



March 30, 2015

**VIA ONLINE SUBMISSION**

Christopher Kirkpatrick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**RE: Position Limits for Derivatives and Aggregation of Positions,  
RIN 3038-AD99; 3038-AD82**

Dear Mr. Kirkpatrick:

By this letter, the Natural Gas Supply Association (“NGSA”) respectfully submits these comments in response to the U.S. Commodity Futures Trading Commission’s (the “CFTC’s” or “Commission’s”) reopening of the comment period on its Proposed Rule, Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013) (the “Proposed Rule”) and its companion Proposed Rule, Aggregation of Positions, 78 Fed. Reg. 68946 (Nov. 15, 2013) (the “Proposed Aggregation Rule”). NGSA submitted comments on February 10, 2014, June 26, 2014 and August 4, 2014 and appreciates the Commission’s diligent consideration of the many concerns spurred by the Proposed Rule. Following up on the discussion at the February 26, 2015 Energy and Environmental Markets Advisory Committee (“EEMAC”) meeting, **NGSA wishes to offer a path forward that will protect the integrity of markets for both consumers and the industries that rely on them.**

NGSA supports the Commission’s commitment to ensuring well-functioning, efficient energy markets that are free from manipulation and excessive speculation, including the implementation of reasonable speculative position limits to the extent such limits are necessary to maintain orderly markets. **Markets can function well where speculative position limits are appropriately set and where exemptions for *bona fide* hedging are appropriately managed.**

To accomplish this, speculative position limits and their subsequent administration must: (1) be transparent, efficient and principled; (2) provide flexibility to allow for the development and use of innovative hedging practices; and (3) be established in a way that is reflective of underlying market conditions. Inadequacy in any of these areas risks dampening or distorting the market response to changes in underlying fundamentals, discouraging risk management practices, reducing liquidity, and increasing the cost of hedging.

The Proposed Rule misses the mark in these areas. While countless market participant concerns have been raised in thousands of pages of comments filed since the issuance of the Proposed Rule in late 2013, the bulk of these concerns can be remedied by the Commission getting the following fundamental issues right: (1) providing an adequately flexible process for securing a *bona fide* hedge exemption; (2) maintaining a proper focus on physically settled spot-month contracts; and (3) establishing an appropriate estimate of deliverable supply upon which the spot-month limit on physically settled contracts will be based.

In this letter, NGSa respectfully proposes a few practical solutions that address these issues in a workable manner consistent with the requirements of the Commodity Exchange Act (“CEA”), past Commission practice, and the hedging needs and market realities faced by market participants. First, the Commission should, consistent with Congressional authorization and past Commission practice, **delegate increased authority to designated contract markets (“DCMs”) and swap execution facilities (“SEFs”) to (a) review and approve market participants’ use of the *bona fide* hedge exemption to comply with federal position limits in the spot-month and (b) administer controls on positions outside of the spot-month in the form of position accountability levels.** Second, the Commission should **establish significantly higher limits, based on open interest, for cash-settled contracts in the spot-month, with no requirement to divest of the physically-settled contract.** Third, the Commission must **base the spot-month limit on physically settled contracts upon a reasonably current estimate of the deliverable supply of the subject commodity.** These combined approaches will accomplish the important objectives described above in a manner that best serves the Commission, the market participants who rely on commodity markets for risk management, and the consumers ultimately served by such markets.

## I. Delegate Increased Authority to Exchanges to Administer Appropriate Controls on Position Levels.

Congress's purpose in authorizing the Commission to establish speculative position limits consists of the following:

- (i) to diminish, eliminate, or prevent excessive speculation as described under this section;
- (ii) to deter and prevent market manipulation, squeezes, and corners;
- (iii) to ensure sufficient market liquidity for *bona fide* hedgers; and
- (iv) to ensure that the price discovery function of the underlying market is not disrupted.<sup>1</sup>

These purposes would be best fulfilled by delegating administration of the position limits regime in large part to DCMs and SEFs (referred to collectively herein as "exchanges").

Congress and the Commission have a long history of delegating administration of controls on speculative positions to the exchanges. Under the Commodity Futures Modernization Act of 2000 ("CFMA"), DCMs were given authority to implement both position limits and "position accountability levels"<sup>2</sup> under Core Principle 5.<sup>3</sup> As the Commission itself noted in the Proposed Rule, the Commission itself has "long relied on the DCMs to protect the integrity of the exchange's delivery process in physical delivery contracts," which Congress recognized in Core Principle 5.<sup>4</sup> More recently, SEFs have been given identical authority under the Dodd-Frank Act under Core Principle 6.<sup>5</sup> In addition, Congress has given both types of exchanges "reasonable discretion" in determining how to comply with their respective Core Principles.<sup>6</sup>

### *A. Exchange Review of bona fide Hedge Positions*

The flexibility afforded by exchange administration of controls on speculative positions, particularly exchange review of *bona fide* hedges, offers an

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<sup>1</sup> CEA § 4a(3)(B).

