July 13, 2016

<u>Via Electronic Submission</u>

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

RE: Supplemental Notice of Proposed Rulemaking, Position Limits for Derivatives: Certain Exemptions and Guidance
RIN 3038-AD99

Dear Mr. Kirkpatrick:

I. INTRODUCTION

The Edison Electric Institute ("EEI") and the Electric Power Supply Association ("EPSA") (hereafter "Joint Associations") appreciate the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") Supplemental Notice of Proposed Rulemaking concerning Position Limits for Derivatives ("Supplemental Proposal").[1] The Joint Associations have been active participants in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[2], including position limits rules.[3]

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[1] *Position Limits for Derivatives: Certain Exemptions and Guidance*, Supplemental Notice of Proposed Rulemaking, 81 Fed. Reg. 38458 (June 13, 2016) ("Supplemental Proposal").

[2] Pub. L. No. 111-203 (2010)

[3] *See, e.g.*, , Letter from EEI and EPSA to David Stawick, Sec'y, CFTC (Mar. 28, 2011) (on file with the CFTC); Letter from EEI to David Stawick, Sec'y, CFTC (Jan. 17, 2012) (on file with the CFTC); Letter from EEI, AGA, and EPSA to David Stawick, Sec'y, CFTC (Mar. 1, 2012) (on file with the CFTC); Letter from EEI and AGA to David Stawick, Sec'y, CFTC (Mar. 1, 2012) (on file with the CFTC); Letter from EEI to David Stawick, Sec'y, CFTC (June 29, 2012) (on file with the CFTC). Letter from EEI and EPSA to Melissa Jurgens, Sec'y, CFTC (Feb. 7, 2014) (on file with the CFTC); Letter from EEI to Melissa Jurgens, Sec'y, CFTC (Aug. 4, 2014) (on file with the CFTC); Letter from EEI to Christopher Kirkpatrick, Sec'y, CFTC (March 30, 2015) (on file with the CFTC); Letter from EPSA to Christopher Kirkpatrick, Sec'y, CFTC (Nov. 13, 2015) (on file with CFTC).

EEI is the association of U.S. shareholder-owned electric companies. EEI's members comprise approximately 70 percent of the U.S. electric power industry, provide electricity for 220 million Americans, operate in all 50 states and the District of Columbia, and directly employ more than 500,000 workers. With more than $100 billion in annual capital expenditures, the electric power industry is responsible for one million jobs related to the delivery of power.

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

Joint Associations' members are not financial entities. Rather, they are physical commodity market participants that rely on futures and swaps to hedge and mitigate their commercial risk. Regulations that make effective risk management options more costly for end-users of derivatives, such as Joint Associations' members, will likely result in higher and more volatile energy prices for residential, commercial, and industrial electricity customers. As such, Joint Association members have a direct and significant interest in the Commission's establishment of speculative position limits including assuring that there is a definition of *bona fide* hedging that is not too narrow or inflexible. The Joint Associations appreciate the work of the Commission Staff that has resulted in a Supplemental Proposal as well as the Commission's willingness to address end user issues. However, as discussed herein, the Supplemental Proposal substantially increases the regulatory burden for Joint Associations' members and exchanges without providing a workable process.

II. COMMENT SUMMARY

In the Supplemental Proposal, the Commission proposes to: (1) subject to Commission review, develop a new process for an exchange to recognize certain positions in commodity derivative contracts as "non-enumerated" hedges as well as exempt spread positions from position limits; (2) amend the definition of bona fide hedging position to remove the previously proposed incidental test and the orderly trading requirement; and (3) delay the requirement for exchanges to establish position limits for swaps where the exchange lacks access to sufficient swap information.

The Joint Associations support the proposed changes to the definition of *bona fide* hedging position and agree with the Commission's recognition that there is more work to be done towards a final rule that has adequate, practical definitions of *bona fide* hedges which can be utilized by commercial entities that deliver energy commodities to U.S. consumers and that rely on hedging to manage risk. The Joint Associations emphasize that the 2013 Proposed Rule[4] did not represent all legitimate *bona fide* hedging activity. The list must be expanded in order for the final rule to be a fair, workable standard for commercial power providers.

