SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
700 Sixth Street, NW, Suite 700
Washington, DC 20001-3980

TEL 202.383.0100
FAX 202.637.3593

R. MICHAEL SWEENEY, JR.
MEGHAN R. GRUEBNER

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Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

VIA ELECTRONIC SUBMISSION

Re: Position Limits for Derivatives, RIN 3038-AD99

Dear Secretary Jurgens:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the Commodity Futures Trading Commission's (the "**CFTC**" or "**Commission**") reopening of the comment periods for the (i) Notice of Proposed Rulemaking, *Position Limits for Derivatives* ("**Proposed Rule**"),[1] and (ii) Notice of Proposed Rulemaking, *Aggregation of Positions* ("**Proposed Aggregation Rule**"),[2] in connection with the Commission's Energy and Environmental Markets Advisory Committee ("**EEMAC**") meeting on February 26, 2015 ("**EEMAC Meeting**").[3]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

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1 *See Position Limits For Derivatives*, Notice of Proposed Rulemaking, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

2 *See Aggregation of Positions*, Notice of Proposed Rulemaking, 78 Fed. Reg. 68,946 (Nov. 15, 2013).

3 *See Position Limits for Derivatives and Aggregation of Positions*, Notice of Proposed Rulemaking; Provision of Table 11a; and Reopening of Comment Periods, 80 Fed. Reg. 10,022 (Feb. 25, 2015) ("**February 25 Release**").

The Working Group has been an active participant in the Commission's proceedings to develop federal speculative position limits applicable to energy commodities under Section 4a(a) of the Commodity Exchange Act ("**CEA**"), as revised by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**").[4] As stated in its previously submitted comment letters[5] and at the CFTC's June 19, 2014 Roundtable ("**Position Limits Roundtable**"),[6] EEMAC Meeting, and various meetings with Commissioners and staff, the Working Group is hopeful that, if a final rule is ultimately adopted, the Commission will address only legitimate concerns of excessive speculation while fulfilling the Commission's statutory mandate "to ensure sufficient market liquidity for bona fide hedgers" and "to ensure that the price discovery function of the underlying market is not disrupted."[7]

The Working Group appreciates the Commission's continued effort to seek the input of energy market participants on this important rulemaking. The comments set forth herein supplement the Working Group's Comment Letters.

II. EXECUTIVE SUMMARY.

Circumstances have changed since the Commission first proposed a federal speculative position limit regime under the Dodd-Frank Act in January 2011.[8] For instance, the EEMAC Meeting highlighted the reduction in liquidity in certain derivatives markets and the impact it has had on the ability of commercial hedgers to transfer their risk.[9] Likewise, recent data showed an approximate 11.8% decline in global trading volume in energy futures and options.[10] Even the data produced by the Commission highlights the risk to further liquidity erosion associated with

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4 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

5 *See* The Commercial Energy Working Group, *Comment Letter Re: Position Limits for Derivatives*, RIN 3038-AD99 (Feb. 10, 2014) ("**February 10 Letter**"); The Commercial Energy Working Group, *Comment Letter Re: Position Limits for Derivatives*, RIN 3038-AD99 (Aug. 4, 2014) ("**August 4 Letter**") (collectively, the "**Comment Letters**").

6 *See Position Limits for Derivatives and Aggregation of Positions*, Notice of Proposed Rulemaking; Reopening of Comment Periods, 79 Fed. Reg. 30,762 (May 29, 2014).

7 *See* CEA Section 4a(a)(2)(A), as amended by Dodd-Frank Act Section 737.

8 *See Position Limits for Derivatives,* Notice of Proposed Rulemaking, 76 Fed. Reg. 4752 (Jan. 26, 2011); *Position Limits for Futures and Swaps*, CFTC Final Rule and Interim Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011), *vacated, Int'l Swaps and Derivatives Ass'n, et al. v. U.S. Commodity Futures Trading Commission*, CA No. 11-cv-2146 (D.D.C. Sept. 28, 2012) ("**Vacated Final Rule**").

9 *See* EEMAC Meeting Transcript, at Panel I, p. 80-83 (Participant from Exelon Generation (i) stating that there is a need for more speculators in the market because not only do commercial firms need the ability to hedge, they also need transparency in the markets for purposes of pricing contracts in physical markets and (ii) claiming that liquidity issues appear to be the result of an "excessive hedging problem"); *see also* EEMAC Meeting Transcript, at Panel III, p. 221 (Participant from Southern Company describing pre-Dodd-Frank Act markets as having "ponds of liquidity" and claiming these "ponds have dried up" due to the impacts of the Dodd-Frank Act), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

10 *See* Futures Industry Association, 2014 Annual Volume Survey, at p.19 (issued March 2015).

the Proposed Rule.[11] Separately, "futurization"[12] has served to centralize cleared energy derivatives trading under the regulatory oversight of designated contract markets ("**DCMs**"). As a result of all these factors, the Working Group recommends that the Commission reconsider some of the fundamental precepts of the Proposed Rule and delegate more authority to DCMs[13] to administer the federal speculative position limit regime; namely, the authority (i) to determine whether a position represents a permissible *bona fide* hedge and (ii) to protect against excessive speculation in non-spot months through the application of accountability levels in lieu of hard limits.[14]

This comment letter consists of three principal sections and has two attachments appended hereto.

Section III.A sets forth the Working Group's recommendations to delegate authority to the exchanges to administer (i) *bona fide* hedge exemptions and (ii) accountability levels in lieu of federal non-spot month speculative limits.

Section III.B recommends the Commission to adopt a "safe harbor" that would be applied as part of any regime imposing federal speculative position limits.

Section III.C provides comments addressing issues under the Proposed Rule and Proposed Aggregation Rule and supplements the Working Group's Comment Letters.

Attachment 1 provides a cumulative list of key issues and proposed solutions previously addressed in the Comment Letters as well as provided herein ("**CEWG Issues List**"). The CEWG Issues List is not a substitute for the Working Group's Comments Letters. It is intended only to provide a "checklist" of issues that should be addressed before any federal speculative position limit rule is finalized.

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[11] See February 25 Release, Table 11a, which identifies significant numbers of Unique Persons that would exceed spot and non-spot month speculative limits if the CFTC adopted the Proposed Rule. If their positions were speculative, they would be forced to exit the market. If their positions were hedges, their positions would need to fit into the new, narrower definition of *bona fide* hedging or they would also be forced to exit the market.

[12] "Futurization" refers to the phenomenon of exchanges converting many listed cleared swaps contracts to financially settling futures contracts.

[13] The Working Group recognizes that the CFTC's rules implemented under the Dodd-Frank Act contemplate swap execution facilities ("**SEFs**") listing energy contracts and administering position limits. However, to date, no registered SEF currently lists energy commodity derivatives. To the extent energy commodity derivatives contracts begin trading on a SEF, the Working Group would propose that the Commission delegate to both the DCMs and SEFs the authority to administer *bona fide* hedge exemptions and accountability levels.

[14] *See* EEMAC Meeting Transcript, at Panel III, p. 213 (DMO staff noting that "one way forward" with respect to the bona fide hedge definition is to have the exchange process review and grant non-enumerated hedge exemptions), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf. If the Commission believes a new proposed rulemaking would have to be issued to implement the Working Group's recommendation to delegate authority to exchanges to administer bona fide hedge exemptions and accountability levels, the Working Group supports such an issuance.

Attachment 2 provides explanations of various examples of legitimate risk-reducing activity that would not be considered *bona fide* hedging under the Proposed Rule. These examples are sometimes difficult to articulate without various terms of art or jargon used by traders. These examples may represent drastic simplifications of complicated strategies and are intended to represent a class of transactions rather than be limited to the specific hypothetical facts presented therein. The Working Group hopes that the Commissioners and staff provide it further opportunities to explain these examples in person and appreciates the time the Commission and staff have already given to the Working Group to do so.

III. COMMENTS OF THE WORKING GROUP.

A. The Commission Should Delegate to the DCMs the Authority to (i) Determine Whether Positions Represent *Bona Fide* Hedges and (ii) Administer Regulatory Oversight over Non-Spot Month Positions through Accountability Levels.

In adopting the Dodd-Frank Act, Congress specifically directed the Commission not to harm the ability of commercial end users to hedge risk effectively through derivatives contracts. Yet despite the lack of evidence indicating commercial end users have abused *bona fide* hedge exemptions to engage in excessive speculation, the Proposed Rule constrains the definition of *bona fide* hedging. Indeed, the Proposed Rule eliminates "non-enumerated hedges," and restricts *bona fide* hedging activity to a finite list of enumerated hedges, which do not include many hedging practices commonly utilized in the energy industry. Consequently, there has been much debate about the appropriateness of this proposed approach. As demonstrated at the EEMAC Meeting, there still is substantial concern among energy market participants that a large number of standard risk-reducing transactions would not qualify as *bona fide* hedges under the Proposed Rule.[15] The Working Group therefore suggests the CFTC adopt the approach described below for implementing federal speculative position limits.

1. The Working Group Recommends that the Commission Expand the List of Enumerated *Bona Fide* Hedges and Adopt a Provision Permitting Non-Enumerated *Bona Fide* Hedges.

The Working Group acknowledges that a list of permitted enumerated *bona fide* hedges has been a part of the Commission's *bona fide* hedge definition since 1977.[16] However, this list is outdated and does not reflect standard risk-reducing practices utilized in energy markets.

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[15] *See* EEMAC Meeting Transcript, at Panel III, p. 203-06 (Participant from the National Gas Supply Association expressing concern that common risk-reducing practices in the natural gas industry might not receive enumerated *bona fide* hedging treatment and that an efficient process is not in place to receive a non-enumerated hedge), *see also* EEMAC Meeting Transcript, at Panel III, p. 176 (Participant from the American Gas Association noting for the record that hedging the value of owned or leased storage capacity, which would not receive *bona fide* hedge treatment under the Proposed Rule, is the "bread and butter" transaction used by natural gas utilities regulated by the fifty states to hedge their commercial risk), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

[16] *See Definition of Bona Fide Hedging and Related Reporting Requirements,* Final Rule, 42 Fed. Reg. 42,748 (Aug. 24, 1977).

First, hedging techniques in commodities markets have evolved substantially since the CFTC initially adopted its list of enumerated hedges. If the Commission remains committed to this finite list of enumerated *bona fide* hedges, it will severely restrain hedging in the energy markets. Reducing hedging will result in risk premiums being built into energy prices, ultimately causing consumers to bear those risk premiums.

Second, the Commission initially established its current enumerated list contemplating only a limited group of commodities and indicated that such list would need to be modified if the CFTC subjected additional commodities to federal speculative position limits.[17]

Third, certain elements of the *bona fide* hedge definition, such as the "five-day rule"[18] and cross-commodity hedge exemption, have vastly different effects on the agricultural markets (where the Commission has experience in applying it) and energy markets (where it does not). Agricultural markets trade through the delivery month, and most physical agricultural market participants exit any remaining positions before the last "five days" of trading and enter into next month's contract, while energy markets cease trading before the delivery period and rely on the "five day" period (*i.e.*, spot month) to hedge the risk of their physical market commitments for the following month.

Fourth, the assertion that no market participant has petitioned for non-enumerated exemptions in the past[19] cannot be used as rationale for adopting the finite list of enumerated *bona fide* hedges under the Proposed Rule. Specifically, energy market participants never have needed to petition the Commission for non-enumerated hedges in the past as (i) federal speculative position limits did not apply directly to the energy markets, and (ii) accountability levels rather than hard limits were administered by DCMs to monitor non-spot month positions.

Accordingly, the Working Group recommends that any list of enumerated hedges

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[17] *See id.* at 42,750 (In response to public comments that the enumerated *bona fide* hedges would be deficient for certain commodities where the Commission currently had no speculative position limits, the Commission stated that it was aware of this possibility but determined that it was not necessary at the time to enumerate *bona fide* hedge positions for markets that were not currently subject to speculative limits).

[18] The "five-day rule" refers to the restriction on holding physical delivery Referenced Contracts in the spot month ("**Five-Day Rule**").

[19] *See* EEMAC Meeting Transcript, at Panel III, p. 152-53 (CFTC Division of Market Oversight ("**DMO**") staff stating that, with respect to the nine agricultural products historically subject to federal position limits, no market participant has ever applied for a non-enumerated hedging exemption), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

adopted in the final rule give full meaning to the statutory definition[20] and include the risk-reducing strategies outlined in the Comment Letters and the comments herein.[21] In addition, the Working Group recommends the Commission delegate to DCMs the authority to grant *bona fide* hedge exemptions in the energy industry either on an enumerated or non-enumerated basis.

2. The Working Group Recommends that the Commission Delegate to DCMs the Authority to Grant *Bona Fide* Hedge Exemptions Subject to the Statutory Definition.

Because DCMs have intimate knowledge of energy markets and the business practices of energy market participants, they are best positioned to determine what constitutes a *bona fide* hedge. They have every incentive to exercise care in that role. Pursuant to their core principles and duties, DCMs have a regulatory obligation to actively monitor trading activities within their markets and prevent market disruptions. Specifically, DCM Core Principle 4 currently obligates DCMs to monitor for market anomalies in meeting its statutory obligations to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.[22] To avoid employing duplicative efforts, the Commission should simply rely on DCMs to administer *bona fide* hedge exemptions from federal speculative position limits as they carry out their core duties to ensure orderly markets.