<sup>2</sup> "Position accountability levels are not fixed limits, but rather position sizes that trigger an exchange review of a trader's position and at which an exchange may remediate perceived problems, such as preventing a trader from increasing his position or forcing a reduction in a position." Proposed Rule at 75749.

<sup>3</sup> CEA § 5(d)(5).

<sup>4</sup> Proposed Rule at 75712-13.

<sup>5</sup> CEA § 5h(f)(6).

<sup>6</sup> CEA §§ 5(d)(1)(B), 5h(f)(1)(B).

ideal solution for ensuring that market participants have adequate flexibility with respect to their commercial hedging activities as Congress intended. To be sure, preserving commercial market participants' ability to use derivatives to hedge risk without excessive regulatory burden was a central priority of Congress in enacting the Dodd-Frank Act:

No rule, regulation, or order issued under subsection (a) of this section shall apply to transactions or positions which are shown to be *bona fide* hedging transactions or positions[.]<sup>7</sup>

In implementing Congress's directive to exempt *bona fide* hedges from speculative position limits, the Commission has defined a *bona fide* hedge position in the Proposed Rule as a position that:

- (A) 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;
- (B) Is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;
- (C) Arises from the potential change in the value of –
  - (1) Assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
  - (2) Liabilities which a person owes or anticipates incurring; or
  - (3) Services that a person provides, purchases, or anticipates providing or purchasing; and
- (D) Is enumerated in paragraph (3), (4) or (5) of this definition . . . .<sup>8</sup>

Clauses (A)-(C) of this definition match the directive given by Congress in Section 4a(c)(2) of the CEA, which provides detailed but flexible criteria regarding what constitutes a *bona fide* hedging transaction. However, clause (D) of this definition, which requires *bona fide* hedges to fall within a limited number of categories enumerated by the Commission, is not prescribed anywhere in the CEA. Unfortunately, and of great concern to market participants, such a **narrowly-scoped list of *bona fide* hedges would limit a dynamic and diverse**

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<sup>7</sup> CEA § 4a(c)(1). *See also* Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson 1 (June 30, 2010) (“Regulators . . . must not make hedging so costly it becomes prohibitively expensive for end users to manage risk.”).

<sup>8</sup> Proposed Rule at 75823, 17 C.F.R. § 150.1.

**market to a pre-envisioned “menu” of risk management practices that, in a well-functioning, competitive market, will always be out of date.** The deluge of industry comments regarding the inadequacy of the scope of the Proposed Rule’s list of enumerated hedges illustrates the inadequacy of such a list perfectly.

The list, on issuance, failed to include even many of the *current* risk management practices, as described in NGSAs February 10, 2014 comments on the Proposed Rule. For example, with respect to the proposed restriction on short anticipatory hedge positions, NGSAs members routinely hedge natural gas production expected or “anticipated” to be produced during the spot-month or delivery period by selling NYMEX Henry Hub Natural Gas (“NG”) contracts. With the passage of time, future production hedged with forward contracts eventually becomes current month production hedged with spot-month contracts. Consequently, the ability to make delivery on a NG anticipated production hedge promotes cash and futures market convergence, promoting the price discovery function of the underlying physical-delivery futures market. The inability of a market participant to garner a *bona fide* hedge exemption in this instance risks disrupting the price discovery function of the NG market.

With respect to hedges of anticipated revenues associated with owned or leased merchandising capacity, many natural gas market participants hold contractual rights for natural gas storage capacity that is typically used to store natural gas during times of lower demand (summer) for later use during times of higher demand (winter). Market participants may lock in the spread between their anticipated injections or purchases and their anticipated withdrawals or sales with natural gas calendar spread hedges. Importantly, the risk to the company is not just the rent paid for use of the storage facility. An additional risk is the fact that the spread will narrow during the same time. Thus, the economic value of a storage contract is the market value, which is a function of the calendar spread and the volatility of that spread. Absent the ability to garner a *bona fide* hedge exemption if necessary, a company with a storage contract would be exposed to the risk of a loss in economic value of such contract that might have otherwise been hedged.

