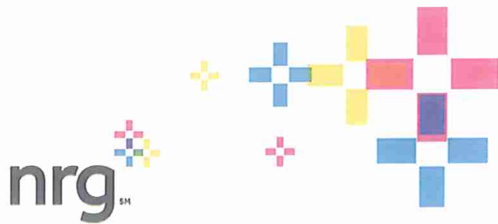

NRG Energy, Inc.
211 Carnegie Center
Princeton, NJ 08540

January 20, 2015

VIA EMAIL AND OVERNIGHT COURIER

Hon. Sharon Y. Bowen
Commissioner
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: CFTC's Proposed Rule on Cross-Commodity Hedging

Madam Commissioner:

We are writing to thank you for meeting with us last month and discussing, among other things, the provisions of the Commission's proposed rules on position limits[1] (the "Position Limit Rules") that govern cross-commodity hedging. NRG Energy, Inc. ("NRG") would also like to thank you for the opportunity to continue our dialog on this important issue and would kindly ask that this letter be included in the comment file for the Position Limit Rules.

NRG's view is that the above-referenced provisions on cross-commodity hedging (the "Proposed Cross-Commodity Hedging Rule") are restrictive and would effectively eliminate an important source of liquidity that a range of end-users currently rely on to manage price risk. We also believe that (i) the Proposed Cross-Commodity Hedging Rule's focus on the spot prices of commodities, (ii) its requirement that cross-commodity hedges meet a mathematical correlation formula and (iii) its reliance on a single accounting practice for its foundation do not reflect the commercial realities of trading in the commodity and derivatives markets (the "Markets"). Our conclusion is that the Commission's current "substantial relationship" test, which the Commission has successfully applied for decades to determine whether a cross-commodity hedge qualifies as a bona fide hedge[2], is a reasonable and sufficient test and that it should not be amended. In the event that the Commission is determined to amend the substantial relationship test, we respectfully urge the Commission to strongly consider implementing a cross-commodity hedging rule that requires a mathematical correlation of 0.50 or less and provides for an efficient means of evaluating for approval any cross-commodity hedge that has a correlation that is less than the adopted mathematical threshold. The reasons for our view are outlined below.

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

2 *See Revision of Federal Speculative Position Limits,* 52 Fed. Reg. 39814, 38922 (Oct. 20, 1987)

Background

As we discussed, NRG is a leading competitive power company with a significant presence in major U.S. electric power markets and is a major retail electricity provider through Reliant Energy, Green Mountain Energy Company and other affiliates. We supply electricity to 2.8 million retail customers in 23 states. The business activities of NRG include the ownership, development and operation of power generation facilities, the trading of energy, commodities and derivatives, and the supply of cleaner energy and carbon offset products to retail electricity customers. NRG uses physical commodities like natural gas to fuel its power plants and uses various commodity-based derivative products to manage the commercial risks associated with owning those commodities and the power it generates.

NRG supports the efforts that the Commission, the Federal Reserve, the Congress, the Federal Energy Regulatory Commission and others have made in the past several years to promote greater stability, reliability and transparency in the Markets. NRG, like many competitive power producers, utilities and other end-users, also believes in and depends on liquid, competitive and efficient Markets where many actors participate and multiple hedging options are available to end-users. This scenario helps end-users to manage price risk and has a positive effect on the prices that households and businesses ultimately pay for electric power and other commodities that they use on a day-to-day basis.

As an active participant in the Markets, we are concerned that, if financial regulation has the effect of continuously draining liquidity from the Markets, such reductions will likely result in higher electricity and other commodity prices for both commercial and individual consumers. This is a critical issue given that almost all of the world's largest commercial banks, which traditionally accounted for a substantial portion of Market liquidity, have recently either significantly downsized or eliminated their commodities and derivatives trading operations.[3]

In the face of the decline in bank participation in the Markets, taking the additional step of restricting end-users' ability to engage in cross-commodity hedging by adopting the rigid 0.80 mathematical correlation formula contained in the Proposed Cross-Commodity Hedging Rule will leave end-users with few, if any, practical means for managing price risk. This is, of course, problematic for end-users and their individual and commercial customers.

Summaries of the Applicable Provisions of Existing and Proposed Cross-Commodity Hedging Rules

For decades, the Commission and commodity exchanges have permitted Market participants to engage in cross-commodity hedging where the "fluctuations in value of the position in any agreement, contract or transaction are *substantially related* to the fluctuations in value of the actual or anticipated cash positions."[4]

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[3] *Credit Suisse Joins Pull-Back from Trading*, Platts Megawatt Daily, Volume 19, Issue 140, page 1 (July 23, 2014).