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[20] CEA Section 4a(c)(2) provides:

> For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that—
>
> (A) (i) 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;
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> (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
>
> (iii) arises from the potential change in the value of–
>
> (I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
>
> (II) liabilities that a person owns or anticipates incurring; or
>
> (III) services that a person provides, purchases, or anticipates providing or purchasing; or
>
> (B) reduces risks attendant to a position resulting from a swap that—
>
> (i) was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction pursuant to subparagraph (A); or
>
> (ii) meets the requirements of subparagraph (A).

[21] There has been sufficient discussion of the Working Group's *bona fide* hedge proposals so that it is unnecessary to consider them in the future as "non-enumerated hedges." The Commission can, and should, adopt them in any final rule as part of a list of enumerated *bona fide* hedges.

[22] *See* CFTC Regulations 38.250-54; Core Principles and Other Requirements for Designated Contract Markets, Final Rule, 77 Fed. Reg. 36,612, at 36,634-37 (June 19, 2012).

Further, because DCMs have administered speculative position limits and *bona fide* hedge exemptions applicable to energy markets over several years, they have acquired significant experience and expertise in granting appropriately-tailored, workable *bona fide* hedge exemptions. DCMs have expended substantial resources in monitoring positions up to and through the delivery process and are in constant communication with market participants about the size of positions and market intentions. As noted at the recent EEMAC Meeting, DCMs have the resources needed to review and approve requests for hedge exemptions as well as monitor for the abuse of such hedge exemptions.

Relying on DCMs will preserve the Commission's limited resources.[23] It also will allow for a thorough case-by-case analysis of the circumstances establishing a market participant's *bona fide* need for a requested hedge exemption, including the circumstances establishing whether a market participant's commercial operations have committed physical or financial resources towards anticipated transactions. This case-by-case analysis will help address the "additional facts" and "plus factors" concerns that prevented the Commission from adopting certain Working Group examples of *bona fide* hedges in the Proposed Rule.[24]

Delegating authority to DCMs to grant and administer *bona fide* hedge exemptions for enumerated and non-enumerated positions will not diminish any of the safeguards preventing the abuse of hedge exemptions. Importantly, the Working Group proposes that DCMs would require a market participant to file a hedge application (*e.g.*, on an annual basis or more frequently if so needed) supporting its request for a *bona fide* hedge exemption and receive *prior* approval of such application *before* exceeding applicable speculative position limits.[25] Further, the Working Group proposes under this delegation that, when a market participant exceeds an applicable federal speculative position limit and utilizes its exchange-administered hedge exemption, it

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[23] *See* EEMAC Meeting Transcript, at Panel III, p. 241-42, (CFTC Commissioner noting that the CFTC might not be equipped to review on an ad hoc basis numerous non-enumerated hedging exemption applications), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

[24] *See* EEMAC Meeting Transcript, at Panel III, p. 168-70 (DMO staff noting that a merchandising hedge example in the Working Group's "BFH Petition" was rejected since the CFTC could not establish "plus factors" that could distinguish between a speculator buying at unfixed price and using that as a pretext for an exemption and a merchant buying at unfixed price as part of its normal business practice and who had transportation arrangements in place—of which ICE and CME would have considered), *see also* EEMAC Meeting Transcript, at Panel III, p. 180-82 (In responding to the Chairman's question about why a Working Group hedging example was denied *bona fide* hedging treatment under the Proposed Rule, DMO staff stated that it received a generic example without any context or "enough facts" about the commercial hedger's business), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf. The BFH Petition refers to: The Working Group of Commercial Energy Firms, *Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act* (submitted Jan. 20, 2012), *available at* http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/wgbfhpetition012012.pdf. In February 2012, the Working Group of Commercial Energy Firms reconstituted itself as "The Commercial Energy Working Group."

[25] This approach is consistent with the approach currently employed by DCMs in granting *bona fide* hedge exemptions and provides more certainty to market participants so that they may know in advance the positions they may enter into without impermissibly exceeding an applicable speculative position limit.

would be required to file with the CFTC the appropriate Series '04 report,[26] providing its cash positions supporting the hedge exemption granted to it by the DCM. The Commission will have access to position data through large trader reports and swap data repository ("**SDR**") reports and may use its Special Call authority under the Proposed Rule and other CFTC regulations to request further information from market participants where it believes the circumstances warrant.

Significantly, under the Working Group's delegation proposal, the Commission will retain its oversight function to ensure that the DCMs are appropriately applying their delegated authority in administering *bona fide* hedge exemptions from federal speculative position limits. As is current practice, DCMs would be required to comply with their core principles and cooperate with the Commission to oversee the commodities markets and provide any data to the Commission upon request so that the Commission may review any *bona fide* hedge exemption granted by them. Under the proposed delegation approach, if the Commission disagrees with any DCM determination on whether a certain position qualified for a *bona fide* hedge exemption from federal speculative position limits, the DCM cannot be penalized for being in violation of the CEA or CFTC's regulations in connection with such a determination, so long as the DCM acted in good faith in granting the relevant exemption. Further, any market participant exceeding an applicable speculative position limit in reliance upon on a *bona fide* hedge exemption granted by a DCM cannot be penalized for violating the applicable speculative limit.

In light of the above, the Working Group submits that the Commission should (i) include the *bona fide* hedge examples described in the Comment Letters and comments herein in its list of enumerated *bona fide* hedge positions, and (ii) delegate to DCMs the authority to grant pursuant to the Commission's *bona fide* hedge definition exemptions for enumerated and non-enumerated positions.

3. The Commission Should Delay the Implementation of Federal Non-Spot Month Speculative Position Limits, and Instead, Delegate to DCMs the Authority to Administer Accountability Levels.

In the Vacated Final Rule, the Commission deferred the implementation of non-spot month speculative position limits until it could collect swap open interest data sufficient to allow the Commission to properly analyze and establish limits at the levels necessary to prevent excessive speculation. Without much explanation, and without having such data, the Proposed Rule nevertheless imposes hard speculative position limits for single, non-spot month and all months combined positions ("**Any and All Month Limits**"). As noted in the Comment Letters, the Working Group submits that this is inappropriate.[27]

i. Table 11a Raises Substantial Concerns.

Table 11a in the February 25 Release, which updates data in Table 11 of the Proposed

[26] See Section III.C.7, below, for a more thorough discussion of the Series '04 Report issues identified by the Working Group.

[27] *See* February 10 Letter, Section XI, p. 60-63.

Rule, raises substantial concerns with the implementation of hard limits for non-spot month contracts. For example, for the New York Mercantile Exchange ("**NYMEX**") RBOB Gasoline Futures Contract ("**RB**"), over the two-year period reviewed, 11 "Unique Persons" would have exceeded the proposed single, non-spot month speculative limit, and 12 "Unique Persons" would have exceeded the proposed all months combined speculative limit. Yet the Commission fails to explain the methodology used to derive the underlying data presented in the tables.[28] Specifically, neither the Proposed Rule nor Table 11a explain how often or by how much the speculative limits were exceeded; nor do they explain whether the excess was speculative activity or hedging, and, if hedging, whether the hedging activity would be exempted under the Proposed Rule's restrictive definition of *bona fide* hedging.

Moreover, nothing in the Proposed Rule or the presentations at the EEMAC Meeting[29] suggests that the activity constituted "excessive speculation . . . causing sudden or unreasonable fluctuations or unwarranted changes in the price" of the commodity.[30] In short, there is no need to adopt non-spot month speculative limits that would draw liquidity from the RB contract or any other contract.[31]

ii. The Commission Still Does Not Have Swap Data Sufficient to Establish Federal Non-Spot Month Speculative Limits Even Under Its Own Proposed Methodology.

The Proposed Rule establishes initial speculative Any and All Month Limits based on open interest in futures, options, and significant price discovery swaps. Given that speculative Any and All Month Limits also would be applicable to Referenced Contracts in swaps, it is as equally critical that the Commission incorporate data on open interest in cleared and uncleared swaps when establishing speculative Any and All Month Limits.[32] The Commission cannot

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[28] *See id.*

[29] *See* EEMAC Meeting Transcript, at Panel II, p. 95-118 (presentations from ICE Futures U.S. and CME Group), *available at* https://www.youtube.com/watch?v=yGLWQsuqZ-w&feature=youtu.be.

[30] *See* CEA Section 4a(a)(1).

[31] There are several other commodities that, as reflected in Table 11a, would suffer potential liquidity losses if the Proposed Rule is adopted. For example, over the two-year period, potentially 3 Unique Persons would have exceeded the proposed single, non-spot month speculative limit for NYMEX NY Harbor ULSD ("**HO**"), NYMEX Henry Hub Natural Gas ("**NG**"), and NYMEX Light Sweet Crude Oil ("**CL**"), and 6 Unique Persons would have exceeded the proposed Any and All Month Limit for HO. Further, although the Working Group's expertise is not in agricultural commodities, the limits also appear to be too low for certain agricultural products. For example, over the two-year period, 21 Unique Persons would have exceeded the proposed single, non-spot month speculative limits for ICUS Cocoa ("**CC**") and ICE Sugar No. 11 ("**SB**"), and over 20 Unique Persons would have exceeded the proposed Any and All Month Limits for CC, SB, and MGEX Hard Red Spring Wheat ("**MWE**"). While the Commission states that its data demonstrates only a "few persons" exceeded the proposed speculative Any and All Months Limits, these few persons might hold significant liquidity in the applicable markets, or may provide additional liquidity in thinly traded Referenced Contracts or contract months. The Working Group submits that removing *any* liquidity that does not pose the risks associated with excessive speculation is inappropriate and contrary to the basic requirements of the Dodd-Frank Act.

[32] *See* February 10 Letter, Section XI, p. 60-62.

accurately assess how many persons are affected by its initial speculative Any and All Month Limits until it considers all relevant data. Indeed, the Commission admits in the Proposed Rule that any open interest in OTC swaps would increase the levels of the initial speculative Any and All Month Limits.[33]

iii. Accountability Levels, Administered by the DCMs, Are a Rationale Alternative to Federal Non-Spot Speculative Position Limits.

The Working Group recommends that the Commission instead adopt accountability levels for purposes of monitoring non-spot month positions. Energy markets currently operate efficiently under accountability levels imposed by DCMs and without speculative Any and All Month Limits. In this respect, the Working Group believes DCMs are best positioned to administer accountability levels that will less likely reduce liquidity and legitimate hedging, and recommends that the Commission delegate to DCMs the authority to administer accountability levels applicable to energy commodities. As stated in Section III.A.2, above, DCMs have acquired significant expertise and experience in preserving orderly markets and have the resources needed to monitor the size of market participants' positions.

B. The CFTC Should Implement a Safe Harbor From Federal Speculative Limits for Market Participants that Have Relatively Limited Positions in OTC Derivatives.

In establishing spot month speculative position limits, the Working Group proposes that the CFTC adopt the safe harbor described below ("**Safe Harbor**").

<u>*Safe Harbor*</u>

A party that holds positions in Referenced Contracts shall be deemed to be in compliance with applicable federal speculative position limits provided:

1. *That party is at all times in compliance with the applicable speculative position limit(s) administered by each DCM[34] with which the party has transacted, after giving effect to any hedge exemptions provided to the party by the DCM and provided that the party is in compliance with the terms of any such hedge exemption; and*

[33] Proposed Rule at 75,730 n.423.

[34] To the extent energy commodity contracts begin trading on a SEF, the reference to "DCM" in the Safe Harbor should be expanded to include reference to a "SEF."

2. *That party's net position in Referenced Contracts that are other than on-facility contracts is less than 5 times the relevant Core Referenced Futures Contract ("**CRFC**")* [35] *speculative position limit established by the DCM.*

The phrase "on-facility contracts" referenced in the Safe Harbor incorporates all positions transacted on a DCM (and a SEF to the extent energy commodity contracts begin trading on a SEF). If a party's net position in commodity derivatives contracts other than on-facility contracts (*i.e.,* OTC Referenced Contract positions) is relatively small, then the exposures can be efficiently monitored and tracked by the DCMs. In this respect, the potential for small OTC holdings to create excessive speculation is exceedingly low.

C. Comments on Other Aspects of the Proposed Rule.

1. Attachment 1 – CEWG Issues List.

There are numerous issues with the Proposed Rule that the Working Group has identified in its Comment Letters and other "on-the-record" presentations. Rather than repeat them in this comment letter, the Working Group submits as Attachment 1 a "checklist" of the major issues and recommendations the Commission should address in its final rule, and provides citations to its Comment Letters or comments herein that describe the issue or recommendation in more detail.

2. The New Interpretation of the "Economically Appropriate Test."

The commercial infeasibility of the Commission's proposed interpretation of the Economically Appropriate Test has been extensively recorded at both the Position Limits Roundtable[36] and EEMAC Meeting.[37] Companies simply do not manage risk as contemplated

[35] The Working Group submits that 5 times the relevant CRFC is an appropriate threshold given (i) the risk for excessive speculation in OTC Referenced Contract positions would be low and (ii) the threshold aligns with the permitted position in cash-settled contracts under the conditional spot month speculative limit exemption set forth in the Proposed Rule.

[36] *See* Position Limits Roundtable Transcript, at p. 15-16, 30-34, 47-49, (Panelists from the Working Group and Commodities Market Council ("**CMC**") noting that (i) the Commission's proposed interpretation of the Economically Appropriate Test is not feasible given the multiplicity of risks participants transacting in present-day commodity markets must consider, and (ii) addressing risk on a holistic, enterprise-wide basis is commercially impracticable and inconsistent with the regular business practices of a majority of market participants in the energy and agriculture markets); 54-56 (comments of Professor John Parson discussing the reasons why the Commission's proposed interpretation of the Economically Appropriate Test is neither practicable nor commonly utilized by commercial hedgers), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission_061914-trans.pdf.

under the CFTC's proposed interpretation of the Economically Appropriate Test, and the Commission has never required that they do so. The Working Group (and the other participants at the Roundtable and EEMAC Meeting) requests that the Commission refrain from substituting for a commercial enterprise's *bona fide*, prudent risk management an overly simplistic one-size-fits-all government imposed standard for measuring and managing risk.