The list of enumerated hedges in the Proposed Rule was ill-suited to accommodate current practices when it was issued. Further, it is unrealistic to expect a list of enumerated hedges, no matter how large it is, to ever be comprehensive enough, or even appropriately reflect many common industry hedging practices, when commodity industries are so diverse and markets and risks are continually evolving. **Attempting to narrow market participants to a limited menu of enumerated *bona fide* hedges discourages innovation and concentrates the market into a prescribed and predictable set of hedging activities that will undoubtedly raise hedging costs and fuel an environment**

**of hedges that are ill-suited for ever-changing market risks and investments.** This is not in the best interest of consumers, but it can be easily remedied through a process that allows for exchange-administered review and approval of *bona fide* hedges.

Therefore, NGSAs respectfully requests that clause (D) in the definition of *bona fide* hedge position described above be revised to read as follows:

(D)(1) Is enumerated in paragraph (3), (4) or (5) of this definition; or (2) Is approved by the designated contract market or swap execution facility on which such position is held, as applicable, as satisfying the requirements of clauses (2)(A)-(C) of this definition; or . . . .

Consistent with the existing definition of *bona fide* hedging position in Section 1.3(z)(1) of the Commission's regulations, upon which Congress obviously patterned its directive in the CEA, this treatment would effectively recognize that ***bona fide* hedge positions include, but must not be limited to, a prescribed set of enumerated transactions.**

At the June 19, 2014 CFTC staff roundtable on position limits, representatives of two prominent exchanges, the CME Group and the Intercontinental Exchange, indicated that they would be willing to accept Commission delegation of a determination of the validity of non-enumerated hedges. Given the exchanges' administration of hedge exemptions today and the associated familiarity that they have with the hedging needs of commercial companies, the Commission should capitalize on the experience and resources of the exchanges, and the authorization provided to such exchanges by Congress, to ensure that adequate flexibility is preserved with respect to commercial hedging activities.

***B. Exchange Administration of Controls on Non-Spot-Month Positions through Position Accountability Levels.***

The CEA requires the position limits established by the Commission to be both "necessary" and "appropriate" for preventing "excessive speculation . . . causing sudden or unreasonable fluctuations or unwarranted changes in [ ] price" and "market manipulation, squeezes or corners," while at the same time ensuring "sufficient market liquidity for *bona fide* hedgers" and non-disruption of "the price discovery function of the underlying market."<sup>9</sup> **The threat of market**

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<sup>9</sup> See CEA §§ 4a(1), (3)(B).

**manipulation, squeezes, and corners and the possibility of sudden or unreasonable fluctuations or unwarranted changes in price primarily relates to the required convergence of prices in the derivative and cash commodity markets within the spot-month. Therefore, controls on positions outside of the spot-month should be afforded greater flexibility.**

As the Commission noted in the Proposed Rule, exchanges have a history of administering controls on non-spot-month positions in the form of position accountability levels, which are not fixed limits but rather position levels that trigger review of a trader's position and potential dialogue with the trader to determine the appropriateness of such position, potentially followed by directives preventing the trader from increasing its position or forcing it to reduce its position.<sup>10</sup> The Commission recognized the appropriateness of such accountability levels in Section 150.5(b)(3) of its Proposed Rule, allowing exchanges to administer such levels in lieu of hard limits for contracts of sufficient liquidity. Since the NYMEX Henry Hub Natural Gas contract, and presumably most or all of the other "core referenced futures contracts," are highly liquid contracts, the use of accountability levels should be extended to such contracts outside the spot-month.

Importantly, exchange-administered accountability levels **allow the positions held by a company to be expediently evaluated, subject to Commission oversight**, via a dialogue between the exchange and market participant regarding trading activity. Since hedging strategies and tools continuously evolve with changing market conditions, the exchange-market participant dialogue **enables market participants to use a variety of hedging strategies that appropriately evolve over time as market conditions change**. Individual corporate hedging strategies differ for a variety of reasons that, for example, range from risk tolerance and portfolio composition to innovation in hedging practices. A hedging strategy that may appear novel may, in fact, be more efficient and appropriate than a hedging strategy envisioned in prior years and published on a list. Innovation is an important characteristic of any market, financial or physical.