[4] 17 C.F.R. § 1.3(z)(2)(v).

Through the Proposed Cross-Commodity Hedging Rule, the Commission is now proposing a non-exclusive safe harbor for cross-commodity hedges that includes a new quantitative factor.[5] The new safe harbor would replace the above-referenced substantial relationship test. The Proposed Cross-Commodity Hedging Rule would include a qualitative factor, which would require the target commodity of a cross-commodity hedge to have a reasonable commercial relationship to the commodity underlying the commodity derivative contract. In addition, pursuant to the new quantitative factor, the target commodity would also have to be offset by a position in a commodity derivative contract is mathematically correlated to the target commodity. The Commission has stated that it will presume an appropriate quantitative relationship exists when the correlation between the differences or returns in daily spot price series for the target commodity and the prices series for the commodity underlying the derivative of the contract (or the price series for the derivative contract used to offset risk), is at least 0.80 for a time period of at least 36 months.

The Commission will presume that positions in a commodity derivative contract that do not meet the safe harbor are not bona fide cross-commodity hedging position. Any person attempting to overcome this presumption must undertake an administrative process and receive a favorable determination from the Commission based on a presentation of the applicable facts and circumstances.

Importantly, the Proposed Cross-Commodity Hedging Rule deviates from the Commission's and commodity exchanges' longstanding practice of applying the "substantially related" test to permit Market participants to execute reasonable hedges. The "substantially related" test has permitted Market participants to exercise discretion in determining what constitutes a reasonable hedge of risk based on a number of factors that are not necessarily related to price correlation (e.g., liquidity in the hedging contract and other factors). The new quantitative test would limit Market participants' discretion in making this determination and, for example, where there is a less than 0.80 correlated commodity, may foreclose legitimate hedging opportunities.

<u>The Proposed Cross-Commodity Hedging Rule Should Not Focus on Spot Prices</u>

As stated above, the Proposed Cross-Commodity Hedging Rule focuses only on, and requires mathematical correlations based only on, the spot prices of commodities. This approach raises questions given the way spot prices behave and the way that hedgers manage long-term risk. First, since the spot prices of commodities are volatile, the prices of two commodities can, and often do, diverge in the short run. However, the over the long-term, the prices of two commodities, like electric power and natural gas for example, converge across the forward curve. Second, as a result, many hedgers manage their forward price risk by taking this long-term price convergence, as well as other market factors, into account. Therefore, a rule that is based only on a view of short-term spot price correlations would disqualify a cross-commodity hedge that reflects forward curve price convergence. Such a rule would be counter-intuitive and not reflect

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[5] As discussed below, although the quantitative test is non-exclusive, if a market participant does not satisfy the quantitative test, the presumption is that the relevant cross-commodity position is not a 'bona fide" hedging position.

Market and trading realities.

Since Market Liquidity Would Otherwise Suffer, the Commission Should Strongly Consider Using a Reasoned Approach to Cross-Commodity Hedging Instead of a Strict Mathematical Correlation Requirement

We believe that the quantitative factor of the Proposed Cross-Commodity Hedging Rule should be withdrawn because it uses a rigid test to determine whether a particular cross-commodity hedge will qualify as a bona fide hedge instead of using reasoned analysis. The arbitrary nature of the test is illustrated by the fact that many standard, long-standing cross-commodity hedging strategies that neither the Commission nor the commodity exchanges had openly challenged as being unsound would suddenly be disqualified because of a numerical benchmark. Such a test ignores the use of reasoned analysis of Markets, particular commodities and commercial and consumer needs. As a result, the availability of established hedging alternatives for end-users would suffer without prudent consideration of pertinent factors.

Here are two examples:

- As a part of a long-recognized practice, many competitive power generators and utilities have used natural gas futures contracts to hedge their exposure to electric power markets.[6] This is because there is a Market accepted connection between the price of electricity and the price of natural gas. Before the publication of the Proposed Cross-Commodity Hedging Rule, this practice was accepted by the Commission and commodity exchanges. However, due to the mathematical correlation required under the Proposed Cross-Commodity Hedging Rule, fluctuations in the price of electricity would not be considered to be substantially related to fluctuations in the price of natural gas. Therefore, this longstanding practice would be prohibited. This would be very costly to competitive power producers and utilities that serve the power needs of virtually every industrial and individual consumer.

