Edison Electric Institute

Power by Association

March 30, 2015

Via Electronic Submission

Chris Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Mr. Kirkpatrick:

I. INTRODUCTION

Position Limits and the Commodity Futures Trading Commission's ("CFTC" or "Commission") Proposed Rule for Position Limits for Derivatives[1] remains an issue for Edison Electric Institute ("EEI")"[2] and its members. A number of these concerns were discussed during the Energy and Environmental Markets Advisory Committee ("EEMAC") meeting on February 26, 2015. EEI appreciates the Commission's willingness to accept additional comments to address these important issues discussed during the EEMAC meeting. Pursuant to the Notice Re-Opening the Comment Period,[3] EEI offers the following additional comments on the Proposed Rule.

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.[4] 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. Regulations that make effective risk management options more costly for end-users of derivatives and will likely result in higher and more volatile energy prices for retail, commercial, and industrial

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

[2] EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 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.

[3] *Position Limits for Derivatives and Aggregation of Positions*, 80 Fed. Reg. 10,022 (February 25, 2015).

[4] *See* e.g. Letter from EEI and EPSA to Jurgens Position Limits for Derivatives, Sec'y, CFTC (Feb. 7, 2014) (on file with the CFTC); EEI Supplemental Comments Position Limits for Derivatives to Jurgens, Sec'y, CFTC (August 4, 2014) (on file with the Commission).

customers. This includes adopting rules that have the impact of reducing liquidity in the market by reducing the counterparties willing to participate in the commodity market as well as adopting a definition of *bona fide* hedging that is too narrow or inflexible. This outcome will make important hedging activities more difficult for commercial end-users which, as a consequence, may increase the price and volatility of energy for all consumers of electricity. The position limits rule as proposed is complex and places significant additional burdens on end-users as they use transactions to hedge and mitigate commercial risk. As end-users of commodity derivatives who hedge commercial risk, EEI's members have a direct and significant interest in when and to what extent the Commission exercises its authority to establish speculative position limits.

As discussed in more detail in the Comments below, 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 engage in transactions primarily as end-users, not as speculators, 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.

II. COMMENTS

A. Specific Findings for the Need for Position Limits Are Needed

The Commission stated in the preamble to the Proposed Rule that "the CEA mandates the imposition of speculative position limits."[5] The Commission appears to believe that it need not determine that speculative position limits are necessary in order "'to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the price of' commodities."[6] Yet, "out of an abundance of caution," the Commission also determined that speculative position limits are necessary.[7]

The discussion during the EEMAC meeting highlighted the need for a necessity finding and for the Commission to exercise its discretion. As indicated by Professor Craig Pirrong, Professor of Finance and Energy Markets, Director of Global Energy Management Institute, Bauer College of Business, University of Houston: "Position limits are intended to prevent excessive speculation that causes unreasonable or unwarranted price fluctuations."[8] The question for the Commission is what constitutes excessive speculation as some amount of speculation is needed to maintain liquidity in the markets. What constitutes excessive speculation may also depend on the market as commodity prices are inherently volatile and are dependent on a number of factors such as demand for the commodity, customer demand, weather, mechanical outages among others. If applied inappropriately position limits could have

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[5] Proposed Rule at 75,685.
[6] *Id.* (quoting CEA section 4a(a)(1) pre-Dodd-Frank).
[7] *Id.* 75,685.
[8] Energy and Environmental Markets Advisory Committee, Transcript at 28:14-17 (February 26, 2015) ("EEMAC TR").

the effect of limiting or constraining risk transfer by inhibiting hedging.[9] Other participants also expressed similar concerns, for example, Erik Haas, Director – Market Regulation, ICE Futures U.S., indicated that there isn't a lot of speculation in the commodity market and that in the natural gas markets "any regulations aimed at excessive speculation is a solution to a nonexistent problem in these contracts."[10]

As such, EEI reiterates its request that the Commission make a specific fact-based finding of necessity as to each of the 28 core referenced futures contracts in the Proposed Rule[11] as the Proposed Rule does not contain any analysis as to why the 28 core referenced contracts were chosen.

B. 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.[12] 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, especially 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."[13] 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,

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[9] *See e.g. Id*. at 39:3-21

[10] *See* discussion *Id* at 64-70; 70:6-9

[11] *See* CEA section 4a(a)(1).

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

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

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.

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.[14] As such, Trade Options impact the availability of the conditional limit. Under the Proposed Rule, Trade Options are treated as swaps that do not fit within the *bona fide* hedging positions put forth by the Commission. 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.