The Supplemental Proposal is a positive development in that it provides a mechanism for those hedging commercial risk to see that their legitimate hedging needs can be met even if they

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

do not fit within the enumerated hedges listed in the 2013 Proposed Rule. However, the Supplemental Proposal does add more process and complexity to a proposed process that is already overly burdensome and confusing. The proposed non-enumerated *bona fide* hedge ("NEBFH") review process brings new complexities to the average commercial market participant that hedges now, or may hedge in the future, in a commercial environment that could look very different than the one hedgers face today. These complexities can be mitigated, however, by expanding the scope of delegation to exchanges for companies that rely on futures for hedging; and by a broad expansion of enumerated hedging to cover the many needs of the average commercial power provider – including its regular, seasonal anticipatory hedging activity and its cross-commodity hedging activity. Further, the Commission can mitigate these concerns by ensuring an appropriate balance between the responsibilities and delegated authority of the exchanges and the authority of the Commission to review the exchanges' oversight activities. This balance is crucial to the orderly administration of the proposed NEBFH review process: neither the exchanges nor their users should be unnecessarily burdened and the Commission's resources and involvement should be judiciously focused on circumstances that clearly require its oversight.

The Supplemental Proposal is problematic in that it contemplates a delegation to exchanges based on their current successful administration of hedge exemptions and yet proposes to alter those practices by mandating new data submission requirements, as well as potentially changing the scope of current exchange recognition of *bona fide* hedges. The Joint Associations request that the Commission revise the Supplemental Proposal such that the exchanges would be able to use their current hedge exemption processes to administer and modify a specific user's contract level authorizations without piecemeal exemption approvals from the Commission. The Joint Associations believe that this change is necessary to avoid abrupt, economically damaging impacts on a user of the exchange or on the broader contract market, and that the exchanges' well-established history ensures that they will continue to serve the essential purpose of administering hedging exemptions under a federal position limits rule.

The Joint Associations also request that the Commission adopt a definition of *bona fide* hedging that is easily understandable and commercially practical, building on the existing foundation used by the exchanges today. The Commission should integrate the exchanges' expertise and well-established flexibility toward a process that assures *bona fide* hedging with a limited burden on end users. To address these concerns and develop a rule that is more workable for commercial hedgers, while still providing meaningful accountability for the Commission, the Joint Associations propose that the Commission:

- Delegate the authority to exchanges to establish federal position limits for companies that rely upon futures for hedging, such that the exchanges can establish federal position limits which mirror the exchanges' position limits as modified by exchange-granted hedge exemptions.

- Reduce the regulatory burden on end users by avoiding duplicative recordkeeping and reporting obligations, provide additional clarity on required forms by creating a comprehensive user's manual for the forms; provide a phase-in period of at least 18 months before end users are required to comply; and work with stakeholders and exchanges to streamline the recordkeeping and reporting processes.

- Develop a mechanism that allows exchanges to announce generic recognition of a non-enumerated *bona fide* hedge for market participants that satisfies certain facts and circumstances.

- Remove the requirement for exchanges to demand and collect three years of cash market information in order to address every requesting entity's application for a non-enumerated hedge.

- Allow additional time to unwind a hedge if an exemption is denied.

- Grant additional discretion to the exchanges.

- Continue to permit the institution of a retroactive non-enumerated bona fide hedge.

- Provide regulatory certainty by including anticipatory and cross-commodity hedging as enumerated *bona fide* hedges.

III. COMMENTS

The Joint Associations reiterate that the proposed definition of *bona fide* hedging is too narrow and inflexible. The Joint Associations and the broader energy end user community have described this issue in detail in comments on the 2013 Proposed Rule and at meetings of the CFTC Energy and Environmental Markets Advisory Committee ("EEMAC") on February 26 and July 29, 2015. At the July 29 meeting there was substantial discussion of the process used by the Commodity Markets Exchange ("CME") and the InterContinental Exchange ("ICE") to evaluate and grant hedging exemptions and how this process could be utilized to grant exemptions for non-enumerated hedges as part of a new federal regime.[5] There was broad support at the EEMAC meeting for leveraging the expertise of the exchanges to create a hedge exemption process based on the hedge exemption process that had been successfully used by the exchanges to date. Unfortunately, the process outlined in the Supplemental Proposal falls short of this goal by increasing the regulatory uncertainty and regulatory burdens for exchanges and end users.

Upon reviewing the Supplemental Proposal, the Joint Associations continue to be very concerned that, unless the federal rule provides adequate, workable definitions for a *bona fide* hedge, any additional processes for the recognition of legitimate hedging activity, including those proposed in the Supplemental Proposal, will not make this rulemaking easier, more logical,

[5] The industry at large has provided an abundance of information regarding the critical need to modify and expand the enumerated *bona fide* hedges to cover ordinary, day-to-day hedging activities that support the commercial risk management activities of U.S. power providers. These comments are documented extensively in issuances from the EEMAC, including the meeting transcripts. The Joint Associations hereby incorporate by reference the entire transcripts from the February 26, 2015 and July 29, 2015 EEMAC meetings into the record for this proceeding. *See Meeting of the Energy and Environmental Markets Advisory Committee*, July 29, 2015, *available at* http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/emactranscript072915.pdf; *Meeting of the Energy and Environmental Markets Advisory Committee*, February 26, 2015, *available at* http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf.

or cost-effective to implement. Given this critical concern, Joint Associations provide several comments below as to areas where the specific Supplemental Proposal should be modified.