The CFTC's existing and proposed regulations do not support the Commission's interpretation of the Economically Appropriate Test set forth in the preamble to the Proposed Rule. Specifically, the preamble states:

> In order for a position to be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, the enterprise generally should take into account ***all inventory or products that the enterprise owns or controls, or has contracted for purchase or sale at a fixed price***.[38]

Yet proposed CFTC Regulation 19.00(b)(1) provides:

> If the ***regular business practice*** of the reporting person is to ***exclude certain source commodities, products or byproducts*** in determining his cash positions for *bona fide* hedging positions (as defined in §150.1 of this chapter), the same shall be excluded in the [applicable Series '04] report . . . ."[39]

Clearly, the Commission has recognized, and continues to recognize, that it is prudent in the regular practice of commercial businesses ***not*** to include all inventory or fixed price contracts in calculating cash positions when determining *bona fide* hedging needs. The Economically Appropriate Test therefore should be consistent with that approach. That is, a commercial enterprise should be permitted to exclude not only source commodities, products and byproducts, but also inventory and contracts of the actual commodity, if it is the "regular business practice" of that enterprise to do so in "determining [its] cash positions for *bona fide* hedging purposes."

The Working Group provides the following illustrations explaining why it would be

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[37] *See* EEMAC Meeting Transcript, at Panel III, p. 158-70, 186-91, 216-18 (Panelists from the Working Group and CMC, and EEMAC participant from Southern Company stating the Commission's proposed "one-size-fits-all" approach for interpreting and applying the Economically Appropriate Test is neither commercially nor operationally practicable for the management of risks presented by complex and diverse energy commodity portfolios), 196-200 (EEMAC participant from the National Rural Electric Cooperative Association stating that Congress did not intend for the CFTC to substitute its judgment for the business judgment of commercial end users who are trying to hedge their commercial risk in connection with their "business of providing modern civilization"), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

[38] *See* Proposed Rule at 75,709 (emphasis added).

[39] *See* proposed CFTC Regulation 19.00(b)(1) (emphasis added). Similarly, existing CFTC Regulation 19.00(b)(1) allows a reporting person to exclude products and byproducts from its Series '04 report if, it is the "***regular business practice***" of the person to "***exclude such products or byproducts*** in determining his cash positions for *bona fide* hedging." *See* CFTC Regulation 19.00(b)(1) (emphasis added).

unworkable for a commercial enterprise to consider ***all*** inventory and contracts.

1. Location – Entity A has natural gas in inventory at the Chicago Citygate and a fixed price sale to supply natural gas in Los Angeles. Its regular business practice is to manage those risks independently because the Chicago natural gas market is subject to different supply and demand fundamentals than the Los Angeles natural gas market. Yet the proposed Economically Appropriate Test would require Entity A to hedge both or neither. Entity A would not receive *bona fide* hedge treatment under the Proposed Rule if it treated these outlined risks as separate price risk profiles.

2. Tenor – Entity A has a fixed price sale contract to sell 240,000 barrels of RB in May 2015. It also has a 2-year fixed price offtake agreement to buy 10,000 barrels of RB per month from a refinery. Its regular business practice is to manage those independently because the supply and demand fundamentals for RB in May 2015 are different than they are, for example, in May 2017. Yet the proposed Economically Appropriate Test would require Entity A to hedge both the purchase and the sale or hedge neither. Entity A would not receive *bona fide* hedge treatment under the Proposed Rule if it treated these outlined risks as separate price risk profiles.

3. Different business lines – Entity A is an integrated oil company. Its exploration and production ("**E&P**") businesses are managed independently of its refineries. The E&P business is long crude oil, and the refinery has sold some of its excess inventory. The price of crude oil has been in steep decline, and the forecast for the general economy is weak. The Proposed Rule would not provide a *bona fide* hedge exemption if the E&P entered a short futures position to hedge the risk of a further price decline and the refinery did not put on a long position to hedge its fixed price sale, even though that hedge will cause the refinery to lose money if the market continues in decline.

4. Management of physical assets – Entity A has five different power plants. Its regular business practice is to manage each independently and account for them separately on the company's financial books and records. One plant is net long natural gas, and the other plant is net short. The Proposed Rule would require Entity A to manage its risk jointly if it wished to receive *bona fide* hedging treatment. Entity A would not be permitted to allow its independent managers to make independent risk management decisions, even if they had different opinions on the appropriate manner in which to manage risk in the operation of a particular power plant.

5. Affiliated entities – Entity A is a subsidiary of Parent B. Entity C, another subsidiary of Parent B, has a 60% ownership interest in an E&P joint venture ("**JV**") with three of its competitors. The JV has independent management. However, because it is consolidated with Parent B and its subsidiaries for accounting purposes, the JV did not meet the disaggregation criteria under the Proposed Aggregation Rule. As such, Parent B (and by extension, Entity A) and the JV are forced to aggregate positions under Proposed Rule 150.4. Entity A has a fixed price sale contract, and the JV is long inventory. Under the proposed Economically Appropriate Test and Proposed

Rule 150.3(i), both exposures would have to be hedged or neither could be hedged. Entity A would not receive *bona fide* hedge treatment under the Proposed Rule if it managed its risk without regard to the JV's cash positions.

6. Inventory Targets – Entity A holds inventory as a normal part of its business. Entity A has established target inventory levels, and any shortfall or surplus compared with these targets is managed as a price risk exposure. These targets may be established for all inventories and any inventory shortfall or surplus may be managed by facility, region, business unit, or other subset of Entity A. For example, assume Entity A has 10 million barrels of crude oil storage capacity available at a facility and has established a target inventory level of 5 million barrels. If actual inventory is only 4 million barrels, Entity A has a 1 million barrel short inventory price risk position. The Proposed Rule, however, would not provide *bona fide* hedge treatment if Entity A entered a long futures position to hedge this inventory shortfall, even though this shortfall represents the actual inventory price risk borne by Entity A.

Based on the foregoing, the Commission should interpret the Economically Appropriate Test to allow a market participant to exclude all source commodities, products, byproducts, inventory, and contracts of the actual commodity in "determining [its] cash positions for *bona fide* hedging positions," so long as it is the "regular business practice" of the market participant to do so.[40]

3. Cross-Commodity Hedging.

The Working Group again refers the Commission to its prior comments on this issue.[41] With respect to the relationship between power and natural gas, the Working Group notes herein that further data from several ISOs confirm that natural gas remains the best available substitute commodity for exposure in power prices.[42] Accordingly, natural gas Referenced Contracts are

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40 If the Commission determines to adopt its proposed interpretation of the Economically Appropriate Test, the Working Group submits that the Commission must first provide clarification and guidance on the scope and applicability of the Economically Appropriate Test to enable market participants to fully understand how to comply with such test consistent with the issues raised above.

41 *See* February 10 Letter, Section VI, p. 37-51; August 4 Letter, Section III.B, p. 8-10.

42 *See* PJM Annual Report, at 14, 22-23 (2013) ("Challenging all aspects of PJM's business is the massive fuel transition under way as many coal-fired power plants retire and natural gas-fired resources become a greater part of the generation mix. While this transition is occurring across the nation, it is taking place especially rapidly in the PJM region. . . . The growth of natural gas as a generating fuel nationally has raised concerns about the reliability implications for the electricity grid if the fuel can't be delivered to power plants, especially during weather extremes. PJM and other grid operators, along with the gas industry and regulatory agencies, are carefully examining the gas electric interface to identify issues and develop solutions."); *see also Annual Markets Report ISO New England Inc.*, at 3 (2013) ("The reliability of New England's wholesale electricity market is dependent on the availability of natural gas and fuel oil. . . . In fact, the increase in natural gas consumption by New England generators since 1999 accounts for more than 95% of the overall increase in natural gas consumption for the region. The confluence of these forces has resulted in a much higher proportion of electricity being generated by gas-fired generators in New England, while pushing gas pipeline capacity to its limits during periods of peak gas demand. As a consequence, the reliability of New England's wholesale electricity grid is dependent, in part, on the owners and

an appropriate mechanism to hedge power prices, notwithstanding the contradictory conclusion suggested by the Commission's "quantitative test."[43]

4. Merchandising—the Supplier that Steps into the Shoes of the Producer or Refiner.

The Commission recognizes the need of a producer to hedge its anticipated unsold production (which to the producer is a floating price risk) and the processor to hedge its anticipated unfilled requirements (which to the processor is a floating price risk). But where the producer sells to a supplier on a floating price basis, or the processor buys from a supplier on a floating price basis, the Proposed Rule would not allow the supplier to receive a *bona fide* hedge exemption if it used derivatives to hedge that same risk even though the supplier's risk is identical to the producer or the processor with whom it contracted. For reasons stated in the Comment Letters, there is no legal or policy basis for applying different regulatory treatment to the supplier (merchandiser) versus the producer or processor.[44] Accordingly, the Working Group recommends that the CFTC's proposed *bona fide* hedge definition be expanded to apply to the supplier's risk under these circumstances.[45]

5. Ensuring Supply (or Outlet)—a Hedge that Should be Exempt From the Five-Day Rule.

Certain physical-delivery energy commodity derivative contracts frequently are used to ensure supply or outlet for products that will be purchased or sold. For example, an energy producer may use a physical-delivery commodity derivative contract to hedge its anticipated

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operators of natural gas-fired generators effectively managing natural gas deliveries during contemporaneous periods of high gas and electric power demand.").

[43] Under the Proposed Rule, the "quantitative test" would require the correlation between the daily spot price series for a target commodity and the price series for the commodity underlying the derivative contract to be at least 0.80 for at least 36 months.

[44] *See* CEA Section 4a(c)(2), which provides:

> For the purposes of implementation of subsection (a)(2) for contracts of sale for future delivery or options on the contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that—
>
> (A) (i) 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;
>
> (ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
>
> (iii) arises from the potential change in the value of–
>
> (I) assets that a person owns, produces, manufactures, processes, or ***merchandises*** or ***anticipates*** owning, producing, manufacturing, processing, or ***merchandising*** . . . .

(emphasis added).

[45] *See* February 10 Letter, Section IV.B, p. 16-21; August 4 Letter, Section II.A.3, p. 5-6.

unsold production or a refiner may use derivatives to hedge its anticipated unfilled requirements (or increases in inventory that it chooses in its business judgment to hold). A wholesale supplier that contracts to buy from the producer or sell to the refiner may utilize the same approach (as it essentially steps into the shoes of the producer or refiner). In such circumstances, the physical transaction for which the hedge is a substitute often will not occur until the last few days of trading in the expiring contract, *i.e.,* the spot month for energy commodities—a period in which *bona fide* hedge treatment is not available for physical-delivery Referenced Contracts.

Empirical market data covering the last three days of trading and the day on which Exchange for Physical ("**EFP**") transactions are settled for the past 12 contract expiries for the NYMEX CL futures contract (*i.e.,* for the period running from March 2014 to March 2015) demonstrates that, on average, almost 10 million barrels per month of crude oil were the subject of EFP transactions, where parties likely converted their NYMEX CL futures contract commitments to "make or take" actual physical market commitments. Given the substantial amount of crude oil business conducted in this manner, the failure to provide *bona fide* hedging treatment for the NYMEX CL futures contract positions that must be held during the spot month will (i) severely disrupt liquidity in markets for crude oil (and other energy markets where physical delivery commodity derivative contracts or trade options are transacted in a similar manner) and (ii) harm market participants' ability to use certain physical-delivery energy commodity derivative contracts to ensure supply or outlet for products that will be purchased or sold.

6. The Storage Hedge.

There was much discussion at the EEMAC Meeting about the need for the Commission to reinstate the storage hedge.[46] The Working Group will not belabor such discussion herein. However, the Working Group notes that the CME Group is attempting to launch "the first physically settled storage" futures contract designed specifically to allow a market participant to hedge the value of storage. This is an innovative contract and, potentially, a risk management tool. There is no reason that a party should be permitted to use this instrument to hedge risk, but not be afforded *bona fide* hedge treatment if it instead uses existing derivative contracts.

7. Part 19 and Series '04 Reporting Requirements.

i. The Part 19 Reporting Requirements Should Be More Appropriately Tailored.

As set forth in Section III.C.2, above, proposed CFTC Regulation 19.00(b)(1) permits a reporting person to exclude from its applicable Series '04 reports (*e.g.*, Form 204) certain source

[46] *See* EEMAC Meeting Transcript, at Panel III, p. 170-80 (Panelist from the Working Group and EEMAC participant from Exelon Generation stating that hedging the value of a storage asset should receive *bona fide* hedge treatment because it satisfies the statutory standards established by Congress and expressing concern that the Commission would deny *bona fide* hedge treatment to a physical asset), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf; *see also* Attachment 2, slides 5-7.

commodities, products, and byproducts if the regular business practice of the person is to exclude such source commodities, products, or byproducts in determining its cash positions for *bona fide* hedging. This proposed provision should be expanded. For example, as described in Section III.C.2, above, the person may as a regular business practice exclude inventory and contracts of the ***actual commodity*** (not just the source or products or byproducts) in considering its cash position for hedging purposes.

