Electric Power http://www.nerc.com/pa/RAPA/ra/Reliability%20Assessments%20DL/NERC_PhaseII_FINAL.pdf; Coordination Between Natural Gas and Electricity Markets , AD12-12 FERC Staff Quarterly Reports, http://www.ferc.gov/legal/staff-reports/2013/A-4-presentation.pdf;; Potomac Economics 20121 State of the Market Report for the ERCOT Wholesale Electricity Markets, http://www.potomaceconomics.com/uploads/ercot_reports/2012_ERCOT_SOM_REPORT.pdf; ISO New England 2013 Regional Electricity Outlook, http://www.iso-ne.com/aboutiso/fin/annl_reports/2000/2013_reo.pdf;

recently initiated a rulemaking process[12] and an administrative docket to evaluate the correlation between the two markets and direct the natural gas markets and the electricity markets to work together to ensure greater coordination between the two markets.[13]

EPSA notes other misconceptions reflected by the Commission's proposed limitations on cross-commodity hedges. For instance, the Commission proposes using spot prices to make the determination of an appropriate cross-commodity hedge; however, in the energy and electricity sector, such a determination is inconsistent with actual market practice. Many market participants hedge long-term electricity price exposure with natural gas futures contracts because there is insufficient liquidity in deferred month electricity futures contracts. They convert the hedges to electricity futures contracts 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 likely higher costs for consumers. The Proposed Rule would inappropriately limit a necessary, well-established, and beneficial hedging practice. EPSA is concerned that the Commission will reduce a complex, and often subjective, process to a flawed mathematical formula which will inappropriately eliminate the best available hedge.

The Commission has historically granted market participants significant flexibility regarding how market participants manage their commercial risk. EPSA sees no reason why the Commission should now restrain market participants' ability to effectively manage risk by substituting the Commission's administrative judgment for market participants' historically sound, commercially reasonable and effective risk management strategies, particularly when market participants possess such extensive experience responsibly managing complex and dynamic commercial risks. For the reasons explained at the Public Roundtable, and reiterated briefly above, EPSA opposes the Commission's approach to evaluating cross-commodity hedges as set forth in the Proposed Rule. We restate our request that, rather than the Commission defining when a hedge is "substantially related" to the price of an underlying commodity using an arbitrary numeric threshold, the CFTC should permit market participants to continue to make commercially reasonable determinations of which contracts are substantially related and will best manage their commercial risk.

C. *The Commission Should Not Regulate Exempt Commodity Trade Options As Referenced Contracts*

As noted at the Public Roundtable, EPSA reiterates that commodity trade options should be excluded from the definition of "Referenced Contract" [14] and, thus, exempt from the Position Limits rules. As currently drafted, the proposed definition of "Referenced Contract" would

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[12] *Coordination of the Scheduling Processes of Interstate Natural Gas Pipelines and Public Utilities*, 79 Fed. Reg. 18,223 (April 1, 2014).

[13] *Winter 2013-2014 Operations and Market Performance in Regional Transmission Organization and Independent System Operators*, Docket No. AD14-8-000.

[14] Under the Proposed Rule, all Referenced Contracts, as defined in proposed regulation 150.1, will be subject to the Position Limits Final Rule.

include commodity trade options. While commodity trade options technically fall within the definition of a "swap", such transactions are generally exempt from regulation under Part 32 of the CFTC's rules because they are entered into by commercial market participants and, if exercised, would result in the sale of a physical commodity for immediate or deferred shipment or delivery.[15] Trade options must be transacted by commercial market participants as part of their commercial businesses. EPSA notes that a trade option is not a speculative derivative and cannot give rise to excessive speculation.

EPSA previously urged the Commission to exclude from the definition of Referenced Contract commodity trade options that are exempt under Part 32 explaining that subjecting commodity trade options to position limits would impose a complex and expensive new regulatory regime on a category of non-speculative commercial transactions (and in many cases, commercial market participants) that have never been subject to position limits set by the CFTC or any other financial regulator.[16] Position limits are established limits for speculative positions, and the CFTC has previously recognized that Commodity Trade Options are not for speculative purposes.[17] Commodity trade options provide a mechanism for merchandisers to sell future production, and for consumers to purchase a physical commodity. Trade options can have longer, multi-year terms, and embedded volumetric optionality. If trade options are subject to position limits, one long-term trade option could inappropriately use up the majority of a market participant's [speculative] trading limits for multiple years. Moreover, the CFTC expressly recognized the importance of agreements that contain embedded optionality when it recognized that "supply and demand requirements cannot always be accurately predicted" and that embedded volumetric optionality can be a "commercially reasonable way to address [such] uncertainty."[18] Given that the Commission has expressly asserted that trade options are non-speculative and has described explicitly an exempt trade option as a transaction entered into "solely for non-speculative purposes demonstrably related to [the offeree's] commercial business in the commodity which is the subject of the option transaction," EPSA urges the Commission to exclude from the definition of Reference Contract commodity trade options.

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

[16] This is particularly true for commercial market participants that enter into forward contracts with embedded optionality. Due to regulatory uncertainty over whether certain contracts with embedded optionality are swaps or excluded forward contracts, many market participants have, out of an abundance of caution, characterized their agreements as commodity trade options in order to reduce the risk that these forward contracts would be deemed in hindsight to be swaps and, therefore, subject to extensive regulatory requirements. Subjecting otherwise exempt commodity trade options to position limits makes this safe harbor much less viable for many market participants.

[17] *Regulation of Commodity Option Transactions*, 43 Fed. Reg. 54220, 54221 (November 21, 1978); *see also Proposed Reissuance of and Amendments to Regulations Permitting the Grant, Offer and Sale of Option on Physical Commodities*, 46 Fed. Reg. 23469, 23476 (April 27, 1981).

[18] *Further Definition of "Swap", "Security-Based Swap", and "Security-Based Swap Agreement"; Mixed Swaps, Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 (August 13, 2012).

Additionally, since there are still outstanding requests for clarification on the treatment of physical forward contracts with embedded volumetric optionality, EPSA reiterates our request for clarification and reasserts that commodity trade options should be exempt from the position limits rules.

IV. Conclusion

EPSA appreciates the Commission's continued consideration of industry participants' input regarding development and implementation of Position Limits Rules and on the Proposed Rule. For the foregoing reasons, EPSA respectfully requests that the Commission adopt its comments and allow its members to continue to operate in a commercially reasonable manner to manage their risk in the commodities markets.

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

Respectfully submitted,

/s/ Melissa M Mitchell

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