C. The Commission Should Expand Hedging Criteria Used in the End-User Exception for Clearing to Position Limits

One theme that was repeated during the EEAC meeting on February 26, 2015 was a concern that liquidity in the energy markets is decreasing, both on exchanges and in the over-the-counter markets.[15] A second theme was that hedgers are bearing a significant amount of the burden created by the proposed Position Limits regime.[16] The establishment of new enumerated hedge criteria in the Proposed Rule only exacerbates the burden placed on hedgers and end-

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[14] Proposed Rule 150.1(4)

[15] *See e.g.* EEMAC TR 81:7-82:18.

[16] *See e.g. Id. 39:15-21.*

users, particularly those participating in the OTC (Off-exchange) market by adding even more complexity and uncertainty for those actively engaged in hedging. Ironically, the market participants being adversely affected by the Proposed Rule are the same market participants that Congress and the Commission are attempting to protect.

The hedging definition and criteria established by the Commission in the *End-User Exception to the Clearing Requirement for Swaps* rule[17] appropriately alleviates burdens on end users while still maintaining reasonable safeguards to protect the public and other market participants. EEI suggests that the criteria used by the Commission to determine if a transaction is a hedge under the end user exception be expanded to Position Limits. This would mean that the criteria used to determine if a transaction is a hedge under the end user exception would replace the enumerated hedge paradigm outlined in the Proposed Rule.

As such, the Commission should consider transactions in which a counterparty has elected to utilize the end-user exception (and therefore meets the requirements of 17 CFR 50.50(c)(a)(1) and 17 CFR 50.50(c)(a)(2)) be considered "bona fide hedges" for purposes of Position Limits as described in section 4a(a)(2) rather than applying the enumerated hedging criteria. Since the end-user exception criteria in 17 CFR 50.50(c)(a)(1) is substantially identical to the criteria utilized by Congress in its mandate to define a *bona fide* hedging transaction in the CEA , the use of this existing framework will accomplish the Commission's goal of protecting market participants and the public from excessive speculation in OTC markets while avoiding the creation of new administrative burdens for end users.

D. The Definition of *Bona Fide* Hedging Should Not Be Too Narrow or Inflexible.

If the Commission chooses not to expand the end-user exception to Position Limits then it should ensure that the definition of *bona fide* hedging is not too narrow and inflexible. The Commission should expand the list of enumerated hedges to include all legitimate commercial activity. EEI is concerned that the Proposed Rule unduly limits the hedging activities of commercial end-users by precluding long established hedging practices. Without explanation, the Proposed Rule contains a more restrictive version of the current 1.3(z) which says, that the enumerated hedges or bona fide hedges include but are not limited to the enumerated hedges. The Proposed Rule states that enumerated hedges are the only permitted hedges.[18] This proposed change discounts the importance of long established hedging practices that have been used by EEI members and other commercial end-users.

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. Many EEI members have front office commercial operations personnel, supported by middle office risk management policies and back office derivative accounting

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[17] *End User Exception to the Clearing Requirement for Swaps, Final Rule,* 77 Fed. Reg. 42560 (July 19, 2012).

[18] Proposed Rule at 75,706-75,710.

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 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.

As such, EEI urges the Commission to defer to accepted hedging practices and to expand the proposed definition of *bona fide* hedging to allow commercial end-users to continue to engage in the common hedging practices listed below without subjecting them to position limits.

1. <u>Gross Hedging</u>

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."[19] This implies that an entity has to consider all of its exposures in order to qualify for the test when hedging, and that the entity can't take into account exposures on a legal entity or portfolio basis. 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 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.

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

2. <u>Cross - Commodity Hedging</u>

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[19] Proposed Rule 150.1.

The Proposed Rule permits 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."[20] 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. Under the Proposed Rule, the Commission only presumes 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."[21] 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.[22]

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.

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

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[20] Proposed Rule at 75,824.
[21] *Id.* at 75,717.
[22] *Id.*

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 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.

3. 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 binding and irrevocable bid prices will result in the risk being factored into the price, which will raise prices for consumers.

4. Unfilled or Unfixed Anticipated Requirements

EEI members are concerned that the proposed position limits rule only provides bona fide hedge treatment for "unfilled" anticipated fuel requirements for a generator. However it is common in the electricity industry for a generator to "fill" its fuel requirements with an unfixed price fuel supply contract. This contract ensures the generator will have the physical fuel supply, but still leaves the generator exposed to unfixed or variable price risk. *Bona fide* hedging treatment should be provided to generators (or other commercial market participants) for index transactions that hedge or "fix" their market exposure to unfixed price risk, even if their anticipated fuel requirements are "filled".