Moreover, proposed CFTC Regulation 19.00(b)(1) would permit a source commodity to be excluded from a market participant's cash positions for purposes of filing for *bona fide* hedge exemptions *only if* the amount is *de minimis*, impractical to account for, or on the opposite side of the market from the market participant's hedging position. Supporting this proposal, the Commission states that it does not believe it would be "economically appropriate" for a market participant to exclude large quantities of a source commodity held in inventory *when it is calculating value at risk to a source commodity and it intends to establish a long derivatives position as a hedge of unfilled anticipated requirements*.[47] In reality, as described in Section III.C.2, above, there may be many circumstances where a refiner or other processor may have source commodities in another location, contracted for in different timeframes, etc. that make the inclusion of such source commodities irrelevant for Form 204 reporting purposes.

The Working Group submits that the Series '04 reports should be tailored to require only the information that is required to justify the claimed hedge exemption. Form 204 appears to inappropriately require a market participant to list all of its cash market exposures, whether or not the exposures are relevant to the *bona fide* hedge exemption claimed. If a market participant claimed a *bona fide* hedge exemption for the spot month in respect of a short inventory hedge, physical commitments extending beyond the spot month seem irrelevant to the requested spot month exemption. Likewise, if a market participant claimed a *bona fide* hedge for a single month speculative limit in December 2016, its current inventory seems irrelevant. In sum, this information will provide no value to the Commission in determining whether a claimed hedge was indeed *bona fide.*

Accordingly, proposed CFTC Regulation 19.00(b)(1) and Form 204 should be modified to parallel the Working Group's recommendations with respect to the Economically Appropriate Test. In this respect, a reporting person should calculate its cash positions in accordance with its regular business practice and report the cash positions it considered in making its *bona fide* hedging determinations.[48]

ii. Cost-Benefit Analysis.

Given Table 11a suggests hundreds of Unique Persons will need to file a new Form

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[47] *See* Proposed Rule at 75,742 (emphasis added).

[48] The Working Group recommends that the Commission provide as a defined term the phrase "reportable position," which is referenced in proposed CFTC Regulation 19.01(a)(3).

204,[49] the Working Group submits that it will require significant Commission resources to review all such Form 204s, especially if they include extensive amounts of information and data that are unrelated to the applicable hedge exemption sought.[50] The costs to industry participants in collecting and submitting such data and to the Commission in reviewing such data greatly outweigh the regulatory benefit, if any. Therefore, the Working Group recommends that the Commission undertake a cost-benefit analysis to (i) reconsider what information is required to be provided under Part 19 and on Form 204 and (ii) limit the required information to only information that will assist Commission staff in assessing the validity of claimed *bona fide* hedging exemptions.

D. Aggregation.

For purposes of establishing aggregation rules under proposed CFTC Regulation 150.4, the Working Group recommends that the Commission adopt an approach based on the Independent Account Controller ("**IAC**") Exemption[51] and the Federal Energy Regulatory Commission's regulatory barriers to the sharing of information between franchised affiliates and affiliated market-regulated entities. Under this approach, the final rule would be expressed as follows:

Accounts of entities under common ownership need not be aggregated where the entities are excluded affiliates. An excluded affiliate is a separately organized legal entity—

(1) That is specifically authorized by a parent entity to control trading decisions on its own behalf, without the day-to-day direction of the parent entity or any other affiliate;

(2) Over whose trading the parent entity maintains only such minimum control as is consistent with its fiduciary responsibilities to fulfill its duty to supervise diligently the trading of the excluded affiliate or as is consistent with such other legal rights or obligations which may be incumbent upon the parent entity to fulfill (including policies and procedures to manage enterprise-wide risk);

(3) That trades independently of the parent entity and of any other affiliate; and

(4) That has no knowledge of trading decisions of the parent or any other affiliate.

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49 Under Table 11a, there are 194Unique Persons exceeding a spot month speculative limit in an energy product. Assuming they were *bona fide* hedgers, the Commission potentially would have to review 194 Forms claiming *bona fide* hedge exemptions for physical energy contracts in addition to over 300 Forms claiming *bona fide* hedge treatment for cash-settled energy contracts and over 200 Forms for all agricultural products.

50 Information unrelated to the applicable hedge exemption sought would include any data that was not used in determining a reporting person's cash positions for *bona fide* hedging purposes. Such information will not assist the Commission in its oversight function.

51 *See* proposed CFTC Regulation 150.4(b)(5) for a description of the Independent Account Controller Exemption.

The above outlined approach would allow entities under common ownership to individually manage their own trading operations while ensuring they do not coordinate their trading activity or mingle their accounts in contravention of the purpose of position limits.

Finally, in the absence of a specific exemption for pension plans, certain plans and their sponsors will be required to aggregate their positions under proposed CFTC Regulation 150.4, as the proposed IAC exemption fails to exempt many common retirement plan types. The Working Group submits that, given plan managers are subject to independent fiduciary obligations to plan beneficiaries, aggregation with the plan's sponsor serves no public policy goal. Accordingly, the Working Group recommends that the Commission create a specific exemption from the aggregation requirements for ERISA plans.[52]

IV. CONCLUSION.

The Working Group appreciates this opportunity to provide comments on the Proposed Rule and the Proposed Aggregation Rule and requests that the Commission consider the comments set forth herein as it develops any final rules in these proceedings. The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.
R. Michael Sweeney, Jr.
Meghan R. Gruebner

Counsel for The Commercial Energy Working Group

[52] *See* The Commercial Energy Working Group, *Comment Letter, Comment Letter Re: Aggregation of Positions*, RIN 3038-AD82, Section II.D, p.7-8 (Feb. 10, 2014) ("**Aggregation Letter**"); *see also* Attachment 1.

ATTACHMENT 1

THE COMMERCIAL ENERGY WORKING GROUP

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ISSUES THAT SHOULD BE ADDRESSED BEFORE FINALIZING A POSITION LIMITS RULE

SPOT MONTH SPECULATIVE LIMITS

1. In establishing spot month speculative position limits, the CFTC should adopt the Safe Harbor, which would permit a market participant to be in compliance with federal speculative position limits if (i) it is in compliance with the applicable speculative position limits and hedge exemptions administered by the DCMs on which the market participant has transacted and (ii) its net position in OTC Referenced Contracts is less than 5 times the relevant CRFC speculative position limit established by the DCM. *See* Section III.B, above.

2. If spot month speculative limits are to be based on deliverable supply, the Commission should use current data. *See* February 10 Letter, Section X, p. 58-60.

NON-SPOT MONTH SPECULATIVE LIMITS

3. Accountability levels are more appropriate than non-spot month speculative limits for energy markets. Further, they are more cost-effective than non-spot month limits for preventing excessive speculation. *See* Section III.A.3, above; February 10 Letter, Section XI, p. 60-63.

4. The Commission should delegate to DCMs the authority to administer accountability levels applicable to energy market participants' non-spot month positions. *See* Section III.A.3, above.

5. If non-spot month limits are adopted nonetheless, the proposed limits for NYMEX HO and RB futures contracts, among others, are too low. Based upon CFTC supplied data, the proposed limits would reduce market liquidity despite a lack of evidence that such liquidity constituted "excessive speculation." The Commission also must consider swap data before establishing non-spot month limits. *See* Section III.A.3, above; February 10 Letter, Section XI, p. 60-63.

DEFINITION OF "*BONA FIDE* HEDGING POSITION"

"Economically Appropriate Test"

6. The Commission is proposing a new interpretation of the Economically Appropriate Test which substitutes an inappropriate "one-size-fits-all" standard for risk management in place of individualized business practices utilized in the energy

industry. This standard is inconsistent with proposed CFTC Regulation 19.00(b)(1), which allows a person to exclude from its applicable Series ’04 report source commodities, products, and byproducts if its regular business practice is to exclude such in determining its cash positions for *bona fide* hedging purposes. *See* Section III.C.2, above; February 10 Letter, Section III.A, p. 11-14; August 4, 2014 Letter, Section III.A, p. 6-8.

Orderly Trading Requirement

7. The Proposed Rule requires *bona fide* hedging positions to be established and liquidated in an orderly manner in accordance with sound commercial practices. However, as proposed, this requirement raises several procedural due process concerns that must be addressed by the Commission. *See* February 10 Letter, Section III.B, p. 14.

Non-Enumerated Exemptions for *Bona Fide* Hedging Positions

8. The Commission should adopt a provision in its *bona fide* hedging definition that permits non-enumerated *bona fide* hedge positions to be exempted from federal speculative position limits. *See* Section III.A, above; February 10 Letter, Section IV.A, p. 14-16; August 4 Letter, Section III.D, p. 14-15.

9. The Commission should delegate to DCMs the authority to administer *bona fide* hedge exemptions so long as positions or transactions meet the statutory definition of *bona fide* hedging under CEA Section 4a(c)(2). More specifically, under this delegation, DCMs could grant a *bona fide* hedge exemption if a position or transaction is an enumerated position under proposed CFTC Regulation 150.1, as modified and expanded in accordance with the recommendations of the Working Group, or a non-enumerated hedge position, so long as the position or transaction meets the statutory definition under CEA Section 4a(c)(2). *See* Section III.A, above; February 10 Letter, Section IV.A, p. 14-16; August 4 Letter, Section III.D, p. 14-15.

Enumerated Exemptions for *Bona Fide* Hedging Positions

10. ***Merchandising and Anticipated Merchandising***. The Commission should expand the list of enumerated *bona fide* hedge positions to encompass the following commonly-utilized, non-speculative activity:

    (a) anticipated purchases and sales, where a merchandiser has a demonstrable history of buying, transporting, storing, blending, or selling the commodity;

    (b) floating price commitments, where a party has purchased (or sold) a commodity at a floating price with the intention that it will sell (buy) the commodity at a floating price;

    (c) bids and offers that are binding and will require the party to make or take delivery at a stated, fixed price;

(d) the value of assets, such as energy infrastructure, owned or anticipated to be owned;

(e) the value of storage that a party owns, leases or anticipates owning or leasing, as reflected in the price of anticipated purchases to fill the storage and associated sales from storage;

(f) the value of transportation services that a party owns, leases or anticipates owning or leasing, as reflected in the price of anticipated purchases in one location and sales in another;

(g) unfixed price commitments, where a party has purchased (or sold) a commodity at a floating price, and the party wants to lock in the differential that covers its costs and eliminate risk in its ability to sell (or buy) the physical product at the same index; and

(h) unfixed price commitments used to ensure supply or outlet for products that will be purchased or sold before or through the spot month.

See Section III.C.4-6, above; Attachment 2; February 10 Letter, Section IV.B, p. 16-26; August 4 Letter, Section II.A.3, p. 5-6.

11. ***Unfixed Priced Requirements and Unfixed Priced Production***. The Commission should revise the definition of "*bona fide* hedging position" to allow a party that has the need to hedge anticipated requirements or production to lock in the price in instances where it has contracted to purchase its requirements or sell its production but at a floating price. *See* February 10 Letter, Section IV.D, p. 26-27; August 4 Letter, Section II.A.3, p. 5-6; III.C, p. 10-14.

12. ***Utility Hedging Unfilled Anticipated or Unfixed Priced Requirements for Customers***. The Commission should revise subsection 3(iii)(B) of the definition of "*bona fide* hedging position" to apply to "hedges of unfilled anticipated or unfixed priced requirements for customers" and permit a utility or other similar entity designated as a sole provider or a provider of last resort to its customers to claim the exemption. *See* Attachment 2, slides 11-13; February 10 Letter, Section IV.E, 27-28.

13. ***Calendar Month Average Pricing***. Calendar month average pricing is used to lock in a pricing formula for producers and users of energy products and the parties that buy from or sell to them. That practice should be recognized as an enumerated *bona fide* hedge position set forth in proposed CFTC Regulation 150.1. *See* Attachment 2, slides 14-28; February 10 Letter, Section IV.G, p. 29-37; August 4 Letter, Section III.C, p. 10-14.

14. ***Heat Rate Transactions in Electricity Markets***. The Commission should recognize as an enumerated hedge under subsection (3) of the definition of "*bona fide* hedging position" a position in a Referenced Contract used to hedge a transaction in a different commodity that is priced by reference to the commodity underlying the Referenced Contract, (ii) exclude from position limits heat rate derivatives, which are spread contracts, or (iii) modify proposed subsection (5) of the definition of "*bona fide* hedging position" to include as *per se* cross-commodity hedges heat rate

transactions and electricity and natural gas transactions used to hedge physical heat rate transactions. *See* Section III.C.3, above; February 10 Letter, Section VIII, p. 53-55.

15. ***Anticipated Cash Transactions Subject to Ongoing Good Faith Negotiations***. The Commission should expand the *bona fide* hedge definition to address anticipated cash transactions where a market participant has a good faith, reasonable belief that such transactions will be consummated. *See* February 10 Letter, Section IV.C, p. 26; August 4 Letter, Section III.C, p. 10-14.

16. ***Commodity Transactions Priced as Differentials***. The CFTC should expand the *bona fide* hedge definition to address hedging transactions that involve a differential between (i) locations, grades or qualities of two or more commodities, or (ii) a commodity (*i.e.,* electricity) and a fuel source (*i.e.,* natural gas), that arises from a fixed price differential in one or more transactions. *See* February 10 Letter, Section XV, p. 68-70.