- It has long been common for oil market participants to hedge price exposure to various grades of fuel oil by using the NYMEX Light Sweet Crude Oil futures contract. However, due to the mathematical correlation required under the Proposed Cross-Commodity Hedging Rule, traders also could be prohibited from using this hedging strategy.[7]

Further evidence of the fact that using a rigid, mathematical test instead of reasoned analysis will produce results that are contrary to commercial reality is that the Proposed Cross-Commodity Hedging Rule would not permit cross-commodity hedging involving the Brent and NYMEX crude oil and related futures contracts. *This result is significant since these contracts*

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6 See Edison Electric Institute/Electric Power Supply Association letter to Ms. Jurgens, CFTC Secretary, from Mr. McMahon, Vice President, Edison Electric Institute ("EEI"), Lopa Parikh, Director, EEI, and Ms. Mitchell, Director, Electric Power Supply Association, dated February 7, 2014.

7 See Futures Industry Association letter to Ms. Jurgens, CFTC Secretary, from Mr. Lukken, President and CEO, Futures Industry Association, dated February 7, 2014.

represent the same commodity of crude oil, but the correlation may not be high enough to meet the mathematical requirement.[8] Therefore, the use of a mathematical test has only limited use and cannot be used as a substitute for analysis of Market realities.

The Proposed Cross-Commodity Hedging Rule Does Not Fully Reflect Commonly Used Hedge Accounting Practices

The Proposed Cross-Commodity Hedging Rule and its 0.80 correlation requirement are based on an accounting practice that is not universally employed by hedgers. In fact, many companies instead engage in the practice of entering into "economic hedges," which are founded on a principle that is comparable to the Commission's existing substantial relationship test and the Proposed Cross-Commodity Hedging Rule's qualitative factor: Economic hedges emphasize the demonstration of a reasonable commercial relationship between a hedged commodity and the hedging instrument chosen to manage risk. As such, economic hedges emphasize reasoned analysis over a bright-line standard. The Commission has not offered analysis explaining why the commonly accepted accounting industry practice of entering into economic hedges should be overlooked in favor of any other accounting practice, even though the practice of entering into economic hedges is aligned with the Commission's longstanding substantial relationship test.

Further, the Commission has not offered analysis on the costs and burdens to companies that engage in economic hedging of transitioning to a required 0.80 correlation for cross-commodity hedging.

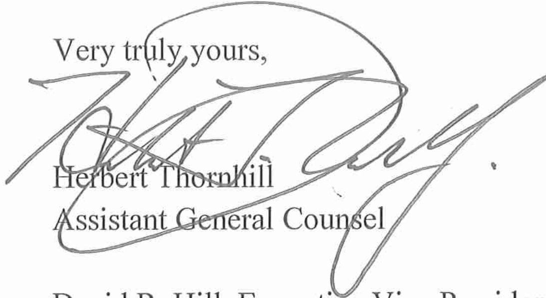
Conclusion

Accordingly, in reviewing the Proposed Cross-Commodity Hedging Rule, the overall proposed position limit rule and other rules affecting end-users, NRG would respectfully ask the you and the other Commissioners to carefully examine all aspects of the impact that further regulation may have on the Markets, consumers and liquidity and the potential costs they face.

[8] We note that NRG is not the only commenter to raise this concern with respect to market-standard cross-commodity hedges. See ISDA/SIFMA letter to Ms. Jurgens, CFTC Secretary, from Messrs. Pickel, CEO of ISDA and Bentsen, President and CEO of SIFMA, dated February 10, 2014 (noting that NYMEX crude oil contracts could not be hedged with Brent crude oil contracts); see also FIA Letter to Ms. Jurgens, CFTC Secretary, from Mr. Lukken, FIA President and CEO, dated February 4, 2014 (noting that fuel oil and NYMEX crude oil cross-commodity hedging strategies may not satisfy the 0.80 test).

NRG would appreciate the opportunity to continue to offer its perspectives on the Markets and additional information to you and your colleagues as the Commission proceeds to shape policy in connection with the Dodd-Frank Act. You can contact me by email at Herbert.Thornhill@NRG.com or at (609) 423-3440.

Very truly yours,



Herbert Thornhill
Assistant General Counsel

cc: David R. Hill, Executive Vice President and General Counsel
Christopher S. Moser, Chairman, President and CEO, NRG Power Marketing LLC