A. Exchanges Should Be Delegated the Ability to Set Federal Position Limits For Companies That Rely on Futures for Hedging

Since the futurization of swaps in 2012, many Joint Associations' members have transitioned to a virtually exclusive reliance on futures for hedging. To the degree such hedging requires a quantity of futures in excess of an exchange position limit; such companies can seek a hedge exemption from the exchange by demonstrating their commercial risk that requires hedging with exchange contracts. The Supplemental Proposal itself does not disturb the exchange position limit process. Instead, it adds a further set of position limits and related processes for obtaining hedge exemptions. Thus, for companies that have transitioned to a reliance on futures (subject to exchange position limits), their hedging activity will be simultaneously subject to two very differently structured regulatory regimes to institute position limits for the same futures contracts.

In the Supplemental Proposal, the Commission recognized the "experience and expertise of the DCMs in administering their own processes for recognition of *bona fide* hedging positions."[6] Based upon the success of the exchange processes, the Commission proposes to delegate to exchanges the authority to recognize NEBFHs for use in the proposed federal enumerated hedge position limits regime.[7] As stated above, the proposal envisions two overlapping position limits but now provides for a mechanism to add NEBFHs (which have been presumably recognized by the exchange in granting a hedge exemption) in the federal position limits process. The Supplemental Proposal also sets forth data and filing requirements for commercial firms to seek and maintain NEBFHs.[8] In addition, it sets forth data, recordkeeping, and process requirements for exchanges.[9]

Since the Commission has recognized the "experience and expertise of the DCMs in administering their own processes for recognition of bona fide hedging positions,"[10] the Joint Associations recommend that rather than implement two overlapping position limit regimes for the same purpose and for the same contracts, the Commission delegate to the exchanges the ability to set federal limits for such hedgers.

The Joint Associations proposal would work as follows:

- Commercial firms that: (1) use futures for the vast majority of their risk management and (2) have received a hedge exemption from an exchange that in effect sets a new position limit,
    - May utilize the exchange-granted hedge exemption limit as the hedger's effective federal position limit.

[6] Supplemental Proposal at 38466.

[7] *Id*. at 38469, proposed § 150.9.

[8] *Id*. at 38473, proposed § 150.9(a)(6).

[9] *Id*. at 38474, proposed § 150.9(b).

[10] *Id.* at 38466.

    - The ability of a commercial firm to utilize the exchange-granted hedge exemption limit as its federal position limit is dependent upon a futures position that equals or exceeds 80% of its futures equivalent hedging contracts.
        - If the commercial firm's futures position falls below 80% of its futures equivalent contracts, it must notify the Commission within five (5) business days and become subject to the otherwise applicable federal position limits.
    - The commercial firm must notify the Commission within five (5) business days of when its position exceeded the otherwise applicable federal position limit.
  - The exchange granting the hedge exemption will notify the Commission of its action simultaneously with its notification to the requesting commercial firm.
    - The Commission may adjust the federal position limit if it disagrees with the exchange; an ultimate determination as to whether the exchange's decision is approved by the Commission should occur through a final ruling of the Commission.

Under the above approach, a commercial firm that uses futures for hedging will be subject to a position limit (thereby achieving the regulatory goal of the Supplemental Proposal), but will not be subject to the administrative burden of complying with two overlapping position limit regimes.

For example,

- Company A <u>exclusively</u> uses the NYMEX Henry Hub Natural Gas contract ("NG") to hedge its commercial natural gas exposure. The exchange position limit is 1,000 contracts. The federal position limit is also 1,000 contracts, each representing 25% of deliverable supply.
- Company A's overall bona fide hedging requirements are 1,200 contracts, and it requests an exemption from the DCM for an additional 200 contracts to meet these requirements.[11]
- DCM grants Company A's hedge exemption request resulting in a revised exchange limit of 1,200 contracts.
- Company A's federal position limit is also revised to 1,200 contracts.
- The result:
  - Company A is able to hedge its *bona fide* risk using the tool of the NYMEX Henry Hub contract;

[11] All such hedging corresponds to the enumerated hedges proposed in the 2013 Proposed Rule.

- Company A is subject to position limits; and
- Company A does not need to implement duplicative processes to satisfy overlapping regimes that are addressing the identical issue.