Directed Hedges of Commodity Price Terms that Are Based on a Commodity that is Different from the Underlying Physical Transaction

17. The Commission should clarify that when a physical transaction is priced with reference to the commodity underlying a Referenced Contract, the hedge transaction in the Referenced Contract does not constitute a "cross-commodity" hedge. *See* February 10 Letter, Section V, p. 37.

Cross-Commodity Hedges

18. A quantitative test for determining whether a cross-commodity hedge qualifies for regulatory treatment as a "*bona fide* hedging position" is unnecessary and unworkable. The CFTC should adopt a qualitative test. *See* February 10 Letter, Section VI, p. 37-51; August 4 Letter, Section III.B, p. 8-10.

19. The Commission should recognize that natural gas Referenced Contracts often provide the best available mechanism to hedge price and operational risk associated with long-term power transactions. *See* Section III.C.3, above; February 10 Letter, Section VI.A.2, p. 41-46. In the same manner, the Commission should recognize other potential "cross-commodity" relationships that are commonly used by commercial energy firms to reduce their exposure to price risk. *See* February 10 Letter, Section VI.A.3, p. 46-47 and Attachment 1 appended thereto (setting forth a non-exclusive list of cross-commodity relationships, other than natural gas and power, commonly utilized by commercial hedgers in the energy sector).

FIVE-DAY RULE AS APPLIED TO CROSS-COMMODITY HEDGES AND GENERALLY

20. The Commission should revise subsection (5) of the definition of "*bona fide* hedging position" to permit market participants to hold a physically delivered Referenced Contract into the spot month as a *bona fide* hedging position where (i) such position is necessary to hedge the risk of commodities that are being delivered or priced in the

spot month, or (ii) where the commodities represent components that, if blended together (or in concert with other components), represent the deliverable grade of the underlying commodity derivative contract. *See* February 10 Letter, Section VI.B, p. 47-51; August 4 Letter, Section III.B, p. 10.

21. The Commission should eliminate the Five-Day Rule from the following provisions of the definition of "*bona fide* hedging position":

    - (2)(ii)(A) (Pass-Through Swap Offsets)
    - (3)(iii) (Hedges of Unfilled Anticipated Requirements)
    - (4)(i) (Hedges of Unsold Anticipated Production)
    - (4)(ii) (Hedges of Offsetting Unfixed Price Cash Commodity Sales & Purchases)
    - (4)(iii) (Hedges of Anticipated Royalties)
    - (4)(iv) (Hedges of Services)

    See February 10 Letter, Section VII, p. 51-53.

22. Similarly, the Commission should provide *bona fide* hedging treatment to hedges of unfixed price commitments used to ensure supply or outlet for products, and permit such hedges to be held through the spot month under this treatment. *See* Section III.C.5, above.

23. Further, the Commission should provide *bona fide* hedging treatment to Referenced Contracts that convert transaction pricing terms to CMA pricing and permit these Referenced Contracts to be held through the spot month under this treatment. *See* Attachment 2, slides 14-28.

<u>TRADE OPTIONS</u>

24. The Commission should exclude trade options from federal speculative position limits. *See* February 10 Letter, Section IX, p. 55-58.

<u>BASIS CONTRACTS</u>

25. The definition of "basis contract" set forth in the Proposed Rule should include the following sets of commodity derivative contracts:

    - Any commodity priced at a differential to any of its products and by-products, such as a crude oil crack spread contract, which represents the difference in prices between crude oil and gasoline blendstock (reformulated blendstock for oxygenate blending or "RBOB") or ultra low sulfur diesel ("ULSD");
    - A product or byproduct of a particular commodity, priced at a differential to another product or byproduct of that same commodity, such as a contract based on

jet fuel priced at a differential to heating oil; both of which are manufactured from crude oil, and

- A particular commodity that includes other similar commodities, such as a contract based on the difference in prices of light sweet crude oil and a sour crude oil that is not deliverable under the WTI contract.

See February 10 Letter, Section XIV.C, p. 68; August 4 Letter, Section IV, p. 15-17.

REFERENCED CONTRACTS

26. The Commission should publish a list of all Referenced Contracts traded on DCMs or SEFs. *See* February 10 Letter, Section XIV.B, p. 67-68.

ELIGIBLE AFFILIATE DEFINITION

27. The Commission should eliminate its proposed definition of "eligible affiliate" in proposed CFTC Regulation 150.1 and instead adopt the definition of "eligible affiliate" contained in CFTC Regulation 50.52(a), which includes two subsidiaries of a common parent ("sister companies"). *See* February 10 Letter, Section XIV.A, p. 66-67.

COMPLIANCE DATE

28. Market participants should be given at least nine months from the date that any final rule is adopted to come into compliance. *See* February 10 Letter, Section XVI. A, p. 70-71.

REPORTING

29. Proposed CFTC Regulation 19.00(b)(1) should be modified to require only those commodities that are considered by a reporting person as part of its regular business practice in determining its cash positions for *bona fide* hedging purposes to be reported on the applicable Series '04 report. *See* Section III.C.7, above.

30. ***Form 204***. The Commission should adopt a good faith standard that provides market participants with a reasonable degree of flexibility when verifying the accuracy of Form 204 submissions. *See* February 10 Letter, Section XIII.A, p. 64-65.

31. ***Form 504***. Form 504 is unnecessary if the Commission adopts the Working Group's suggestion to eliminate the condition associated with the proposed conditional limit. If the Commission, however, adopts the proposed conditional limit as is, the Form 504 should simply require an affirmative representation that a market participant is utilizing the conditional exemption and that they do not hold any physical delivery Referenced Contracts. *See* February 10 Letter, Section XIII.B, p. 65-66.

AGGREGATION

32. Aggregation relief for majority-owned entities is critical and should be based on a facts and circumstances basis. The proposed "Non-Consolidation Requirement"

should be abandoned and replaced with a focus on whether there is trading coordination or shared trading control between the affiliates. *See* Aggregation Letter, Section II.A-B, p. 2-6; The Commercial Energy Working Group, *Comment Letter Re: Responses to Staff Questions Regarding Aggregation of Positions*, RIN 3038-AD82 (Aug. 4, 2014).

33. The Commission should adopt an approach based on the Independent Account Controller Exemption and the Federal Energy Regulatory Commission's regulatory barriers to the sharing of information between franchised affiliates and affiliated market-regulated entities. *See* Section III.D, above.

34. Pension plans should receive an aggregation exemption. *See* Section III.D, above; Aggregation Letter, Section II.D, p. 7-8.

ATTACHMENT 2

THE COMMERCIAL ENERGY WORKING GROUP

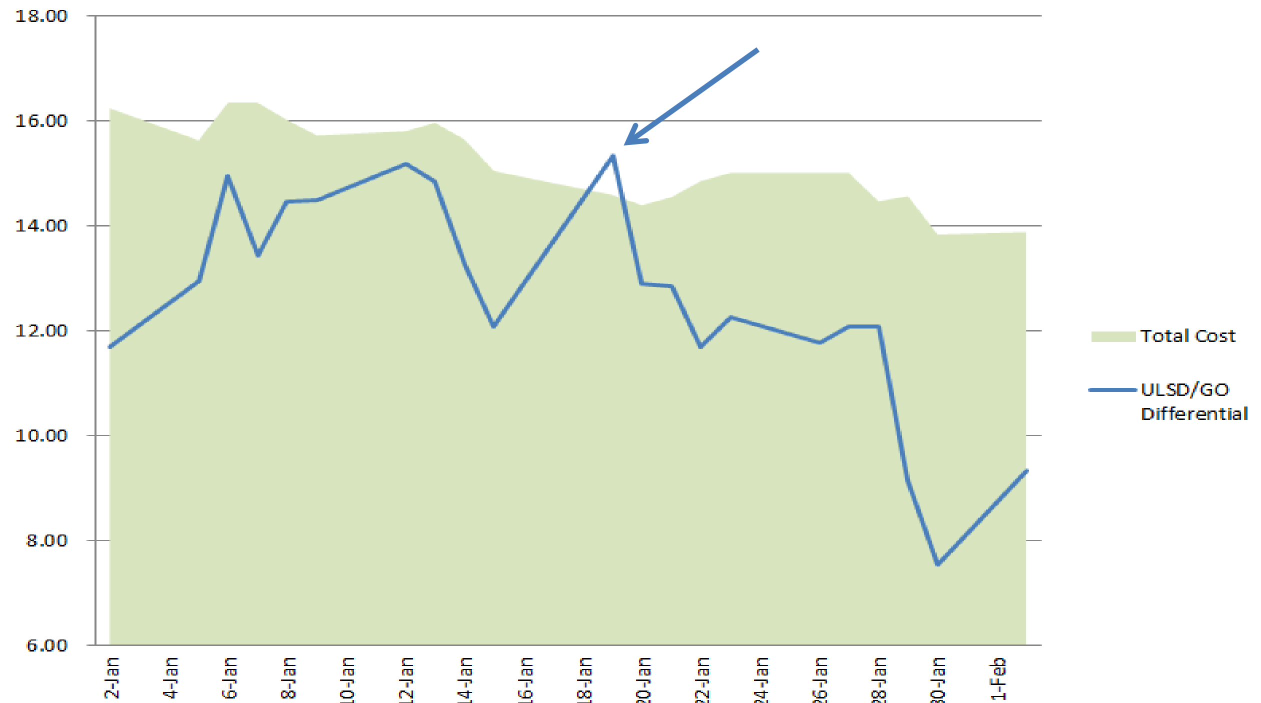
—

POWERPOINT SLIDES DESCRIBING RISK-REDUCING PRACTICES COMMONLY UTILIZED IN THE ENERGY INDUSTRY THAT SHOULD RECEIVE BONA FIDE HEDGING TREATMENT

Buy or Sell Physical At A Floating Price – Other Leg Open

(Example 1, Pg. 20-21, CEWG February 10, 2014 Comment Letter)

All in cpg	***19-Jan***
ICE Feb. Gasoil	151.22
NYMEX Feb. ULSD	166.56
ULSD/GO Differential	15.34
Freight (TC2)	7.26
Other Est. Costs	7.32
Total Costs	14.58
Margin	**0.76**



On January 19th, Importer:

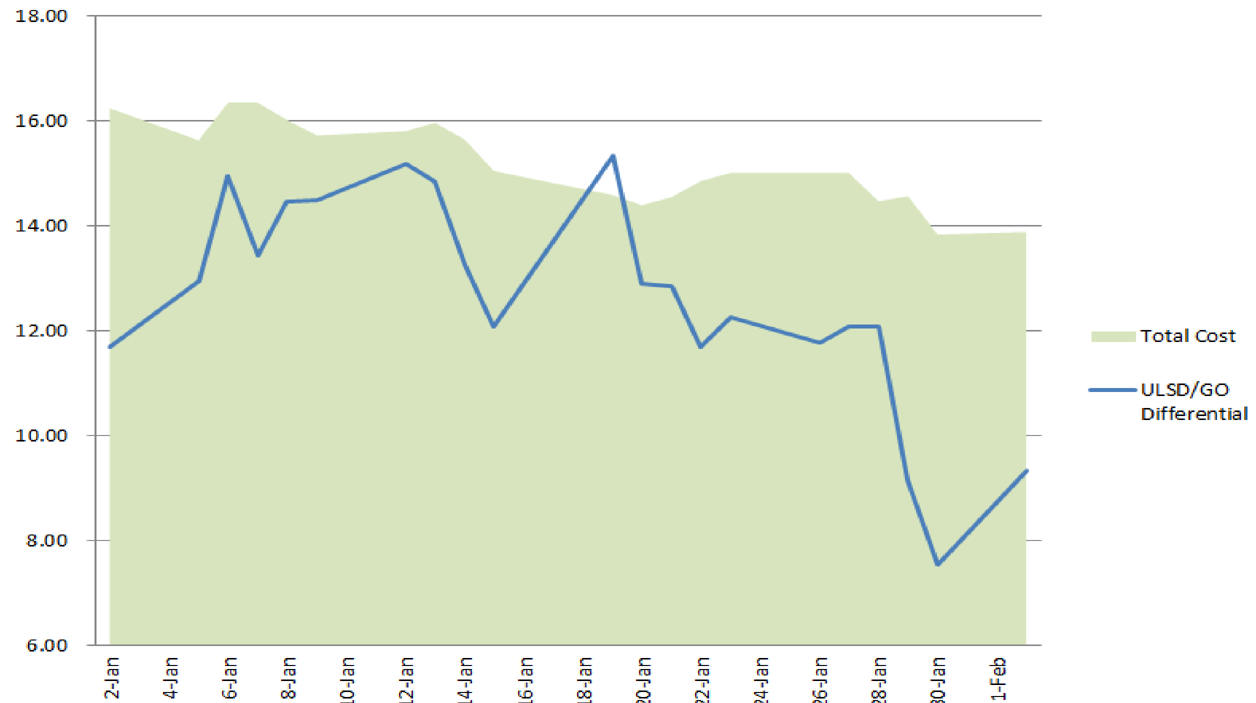
- Buys physical gasoil for forward delivery on a floating price based on ICE Feb. gasoil futures. It has not yet located a buyer for the gasoil, but intends to ship the gasoil to NYH and sell it on a floating price basis.
- Locks in the ULSD/GO Differential of 15.34 by buying ICE Feb. gasoil futures at 151.22 and selling NYMEX Feb. ULSD futures at 166.56.

NOTE: The short NYMEX ULSD futures would not qualify for BFH treatment under the Proposed Rule.

Buy or Sell Physical At A Floating Price – Other Leg Open, Cont'd.