One need look no further than the natural gas market to see the consumer benefits of innovation. Markets evolve and consumers benefit from this evolution. Likewise, hedging strategies must have an ability to evolve so that hedges, including imperfect ones, remain efficient and appropriate for risk management needs in ever-changing markets. There is no better way to accommodate the clear, diverse needs of hedgers than to allow for exchange-

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<sup>10</sup> Proposed Rule at 75749.

administered accountability limits, because such review would allow for a real-time conversation about hedging activities between the exchange and the market participant. With this approach, the Commission can focus its resources on oversight of the broader market and exchanges.

To summarize, providing for exchange review and approval of *bona fide* hedge positions and exchange administration of non-spot-month position controls in the form of position accountability levels ensures adequate flexibility to accommodate the diverse hedging needs of market participants in evolving markets and is consistent with the CEA and past Commission practice. Coupled with the transparent creation of a federal limit that is grounded in factual, well-understood market data, the exchange-administered approach would free Commission resources to focus on oversight and sound implementation of the many remaining issues stemming from the Commission's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

## II. Focus on Physically-Settled Contracts in the Spot-month.

NGSA proposes that the limits on cash-settled contracts in the spot-month be eliminated or substantially raised. This approach would **focus the speculative position limits on contracts where there is the greatest potential for speculative activity in the futures market to influence physical market prices** – the physically-settled, spot-month contract. In addition, this approach would provide a safe place in the financial markets for larger speculative positions to be held – *away* from physically-settled contracts.

As mentioned above, the CEA requires the position limits established by the Commission to be both “necessary” and “appropriate” for preventing “excessive speculation . . . causing sudden or unreasonable fluctuations or unwarranted changes in [ ] price” and “market manipulation, squeezes or corners,” while at the same time ensuring “sufficient market liquidity for *bona fide* hedgers” and non-disruption of “the price discovery function of the underlying market.”<sup>11</sup> For these reasons, position limits on cash-settled contracts in the spot-month should be eliminated, or, at the very least, increased substantially and based upon open interest in the referenced contracts, as opposed to deliverable supply in the subject commodity. Because cash-settled contracts are not subject to physical delivery, there is no “corner” or “squeeze” concern that warrants a limitation based on deliverable supply, and any concerns

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<sup>11</sup> See CEA §§ 4a(1), (3)(B).



about “excessive” speculation can be adequately addressed by a limitation based on open interest relative to other market participants.

If spot-month position limits on cash-settled contracts are retained, the higher “conditional” limits for cash-settled contracts provided under Section 150.3(c) of the Proposed Rule should be maintained (but increased, based on open interest, as discussed above) and should not be limited to traders that only hold cash-settled positions. Rather, the separate treatment of cash-settled and physical-delivery contracts under Section 150.2(a) should be maintained in such instance. The condition that the trader hold no spot-month position in the physical-delivery contract has the potential to harm the market for the physical delivery contract by moving liquidity in the spot-month period from such contract to the cash-settled contract. To summarize, eliminating or substantially increasing the limits on cash-settled contracts in the spot-month will focus restrictions where they can truly serve a useful purpose and will avoid unnecessarily and inappropriately restricting healthy market function.

### **III. Update Estimates of Deliverable Supply Based on Current Data.**

Finally, both exchange-administered accountability levels and federal position limits<sup>12</sup> must be based on *current* deliverable supply data. This is especially important for capital-intensive, growing commodity markets, such as natural gas. Over the last five years, the United States has emerged as the world leader in natural gas production. This achievement both spurs and requires investment. Responding to U.S. natural gas supply growth, U.S. industry is expected to invest \$100 billion over the next half decade to restart previously shuttered industrial facilities or expand approximately 100 new U.S. facilities in the fertilizer, steel, petrochemical and paper industries.<sup>13</sup> In addition, the INGAA Foundation in their report prepared by ICF International in March 2014, estimates that investment in new natural gas transmission capacity (including new mainlines, natural gas storage fields, laterals to/from storage, power plants and processing facilities, gas lease equipment, processing facilities, and LNG export facilities) needed through 2035 to bring the new natural gas supplies to market is projected to average approximately \$14 billion per year.

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<sup>12</sup>Discussion at the EEMAC meeting highlighted the lingering debated regarding Congressional intent, the need for a federal limit and whether or not there has been a finding of excessive speculation. NGSA does not take a position on these issues. Instead, the fact remains - markets can function well with appropriately set speculative position limits and markets do not function well with prolonged regulatory uncertainty.

<sup>13</sup> See NGSA 2014-2015 Winter Outlook available at [www.ngsa.org](http://www.ngsa.org).