EEI requests that the Commission incorporate guidance from CFTC Staff letter 12-07 into the final rule and unambiguously permit unfilled anticipated requirements to qualify as a *bona fide* hedge where a commercial enterprise, such as an electric utility, holds "long-term,

unfixed-price supply or requirements contracts."[23] As indicated above, the Commission also should eliminate the restriction on utility hedging of unfilled anticipated customer requirements to permit all reasonable and prudent hedging activities, regardless of whether they are explicitly "required or encouraged to hedge by its public utility commission on behalf of its customers."

For example, one method that EEI members use to reduce fuel index price risk is to buy fixed-price swaps to fix the price of a percentage of its anticipated natural gas requirements for the next 12 to 24 months. Under the Proposed Rule, these fixed-price swaps will be Referenced Contracts because they are linked to the NYMEX Henry Hub Core Referenced Futures Contract. Because of the risks involved in purchasing large quantities of natural gas in order to ensure that it can meet its public service obligation to generate electricity, EEI members may also determine that it is commercially prudent to enter into long-term, firm purchases of natural gas at an index price to secure delivery of a significant portion of their anticipated natural gas requirements. End-users may enter into these index- or "unfixed"-priced natural gas purchases for weeks, months or years at a time for differing portions of their anticipated natural gas fuel requirements. The index price risk associated with some or all of its long-term, firm purchases of natural gas at index are then reduced by purchasing fixed-price natural gas swaps. This hedging transaction protects EEI members and other end users and, their rate payers against the same fuel price risks as the one above and both are regularly used in the industry.

The Commission has already recognized, through the issuance of Staff letter 12-07, that allowing Hedging Transaction for both unfilled anticipated requirements and contracts to purchase a commodity at an unfixed or index price is appropriated. As such, the Commission should incorporate the guidance into the Final Rule.

5. The *Bona Fide* Hedging Definition Should Accommodate Heat Rate Transactions

The definition of "*bona fide* hedging position" does not contemplate transactions common to the electricity markets known as "heat rate" transactions. Generally, a "heat rate" transaction refers to a physical or financial transaction in an electricity commodity where the price of electricity (or one leg in the case of a heat rate swap) is determined by multiplying an agreed upon heat rate[24] times a gas index price. The term "heat rate" is generally the measure of efficiency for a power plant. The higher the heat rate, the more inefficient a power plant it is and the more expensive it is to run that power plant. Many power markets around the country trade based upon a market heat rate or implied heat rate, which is calculated by dividing the electricity price by the price of natural gas. Because of the inextricable link between the price of natural gas and the price of electricity, many wholesale and commercial electricity transactions are priced on heat rates.

Heat rate transactions may take several forms such as forward sales of physical power (either from an electric generator or from a merchant), forward purchases of physical power, options on physical power, or swaps. Heat rate transactions have many uses in the electric markets. For example, an owner of gas-fired electric generation may use a heat rate swap or

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[23] CFTC Interpretive Letter No. 12-07 at 1, Aug. 16, 2012.

[24] "Heat rate" refers to the amount of energy (typically expressed in British thermal units ("Btu") required by an electrical generator to generate one kilowatt-hour ("kWh") of electricity.

option to hedge electric and gas price risk associated with physical commodity transactions. Or, a market participant (either a generation owner or merchant) may sell physical electricity priced at a heat rate[25] or sell physical heat rate options, then hedge both the electric and gas components of the physical transaction using a combination of electric and gas derivatives. These types of physical heat rate transactions and heat rate derivatives reflect very common transactions in present-day power markets.

EEI is concerned that both natural gas derivatives used to hedge physical heat rate transactions and heat rate derivatives used to hedge commodity price risk would be excluded from the definition of "*bona fide* hedging position" set forth in proposed CFTC regulation 150.1 even though they clearly perform a risk-reducing function and achieve the same purpose as other types of hedge transactions that qualify for *bona fide* hedging treatment under the Proposed Rule.

Specifically, a natural gas Referenced Contract used to hedge a physical heat rate transaction might not qualify under the enumerated *bona fide* hedging exemption for hedges of cash commodity sales or purchases in proposed CFTC regulation 150.1 (3)(i) or (ii) because:

- The enumerated exemptions require the Referenced Contract to reference the same commodity as the cash commodity transaction;

- The enumerated exemptions require that the cash commodity transaction be a fixed price, but a physical heat rate transaction is still a floating price transaction.