(Example 1, Pg. 20-21, CEWG February 10, 2014 Comment Letter)

All in cpg	***19-Jan***
ICE Feb. Gasoil	151.22
NYMEX Feb. ULSD	166.56
ULSD/GO Differential	15.34
Freight (TC2)	7.26
Other Est. Costs	7.32
Total Costs	14.58
Margin	**0.76**



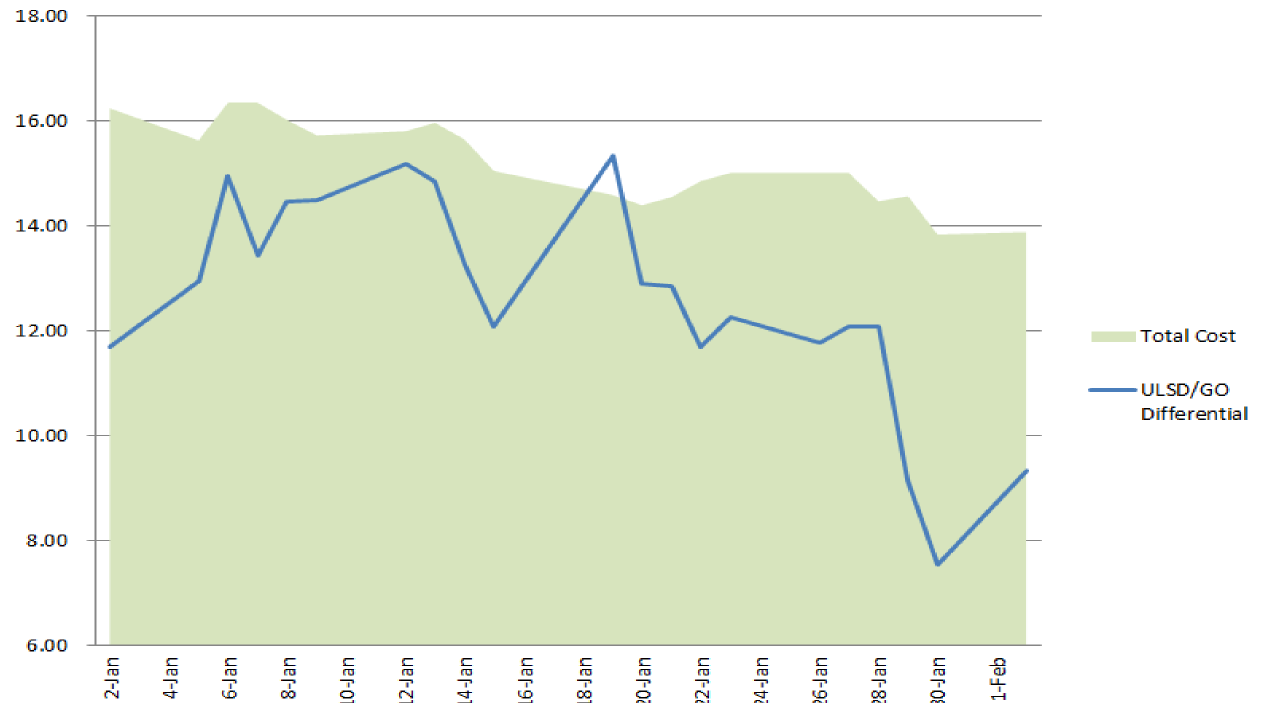
- On January 26th, Importer sells the physical product for delivery in NYH on a floating price based on Feb. NYMEX ULSD futures.

NOTE: The short Feb. NYMEX ULSD futures would now qualify for BFH treatment under the Proposed Rule.

BUY OR SELL PHYSICAL AT A FLOATING PRICE – OTHER LEG OPEN, CONT'D.

(Example 1, Pg. 20-21, CEWG February 10, 2014 Comment Letter)

All in cpg	***19-Jan***
ICE Feb. Gasoil	151.22
NYMEX Feb. ULSD	166.56
ULSD/GO Differential	15.34
Freight (TC2)	7.26
Other Est. Costs	7.32
Total Costs	14.58
Margin	**0.76**



- On January 29th, both physical transactions are priced (buy physical at 152.68; sell physical at 161.84, representing revenue of 9.16 cpg). The futures spread is liquidated at the same prices (sell ICE Feb. gasoil at 152.68 and buy NYMEX Feb. ULSD at 161.84, representing a gain of 6.18 cpg).
- The revenue on the physical purchase and sale plus the gain on the hedge equals 15.34. Subtracting the costs of 14.58 yields the expected 0.76 cpg margin.
- Even though the price of ULSD has dropped by approximately 40% relative to gasoil (and by approximately 5 cpg in absolute terms), through the use of this hedging technique, Importer has protected its profit on the transaction.

BUY OR SELL PHYSICAL AT A FLOATING PRICE – OTHER LEG OPEN, CONT'D.

(Example 1, Pg. 20-21, CEWG February 10, 2014 Comment Letter)

The Feb. NYMEX ULSD futures contracts in this example should be given BFH treatment because it meets the statutory standard set forth in the Act and the Proposed Rule through the time period Jan. 19 to Jan. 26, as follows:

A. It was a substitute for a transaction to be made at a later time in a physical marketing channel (*i.e.* the sale of physical product in NYH);

B. It was economically appropriate to the reduction of Importer's risk (*i.e.* that the relative value of the product in NYH would drop before it sold the physical product on a floating price basis); and

C. It arose from the potential change in value of an asset (gasoil) that Importer owned (had contracted for).

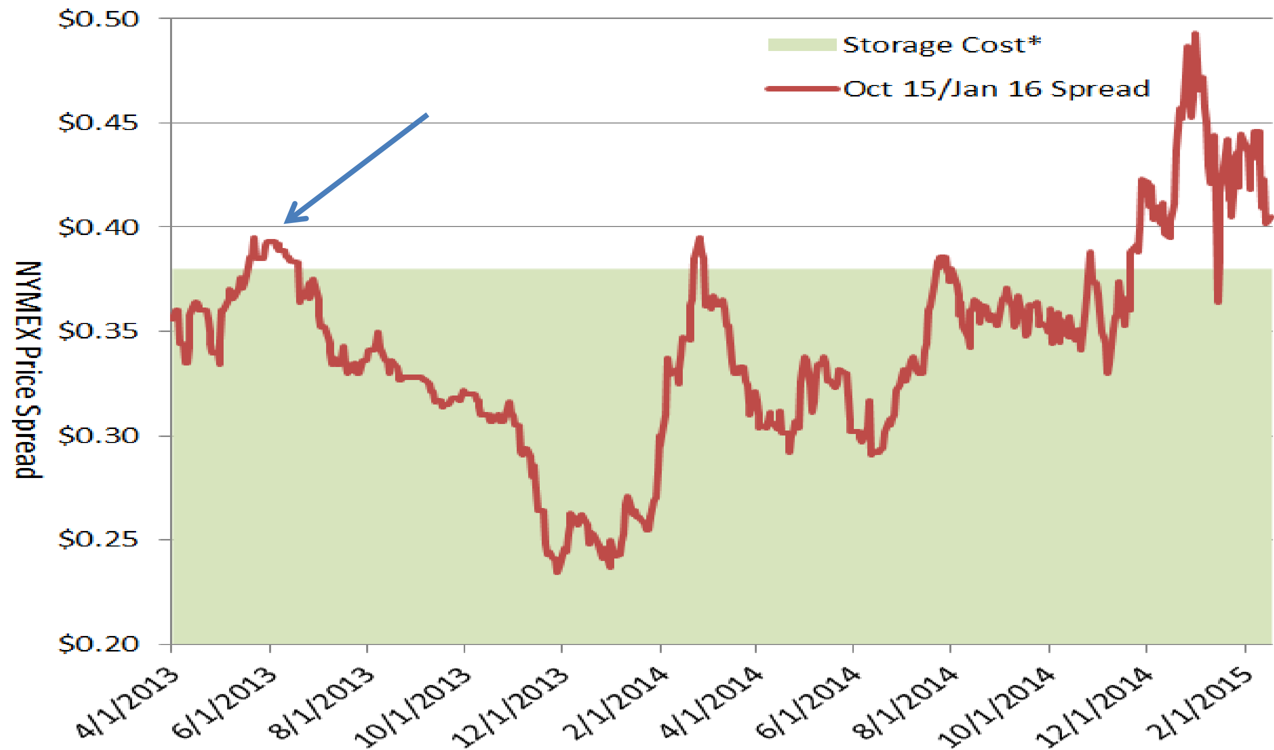
The consumer benefits because gasoil was imported to the United States in response to market signals, ultimately reducing the cost of fuel in the U.S.

The Importer would not have entered into this transaction without the ability to have hedged its risk.

WINTER STORAGE TRANSACTION

(Example 3, Pg. 24-25, CEWG February 10, 2014 Comment Letter)

$ per mmbtu	*3-Jun*
Oct. '15 NG	4.2990
Jan. '16 NG	4.6920
Differential	0.393
Anticipated Cost	0.38
Margin	**0.013**



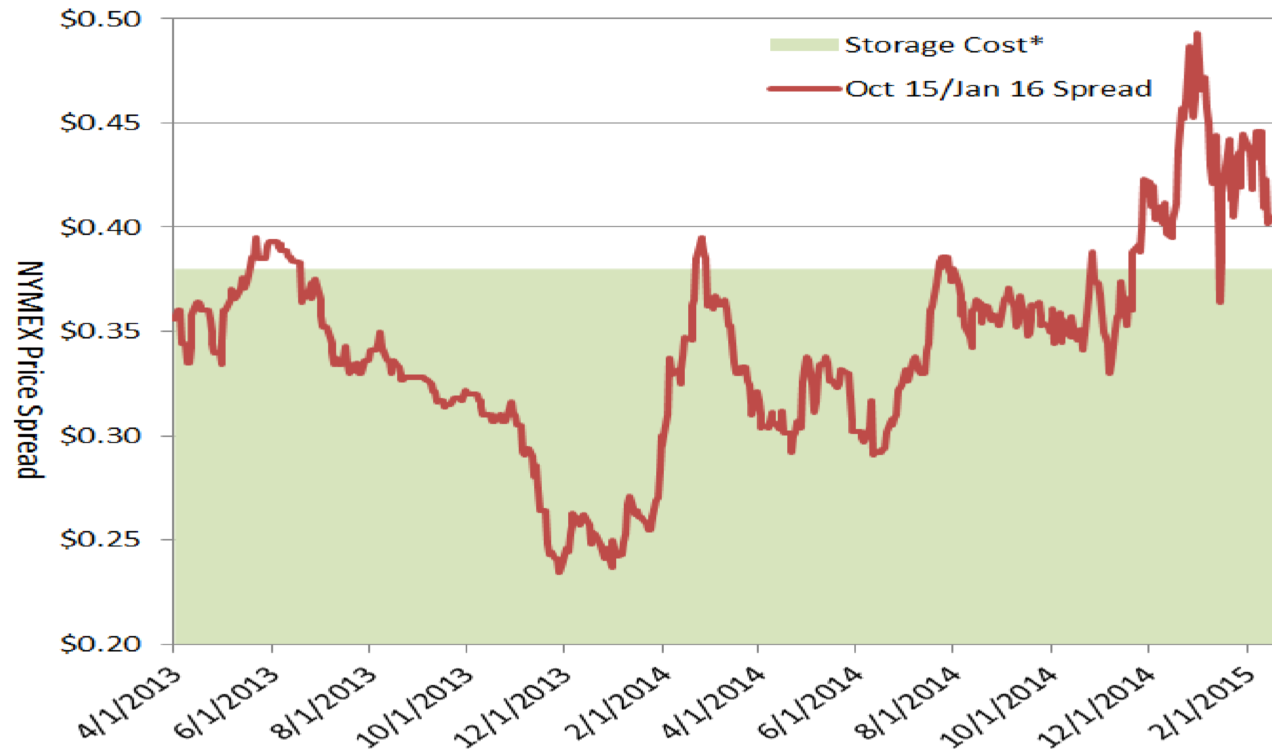
- In April 2013, Supplier decides to lease storage that will cost him $.38/mmbtu to store natural gas during the winter of 2015-16.
- On June 3, Supplier enters into hedge transaction to lock in a profit based on the spread between its expected natural gas purchase and sale prices (buy Oct. NG futures contracts at 4.2990 and sell Jan. NG futures contracts at 4.6920).

NOTE: The October futures contracts and the January futures contracts would not qualify for BFH treatment under the Proposed Rule.

WINTER STORAGE TRANSACTION, CONT'D.

(Example 3, Pg. 24-25, CEWG February 10, 2014 Comment Letter)

$ per mmbtu	***3-Jun***
Oct. '15 NG	4.2990
Jan. '16 NG	4.6920
Differential	0.393
Anticipated Cost	0.38
Margin	**0.013**



- In September 2015, Supplier will buy physical gas to fill the storage in October (and liquidate the Oct. NG futures contracts).
- In December 2015, Supplier will sell gas to be withdrawn from storage in January (and liquidate the Jan. NG futures contracts).

WINTER STORAGE TRANSACTION, CONT'D.

(Example 3, Pg. 24-25, CEWG February 10, 2014 Comment Letter)

The winter storage transaction should be given BFH treatment because it meets the statutory standard set forth in the Act and the Proposed Rule, as follows:

A. It was a substitute for transactions to be made at a later time in a physical marketing channel (*i.e.* the purchase of natural gas to fill storage and withdraw from storage);

B. It was economically appropriate to the reduction of Supplier's risk (*i.e.* that it will be able to recover the cost of its storage obligation and profit from its business of supplying natural gas in the winter); and

C. It arose from the potential change in value of an asset (natural gas/storage) that Supplier owned (storage) and anticipated owning (natural gas).