The ability to efficiently hedge, via both physical and financial tools, **facilitates capital investment in natural gas production and infrastructure.** Unnecessarily restrictive position limits rules, *e.g.* unworkably low limits combined with a narrowly-scoped *bona fide* hedge exemption, risk lowering liquidity and driving up the cost of hedging, which in turn would reduce or eliminate the willingness of end-users to hedge.

The scale of natural gas facilities and the associated fuel portfolios relative to current exchange-set position limits illustrate the importance of appropriately sized speculative position limits. CME estimates the deliverable supply of natural gas at Henry Hub to be 154,200,000 MMBtu, which translates to 15,420 contract units. Twenty-five percent of such deliverable supply would be 3,855 contracts, nearly four-times the CFTC's proposed initial limit of 1,000 contracts.<sup>14</sup> To put this limit into perspective relative to physical energy assets, a market participant could only be assured of its ability to hedge about *half* of the fuel requirements of a portfolio of 2,700 MW of natural gas-fired power generation with the NG contract and still fall under the 1,000 contract limit. A 2,700 MW natural gas-fired combine cycle power generation facility generates enough electricity to supply approximately 1.3 million typical households. While this may appear to be adequate, there are more than 130 million households in the U.S. and 2,700 MW is less than one percent of the currently-installed natural gas-fired electricity generating capacity.<sup>15</sup> Achieving the Administrations environmental objectives will undoubtedly require even more natural gas fired electricity generation. For a company to hedge anything more, a *bona fide* hedge exemption would be required. This example demonstrates how the ability to receive a *bona fide* hedge exemption is particularly critical when the limits themselves are scaled too low relative to the size of risk in a market participant's portfolio. Further, given the scale of energy portfolios and the widespread use of trade options to provide reasonable flexibility with respect to physical supply, trade options simply cannot be subject to speculative position limits.<sup>16</sup>

To be clear, exchange limits do not need to be raised to 25 percent of current deliverable supply with the single stroke of a pen. However, it is time to begin moving the limits for the natural gas contracts into the current decade. A

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<sup>14</sup> See Proposed Rule at 75,840, Appendix D to Part 150. This proposed initial limit is less than 6.5 percent of CME's current deliverable supply estimate for natural gas.

<sup>15</sup> As of November 2014, the U.S. had just under 430,000 MW of installed natural gas-fired generating capacity according to the Department of Energy - Energy Information Administration's December 2014 Electric Power Monthly report.

<sup>16</sup> As discussed in detail in NGS's February 10, 2014 and June 26, 2014 comments on the Proposed Rule, trade options, by their very nature, are not speculative contracts and thus should not be subject to position limits.

federal limit for the NG contract must be based on current deliverable supply data. Sound policy decisions simply cannot be based on foundational data that is severely out of step with the market.

#### IV. Conclusion

The approach proposed by NGSa in these comments would go a long way toward: (1) addressing the myriad of market participant concerns with the *bona fide* hedge exemption; (2) ensuring a workable federal speculative position limits framework that is grounded in physical market realities; and (3) allowing a market for large positions to gravitate away from physically-settled contracts. However, the approach admittedly does not address the question of aggregation and off-exchange transactions.

Years of debate, two proposals and one remanded final rule on position limits have seriously undermined regulatory certainty surrounding market participant hedging practices at a time when U.S. business investment is vital to economic recovery. Clearly, position limit regulations are complicated and the stakes are high. Experience with exchange-administered accountability limits, within the context of a sound federal limit on physically-settled spot-month contracts derived from current deliverable supply information, along with the data from large trader reporting, swap data reporting, and real time reporting, will provide a solid foundation for future consideration of aggregation rules and off-exchange limits. If needed, a viable path forward to address any aggregation and off-exchange limit issues will emerge. However, it is critical that the Commission get the basics right on position limits *before* tackling aggregation and off-exchange limits.

NGSA remains committed to working with the Commission, the exchanges and market participants to develop regulatory solutions that work for both businesses and consumers. Established in 1965, NGSa encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets, thus encouraging increased supply and the reliable and efficient delivery of natural gas to U.S. customers. NGSa members enter into thousands of physical and financial natural gas transactions daily and invest billions of dollars in the long-term development of natural gas supply for sale in the U.S. natural gas market. As large producers and suppliers of natural gas, NGSa members would not invest in the growth of the physical natural gas market if they did not believe the market exhibited three key principles of health – integrity, transparency and efficiency. NGSa believes that its proposed approach will further promote such health and respectfully requests the Commission’s consideration of these comments.

Sincerely,

A handwritten signature in black ink that reads "JFordham". The signature is written in a cursive style with a long horizontal stroke at the end.

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