Similarly, a heat rate swap or physical heat rate option used by an electric generator would not qualify as a *bona fide* hedging position under the enumerated hedging exemption for unsold anticipated production set forth in proposed CFTC regulation 150.1(4)(i). This enumerated hedge provision requires that the Referenced Contract reference the same commodity as the commodity the person anticipates producing. It appears that the natural gas price component of a heat rate derivative would not meet this requirement because the heat rate derivative hedges physical electricity price risk.

Further, under the Proposed Rule, a natural gas Referenced Contract apparently would not qualify as a cross-commodity hedge for a physical power transaction under the proposed Safe Harbor Test. The Commission's proposed correlation threshold under the Safe Harbor Test creates additional problems with some natural gas derivatives. For example, in the context of a heat rate transaction, market participants may use two natural gas derivatives—a Henry Hub Referenced Contract and a basis contract—to hedge the natural gas price risk at a delivery point near the delivery point of the electricity. The market participant could not get *bona fide* hedge treatment even if the natural gas price at the other delivery point satisfied the proposed correlation requirement for a cross-commodity hedge. Economically, the Henry Hub Referenced

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[25] In addition, some power markets around the country trade based on market heat rates or implied heat rates, which are calculated by dividing the market price for electricity by the market price of natural gas. Participants in these markets may hedge physical positions through combinations of electricity and gas derivatives that economically lock in a market heat rate, which positions should be treated as *bona fide* hedging positions.

Contract nets against the basis contract and leaves the market participant with a natural gas position priced at the other, non-Henry Hub delivery point. The Proposed Rule, however, would not permit the market participant to treat the Henry Hub Referenced Contract as a *bona fide* hedge, while also excluding the basis contract and not recognizing the economic offset to the Henry Hub position.

If heat rate transactions are not granted *bona fide* hedging treatment, heat rate options and swaps will create an unusual situation wherein a derivative in one commodity (*i.e.,* electricity) is priced in a way that, for position limits compliance purposes, also creates a derivative position in another commodity (*i.e.,* natural gas). This could result in a situation in which a single transaction is treated as two derivative positions in two separate commodities—electricity and natural gas—with the electric component satisfying the *bona fide* hedging definition.[26] The Proposed Rule harms energy commodity markets and various types of market participants by not permitting heat rate transactions to either qualify as *bona fide* hedging transactions or providing a basis for treating a natural gas position as a *bona fide* hedging transaction.

E. The Commission Should Not Set Non-Spot Month Limits

Additional limits outside of the spot month are not necessary. The Commission does not have the data necessary to set these limits and has not shown a need for them. The Commission recognized this limitation when it proposed and adopted the Position Limits Rule in 2011. Rather than impose potentially harmful limits based on data that was substantially incomplete, the Commission determined that it would not establish non-spot month limits until it had 12 months' worth of reliable data under Part 20.[27]

As indicated above, the discussion during the EEMAC meeting indicated that rather than excessive speculation in non-spot months, there may be an inadequate amount of liquidity supplied by speculators.[28] Establishing non-spot month limits, especially without complete data, would only further tend to dry up needed liquidity. As such, EEI would request that the Commission not establish any non-spot month limits or levels at this time.

Discussion during the EEMAC meeting raised the possibility that accountability levels may be a vehicle to provide oversight. Accountability levels for non-spot months have been used effectively by exchanges for years and the Commission has neither explained a need for hard non-spot month limits nor explained why the current approach for exchange-set limits is not sufficient. However, there is a difference between exchange administered accountability levels and such a program administered by the Commission. Exchanges have complete transparency into their markets and contracts. Exchanges also have a market integrity role with respect to accountability that is narrower than the Commission's broad regulatory role.

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[26] For example, a heat rate swap that hedges a physical heat rate transaction would appear to be a *bona fide* hedge for the power component but not the natural gas component. EEI believes that it is essential for the Commission to address definitional issues like this that may impact electricity commodities that are not Core Referenced Futures Contracts under the proposed rule because of the Commission's stated intention to adopt position limits on electricity transactions in the future. Proposed Rule at 75,726.

[27] *Position Limits for Derivatives*, 76 Fed. Reg. 71,626 (Jan. 26, 2011) at 71,632.

[28] *See e.g*. EEMAC TR 81:7-82:18.

EEI is concerned that establishing federal accountability levels will increase the reporting or other compliance burdens on end users. If considered, the manner in which the Commission would carry out its oversight authority under such a program would need to be clarified. A federal accountability regime needs to be thoughtfully conceived such that it will not create compliance burdens for end- users; create ambiguous authority on the part of Commission staff with respect to the propriety of positions held by end-users; and that it will not adversely affect market liquidity for hedgers. The details of such a regime have not been proposed. EEI would be willing to explore the issue further with the Commission if needed.

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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