Consumers benefit from this transaction because gas will be in storage, mitigating the risk of unavailability of natural gas in cold weather and/or cost of a price spike during Winter '15-'16.

Supplier would not have entered into this transaction and committed to store natural gas without the ability to hedge its risk.

**n.b.* The storage hedge is also a valuable risk mitigation tool to a storage operator that has not leased its capacity.

JET FUEL: CROSS-COMMODITY IN THE SPOT PERIOD

(Adapted from Example 8, Pg. 50-51, CEWG February 10, 2014 Comment Letter)

Batches of jet fuel are bought and sold during any given month for delivery during the last cycle of the month, from January 27 to January 31, for example. These transactions typically will be priced using an adder to the heating oil price and hedged with the spot month heating oil futures, in this example, NYMEX HO contracts.

- Refiner A sells jet fuel to Counterparty B:
  - **Deal date**: January 13, 2014
  - **Delivery Date:** January 31, 2014
  - **Volume**: 200,000 bbls (200 lots) of Colonial Pipeline 54 Grade jet fuel
  - **Price**: (a) FEB2014 NYMEX HO quotation + (b) a basis of USD $-.07 per gallon
- On January 13, Refiner A sells 200 FEB2014 NYMEX HO to lock in sales price.
- On January 13, Counterparty B buys 200 FEB2014 NYMEX HO to lock in purchase price.
- On January 30, the price of the FEB2014 NYMEX HO contract is $2.93/gallon. Refiner A and Counterparty B price their physical transaction at $2.86 per gallon.
- Refiner A and Counterparty B close their respective futures positions.
- On January 31, Counterparty B takes delivery of the 200,000 barrels of 54 Grade jet fuel.

NOTE: The HO futures hedges on these barrels would not qualify for BFH treatment under the Proposed Rule. 200 Contracts is 20% of the HO spec. limit.

Jet Fuel: Cross-Commodity in the Spot Period, Cont'd.

(Adapted from Example 8, Pg. 50-51, CEWG February 10, 2014 Comment Letter)

The use of the HO futures contracts in this example should not be considered a cross-commodity hedge because the parties are hedging the price of heating oil, not the price of jet fuel. If these hedges are not categorized as being "cross commodity", the "5 day" rule would not apply.

However, if this activity is characterized as a cross commodity hedge, it should be given BFH treatment and not be subject to the 5 day rule because it meets the statutory standard set forth in the Act and the Proposed Rule through the time period Jan. 13 to Jan. 30, as follows:

A. The futures were substitutes for transactions to be made at a later time in a physical marketing channel (*i.e.* the sale of physical jet oil at staging terminals adjacent to Colonial Pipeline);

B. The hedges of both Refiner A and Counterparty B, were economically appropriate to the reduction of risk (*i.e.* that the relative value of the product would change between when it was sold on a floating price basis (January 13) and when it was priced (January 30).

C. They arose from the potential change in value of an asset (jet fuel) that Refiner A produces and Counterparty B procures.

Jet Fuel: Cross-Commodity in the Spot Period, Cont'd.

(Adapted from Example 8, Pg. 50-51, CEWG February 10, 2014 Comment Letter)

Without BFH treatment, either party would only be able to hedge five routine transactions of this nature in the spot month within the position limit. Refiners and other jet fuel suppliers typically enter into many more sales each month.

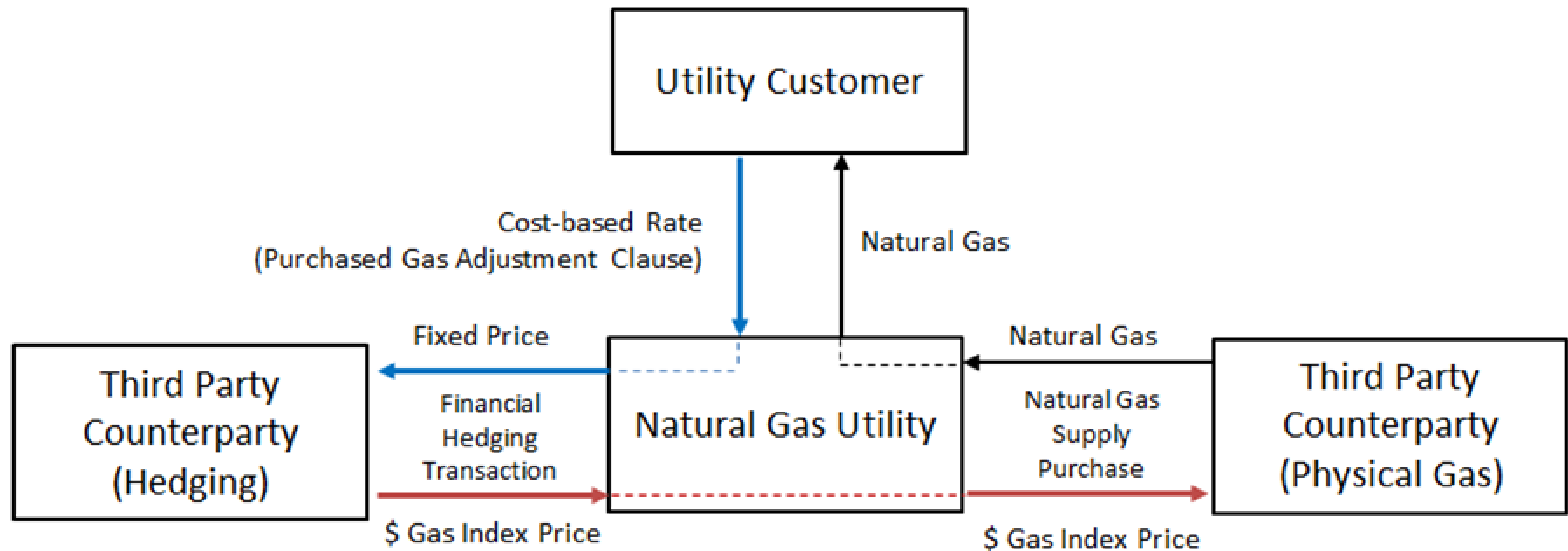
Additionally, the parties probably would not have entered into this transaction without the ability to have hedged their risk through the spot month. Otherwise, they would have been forced to lift their FEB2014 NYMEX HO futures hedges by close of business on January 28 and use suboptimal alternatives:

- Be unhedged for the last two days before pricing;
- Or roll the hedge to the MAR2014 NYMEX HO futures contract. This would have increased exposure to price risk and needlessly increased transaction costs.

Consumers benefited because jet fuel was priced, hedged and delivered in the most efficient manner, ultimately reducing the cost of air travel in the U.S.

Utility Hedging of Unfilled Anticipated or Unfixed Price Requirements

(Pg. 27-28, CEWG February 10, 2014 Comment Letter)



- Rates for natural gas utility customers typically provide for recovery of the actual cost of natural gas paid by the utility, adjusted for gains or losses on permitted hedging transactions.
- Vast majority of physical natural gas, particularly in forward markets, is transacted at index prices; either monthly indices such as NGI or Inside FERC, or daily indices such as Gas Daily.

NOTE: The Utility Hedging Unfilled Anticipated or Unfixed Price Requirements would not receive BFH treatment under the Proposed Rule.

Utility Hedging of Unfilled Anticipated or Unfixed Price Requirements, Cont'd.

(Pg. 27-28, CEWG February 10, 2014 Comment Letter)

Utility Hedging of unfilled anticipated or unfixed priced requirements should be given BFH treatment because it meets the statutory standard set forth in the Act and the Proposed Rule, as follows:

A. Hedging transactions are a substitute for transactions to be made at a later time in a physical marketing channel (i.e. the purchase of physical natural gas at a fixed price);

B. Such hedging is economically appropriate to the reduction of a utility's risk (i.e. that natural gas index prices will rise, increasing the cost of natural gas the utility must acquire to serve its customers); and

C. The utility's risk arose from the potential change in value of an asset that utility anticipated owning (natural gas)

Consumers benefit from utility hedging because the price they will ultimately pay for natural gas is directly determined by the actual cost of natural gas acquired by the utility, together with realized gains or losses on utility hedging transactions

UTILITY HEDGING OF UNFILLED ANTICIPATED OR UNFIXED PRICE REQUIREMENTS, CONT'D.

(Pg. 27-28, CEWG February 10, 2014 Comment Letter)

The Commission proposed to provide an exemption for unfilled anticipated or unfixed price requirements for resale by a utility where the utility is "required or encouraged" to hedge by its public utility commission

A. Public utility commissions generally do not require or encourage utilities to hedge using commodity derivative contracts and generally do not grant *ex ante* approval of specific hedging programs or strategies.

B. Public utility commissions ultimately determine whether to allow or disallow gains or losses from hedging activity to be passed through to customers through rates; *ex post* prudency review is the norm.

C. Municipal natural gas utilities and public gas agencies generally are not subject to oversight from state public utility commissions with regard to rates; therefore, such entities would not be eligible for the proposed exemption conditioned upon a requirement that they be required or encouraged to hedge by their public utility commissions.

The Commission instead should determine that in connection with the exemption for unfilled anticipated requirements, the phrase "for use by the same person" should not be strictly interpreted to mean "consumption by the same person" and extend the exemption to both unfilled anticipated and unfixed priced requirements.

Calendar Month Average ("CMA") Pricing

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Introduction

- Calendar Month Average ("CMA") Pricing is a means by which producers, refiners and the parties that buy from and sell to them frequently price transactions in physical crude oil. It is an index methodology that uses exchange listed futures contracts (which reflect a forward expectation of price for future delivery) to derive an actual spot price for the period in which delivery actually occurs. CMA pricing is more objective than historical "posted prices" for spot market transactions as it uses a trustworthy price discovery source – front month and nearby futures contracts – to derive the spot price. Using the structured combination of front month and nearby futures contracts described below, rather than simply purchasing or selling the nearby futures contract, results in a pricing methodology for spot crude oil that properly matches the timing of daily price observations with the expected timing of physical delivery (or production and consumption).

- The important considerations, in the context of a position limit rule, are: (1) the front month positions constitute a *bona fide* hedging position; (2) the Commission should permit them to be held through the expiration of the contract and not subject them to the "five-day" rule requiring they be liquidated before the spot period; and (3) the nearby futures positions should be recognized as a hedge of the physical commitments represented by the front month futures positions.

- It is important to the marketplace that the Commission recognize this exemption. Buyers and sellers of physical crude oil regularly use the futures market to establish their commitments. On a forward basis, the futures markets can be more liquid than the cash markets. More importantly, establishing the commitment through the futures markets eliminates counterparty credit exposure for a substantial period of time. In addition, establishing a position through daily futures market transactions allows a party the flexibility to fine-tune the volume transacted in response to updated information about expected production or requirements. Finally, parties that establish physical commitments through the futures markets in this manner generally exit those positions in an orderly manner by engaging in exchanges of futures for physicals ("EFP") transactions during or following the "five-day" period. Denying *bona fide* hedge treatment or insisting on the application of the "five day" rule will drive legitimate commercial market participants from the spot period when their participation is so essential to effective price convergence. That result would, contrary to the purpose of the Rule, put true price discovery at greater and unnecessary, risk of improper speculative forces.

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

The Examples

There are a variety of ways in which one can achieve CMA pricing by using published indices or derivatives. Set forth below are examples, not an exhaustive listing of how CMA pricing may be achieved. In addition, the term CMA pricing is used in many contexts and the below is simply a representation of how it may be used.

The examples below are intended to represent how a producer, a refiner, and a wholesale supplier (that may purchase from a producer or sell to a refiner) may use CMA pricing in their business. Each of them has three principle objectives:

- An entity seeks to enter into a transaction to make or take delivery in a given month (December, in the examples below) at the Calendar Month Average (spot price) each day in December plus or minus a negotiated differential.
- The entity must make or take physical delivery during the month.
- The entity must conclude the structure with no open futures position.

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

The Producer

The Producer seeks to be paid the spot price of crude oil on the day that it produces that oil. It has several choices. It could agree to sell to a wholesale supplier (or refiner) at the daily posting price (plus or minus a differential). Another very common alternative is to sell its production through the futures market. Here is how that would work, assuming expected production of 3,000 barrels per day in December:

- When December is the front month futures contract, producer would sell its expected daily production on every trading day. In our example, December is the front month futures contract from October 19th through November 16th. The futures sales are represented in Table 1, Column 3, below.

- The futures sales are "fixed price" sales and the producer hedges those sales each day, using the 2/3, 1/3 methodology common to CMA pricing. The hedges are represented in columns 4 and 5 of Table 1, below. These hedges establish a differential between December and January and February forward pricing. From an economic standpoint, that differential will adjust December forward pricing to spot pricing.

- When the December contract ceases to trade (November 16th), the producer has committed to sell its full December production through the futures market. Generally, producer will enter into an exchange of futures for physicals ("EFP") transaction and exchange its short futures position for a fixed-price physical sale at the December final settlement price ($90.00/bbl) under which it will actually deliver barrels ratably during the month of December. Its February and March futures contracts continue to serve as a hedge for the fixed-price sale of the production.

- As it ratably delivers crude oil on each day during December, it ratably lifts the futures hedge – selling on each trading day contracts that are prompt on that day, first the January contracts and then the February contracts. See Table 2, below.

- Producer will have received $90.00 a barrel under its physical sale contract. It will have lost $.76/bbl on its 63 lot short December futures position and made $8.18/bbl on its 42 lot long January futures hedge and $7.89/bbl on its long February futures hedge. The net amount received for its production is $97.33/bbl., which represents the average spot price for crude oil during the month of December.

*The average of the differential of the price of three December contracts with two January contracts and one February on each trade date in October and November subtracted from the prices at which the long January and long February contracts are liquidated represents sales at the December calendar month average and ties out with the economics of purchasing product fixed price under the EFP and calculating the gains and losses under the futures positions.

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Table 1

Day	Date	Sell 3 Dec	Buy 2 Jan	Buy 1 Feb	Diff
Friday	Oct. 19	89.00	89.15	89.29	
Monday	Oct. 22	89.10	89.30	89.35	
Tuesday	Oct. 23	90.05	90.12	90.14	
Wednesday	Oct. 24	90.04	90.12	90.14	
Thursday	Oct. 25	89.93	90.00	90.10	
Friday	Oct. 26	88.00	88.10	88.20	
Monday	Oct. 29	88.50	88.60	88.70	
Tuesday	Oct. 30	88.61	88.75	88.90	
Wednesday	Oct. 31	88.67	88.79	88.93	
Thursday	Nov. 1	89.10	89.21	89.32	
Friday	Nov. 2	88.95	89.05	89.17	
Monday	Nov. 5	89.07	89.18	89.28	
Tuesday	Nov. 6	89.20	89.30	89.40	
Wednesday	Nov. 7	89.25	89.35	89.45	
Thursday	Nov. 8	89.17	89.29	89.41	
Friday	Nov. 9	89.21	89.32	89.43	
Monday	Nov. 12	89.40	89.50	89.63	
Tuesday	Nov. 13	89.60	89.71	89.85	
Wednesday	Nov. 14	89.58	89.70	89.81	
Thursday	Nov. 15	89.70	89.82	89.95	
Friday	Nov. 16	90.00	90.15	90.27	
Average		**89.24**	**89.36**	**89.46**	**(0.15)**

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Table 2

DAY	DATE	BUY 300 JAN	BUY 300 FEB	+/- DIFF	DAILY PRICE
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10
FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45
MONDAY	DEC. 31		97.90	(0.15)	97.75
Average		97.54	97.35		
CMA					**97.33**

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Why does this represent a *bona fide* hedge for the Producer?

First, it meets the statutory definition of a *bona fide* hedge set forth in the Act and the Proposed Rule, as follows:

A. Its sale of December futures contracts represents a substitute for transactions made or to be made at a later time in a physical marketing channel (i.e. the sale of its production as it is drawn from the ground);

B. It was economically appropriate to the reduction of the Producer's risk (i.e. the risk that the value of its crude oil in the ground would diminish prior to its physical market sale); and

C. It arose from the potential change in value of an asset (crude oil) that the Producer owned.

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

In addition, there are ample policy reasons to recognize the December, January and February positions as *bona fide* hedges:

A. Viewed in isolation, the December futures sales represent a hedge of unsold anticipated production. Under the proposal, this would be a *bona fide* hedge BUT FOR the producer's need to hold the December contracts through the spot period, which would disqualify the hedge under the "five-day rule." However, the Producer in this example is specifically using these futures contracts to sell its current production, so there is no policy rationale for applying the "five-day rule."

B. Looking at the January and February contracts, if the Producer had made its sales, represented by Column 3 of Table 1, in the physical market, the January and February contracts would clearly qualify as hedges of its fixed price sale. There is no policy rationale for permitting the January and February contracts as *bona fide* hedges where the December sales are in the physical market, but denying them where the choice is to make the sales through the physical delivery December futures contracts – a decision that is routinely made for a variety of reasons, including liquidity, credit, and flexibility. The physical delivery futures contract is just that – a physical delivery contract. The Proposed Rule seems to ignore that reality.

C. Allowing the Producer to hold its hedge through the spot period provides the added benefit of keeping commercial participation in the futures market as the market drives toward convergence of futures and cash prices.

What "Plus Factors" could be required by the Commission in connection with deeming these transactions as bona fide hedges?

A. A requirement that Producer regularly produces crude oil in an amount equivalent to the hedge; or

B. A prior filing by the Producer on Form 704 demonstrating that it regularly produces crude oil in an amount equivalent to a requested hedge exemption level.

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

The Refiner

The Refiner seeks to pay the spot price of crude oil on the day that it receives that oil. It has several choices. It could agree to buy from a wholesale supplier (or producer) at the daily posting price (plus or minus a differential). Another very common alternative is to purchase crude oil through the futures market. Here is how that would work, assuming expected receipt of 300,000 barrels per day in December:

- When December is the front month futures contract, the refiner would purchase crude oil futures on every trading day. In our example, December is the front month futures contract from October 19th through November 16th. The futures purchases are represented in Table 3, Column 3, below.

- The futures purchases are "fixed price" purchases and the refiner hedges those purchases each day, using the 2/3, 1/3 methodology common to CMA pricing. The hedges are represented in columns 4 and 5 of Table 3, below. These hedges establish a differential between December and January and February forward pricing. From an economic standpoint, that differential will adjust December forward pricing to spot pricing.

- When the December contract ceases to trade (November 16th), the refiner has secured crude oil through the futures market. Generally, refiner will enter into an exchange of futures for physicals ("EFP") transaction and exchange its long futures position for a fixed-price physical purchase at the December final settlement price ($90.00/bbl) under which it will actually receive barrels ratably during the month of December. Its February and March futures contracts continue to serve as a hedge for the fixed-price purchase of oil.

- As it ratably receives crude oil on each day during December, it ratably lifts the futures hedge -- first the January contracts and then the February contracts. See Table 4, below.

- Refiner will have paid $90.00 a barrel under its physical purchase contract. It will have gained $.76/bbl on its 63 lot long December futures position and lost $8.18/bbl on its 42 lot short January futures hedge and $7.89/bbl on its short February futures hedge. The net amount paid is $97.33/bbl., which represents the average spot price for crude oil during the month of December.

*The average of the differential of the price of three December contracts with two January contracts and one February on each trade date in October and November subtracted from the prices at which the long January and long February contracts are liquidated represents sales at the December calendar month average and ties out with the economics of purchasing product fixed price under the EFP and calculating the gains and losses under the futures positions.

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Table 3

Day	Date	Buy 300 Dec	Sell 200 Jan	Sell 100 Feb	Diff
Friday	Oct. 19	89.00	89.15	89.29	
Monday	Oct. 22	89.10	89.30	89.35	
Tuesday	Oct. 23	90.05	90.12	90.14	
Wednesday	Oct. 24	90.04	90.12	90.14	
Thursday	Oct. 25	89.93	90.00	90.10	
Friday	Oct. 26	88.00	88.10	88.20	
Monday	Oct. 29	88.50	88.60	88.70	
Tuesday	Oct. 30	88.61	88.75	88.90	
Wednesday	Oct. 31	88.67	88.79	88.93	
Thursday	Nov. 1	89.10	89.21	89.32	
Friday	Nov. 2	88.95	89.05	89.17	
Monday	Nov. 5	89.07	89.18	89.28	
Tuesday	Nov. 6	89.20	89.30	89.40	
Wednesday	Nov. 7	89.25	89.35	89.45	
Thursday	Nov. 8	89.17	89.29	89.41	
Friday	Nov. 9	89.21	89.32	89.43	
Monday	Nov. 12	89.40	89.50	89.63	
Tuesday	Nov. 13	89.60	89.71	89.85	
Wednesday	Nov. 14	89.58	89.70	89.81	
Thursday	Nov. 15	89.70	89.82	89.95	
Friday	Nov. 16	90.00	90.15	90.27	
Average		**89.24**	**89.36**	**89.46**	**0.15**

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Table 4

DAY	DATE	SELL 3 JAN	SELL 3FEB	+/- DIFF	DAILY PRICE
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10
FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45
MONDAY	DEC. 31		97.90	(0.15)	97.75
Average		97.54	97.35		
CMA					**97.33**

Calendar Month Average ("CMA") Pricing, Cont'd.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Why does this represent a *bona fide* hedge for the Refiner?

First, it meets the statutory definition of a *bona fide* hedge as set forth in the Act and the Proposed Rule, as follows:

A. Its purchase of December futures contracts represents a substitute for transactions made or to be made at a later time in a physical marketing channel (*i.e.*, the purchase of crude oil);

B. It was economically appropriate to the reduction of the Refiner's risk (*i.e.*, the risk that the value of crude oil will increase prior to its physical market purchase); and

C. It arose from the potential change in value of an asset that the Refiner anticipates owning or a liability it anticipates incurring.

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

In addition, there are other ample policy reasons to recognize the December, January and February positions as *bona fide* hedges:

A. Viewed in isolation, the December futures purchases could represent a hedge of unfilled anticipated requirements. Under the proposal, this would be a bona fide hedge but would qualify under the "five-day rule" ONLY TO THE EXTENT that Refiner's purchase did not exceed its requirements for that month and the next succeeding month. There is no reason to exclude the Refiner's purchase of additional inventory it deems appropriate to hold from the exemption for bona fide hedging. There is no different market consequence and the benefit to the consumer of the hedge is more stable pricing.

B. Looking at the January and February contracts, if the Refiner had made its purchases, represented by Column 3 of Table 3, in the physical market, the January and February contracts would clearly qualify as hedges of its fixed price purchase. There is no policy rationale for permitting the January and February contracts as bona fide hedges where the December purchases are in the physical market, but denying them where the choice is to make the purchases through the physical delivery December futures contracts – a decision that is routinely made for a variety of reasons, including liquidity, credit, and flexibility. The physical delivery futures contract is just that – a physical delivery contract. The Proposed Rule seems to ignore that reality.

C. Allowing the Refiner to hold its hedge through the spot period provides the added benefit of keeping commercial participation in the futures market as the market drives toward convergence of futures and cash prices.

What "Plus Factors" could be required by the Commission in connection with deeming these transactions as *bona fide* hedges?

A. A requirement that Refiner regularly purchases crude oil in an amount equivalent to the hedge; or

B. A prior filing by the Refiner on Form 704 demonstrating that it regularly purchases crude oil in an amount equivalent to a requested hedge exemption level.

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

The Wholesale Supplier

The Wholesale Supplier may commit to buy from the Producer on a CMA basis. At the same time, it may commit to sell to the Refiner on a CMA basis. If it does, it has a matched book and has no need to use the futures market to hedge.

However, to the extent it has either a commitment to buy and none to sell, or a commitment to sell and none to buy, it will use the futures market to match its exposure and hedge its risk. If it had agreed to purchase from Producer on a CMA basis, it will engage in the transactions in Tables 1 and 2; if it had agreed to sell to Refiner on a CMA basis, it will engage in the transactions in Tables 3 and 4. In essence, in those cases it "stands in the shoes" of the Producer or Refiner.

In addition, the Wholesale Supplier has interest in hedging its own economics. Assume that Wholesale Supplier buys from Producer at CMA minus a differential. The differential compensates it for, among other things, the cost of transportation from the production area to a common selling location (i.e. Cushing), the cost of capital in the timing differential between purchase and sell, the cost of blending to meet common stream specifications and its expertise. Wholesale Supplier engages in the futures sales and purchases in Tables 1 and 2 to eliminate its risk that it will not be able to replicate in the physical market the CMA portion of its pricing formula. By locking in the CMA sale in the futures market against its prior purchase in the physical market, it can lock in the full differential that it has negotiated.

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Why does this represent a *bona fide* hedge for the Wholesale Supplier?

First, as it "stands in the shoes of the Producer or Refiner, it meets the statutory definition of a *bona fide* hedge as set forth in the Act and the Proposed Rule, as follows:

A. Its purchase (sale) of December futures contracts represents a substitute for transactions made or to be made at a later time in a physical marketing channel (i.e. the purchase (sale) of crude oil);

B. It was economically appropriate to the reduction of the Wholesale Supplier's risk (i.e. the risk that the value of crude oil will increase (decrease) prior to its physical market purchase(sale)); and

C. It arose from the potential change in value of an asset that the Wholesale Supplier anticipates owning or a liability it anticipates incurring.

CALENDAR MONTH AVERAGE ("CMA") PRICING, CONT'D.

(Example 5, Pg. 29-37, CEWG February 10, 2014 Comment Letter)

Second, when the Wholesale Supplier transacts at a floating price (index) in the physical market plus or minus a differential, it is an appropriate risk reducing activity to replicate and offset the floating price component in the futures market and thereby lock in the differential that it had negotiated. As above, the package of futures is a substitute for a transaction to be made at a later time in the physical marketing channel and reduces the risks that arise from a potential change in value of the Wholesaler's obligation.

Finally, the "other policy reasons" that support the Producer and Refiner hedges described above also support treating the transaction of the Wholesale Supplier that "stands in their shoes" as a *bona fide* hedge. Producers don't always sell directly to Refiners and Refiners don't always purchase from Producers. Wholesale Suppliers (merchants) play the critical role of connecting the ends of the supply chain. Congress expressly provided *bona fide* hedging status to merchandising transactions equivalent to that provided for producers, manufacturers and processors precisely in recognition of this reality.

What "Plus Factors" could be required by the Commission in connection with deeming these transactions as *bona fide* hedges?

A. A requirement that Wholesale Supplier regularly purchases and sells crude oil in an amount equivalent to the hedge; or

B. A prior filing by the Wholesale Supplier on Form 704 demonstrating that it regularly purchases and sells crude oil in an amount equivalent to a requested hedge exemption level.