The Joint Associations submit that the Company A example is common. Many commercial firms rely on futures for hedging. Those companies which also use swaps[12] do so for a very limited amount of hedging.[13] As the Commission has recognized that its access to part 20 swap data gives it "an indication of a potential position limit violation,"[14] a limited amount of swap activity should not create a regulatory gap. If the Commission is comfortable delegating NEBFHs to exchanges, it should be equally comfortable delegating the establishment of federal position limits that mirror exchange-granted hedge exemptions predicated on fundamentally the same analysis as the NEBFH – review of *bona fide* hedging. For companies that rely on futures for their hedging requirements, there is no apparent reason to have two overlapping processes for the same goal.

B. The Supplemental Proposal is Unduly Burdensome for End Users and Should be Revised

As noted above, for many energy companies, the proposed federal position limits regime will represent duplicate regulatory oversight of effectively the same activities. If the Commission does not delegate to the exchanges the ability to establish federal position limits, it must, at a minimum, reduce the burden of its position limits regulation. The companies who are members of the Joint Associations are not speculators. They are physical companies hedging risk arising from producing and delivering electricity.

1. The Reporting and Recordkeeping Requirements for End Users are Unduly Burdensome and Should be Reduced

In the Supplemental Proposal, the Commission indicates that it interprets Commodity Exchange Act ("CEA") section 4a(c)(1) to authorize the Commission to permit exchanges to recognize positions as *bona fide* hedges for purposes of federal limits subject to Commission review and remediation.[15] In order to do so, exchanges would be required to meet the requirements in proposed rules 150.9, 150.10, and 150.11, and market participants would be required to provide specific information to the exchanges, to reapply on an annual basis, and to receive approval in advance of the date that the positions would exceed the limits. As indicated in the chart below, these requirements impose significant regulatory burden for end users without a clear showing of need.

[12] The Commission recent announced that it would not subject trade options to position limits. *See Trade Options*, 81 Fed. Reg. at 14971 (March 21, 2016). The elimination of trade options form the scope of position limit affected swaps further reduces the proportion of swaps that commercial hedgers use vs futures.

[13] The Joint Associations has proposed an 80% futures threshold as a suggestion. The Commission may elect to use a different ratio.

[14] Supplemental Proposal at 38461 (internal citation omitted).

[15] *Id*. at 38464.

150.9	150.10	150.11
Proposed § 150.9(a)(6), requires the applicant to file reports with the exchange recognizing the position, and additionally requires under proposed § 150.9(c)(2) that the exchange would provide such information to the Commission on a monthly basis."	Proposed § 150.10(a), requires a DCM or SEF to establish, pursuant to part 40 of this chapter, an application process for exempting positions for certain spread positions consistent with the requirements of this section.	Under proposed § 150.11(a)(5), applicants would be required to file a report with the Commission pursuant to § 150.7 as proposed in the December 2013 position limits proposal and a copy with the exchange.
Applicants must describe the position and the offsetting cash positions.	Applicants must describe the spread position	Applicants applying for exemptions from position limits for unfilled anticipated requirements will file Form 704 with the Commission in advance of the date the person expects to exceed the position limits established under this part.
Provide detailed information to demonstrate why the position satisfies the requirements and general definition of a bona fide hedging position.	Provide detailed information to demonstrate why the spread position should be exempted from position limits	Provide detailed information on the anticipated activity indicating if the cash commodity is the same commodity that underlies a core referenced futures contract
Provide a statement concerning the maximum size of all gross positions in derivative contracts to be acquired during the year after the application submittal.	Provide a statement concerning the maximum size of all gross positions in derivative contracts to be acquired during the year after the application submittal.	Provide detailed information regarding annual production, requirements, royalty receipts or service contract payments and receipts, of the commodity for three complete fiscal years preceding the current fiscal year
Provide detailed information regarding the applicant's activity in the cash markets for the commodity underlying the position during the past three years.	Applicants must reapply at least on an annual basis *(no different than what is required by the exchanges today)*	Form 704 must be filled with the Commission at least ten days in advance of the date the positions exceed the position limits
	DCM/SEF shall publish on its Web site, on at least a quarterly basis, a summary describing the type of spread position and why it was exempted.	Monthly reporting of remaining anticipated hedge exemptions will be reported on Form 204
		Applicants must provide an annual update on the utilization of the anticipatory exemption on Form 704

First, Joint Association members use both enumerated and NEBFHs. Under the Supplemental proposal, the documentation required to seek an exemption under each of the proposed sections are not the same and may result in duplicative recordkeeping without a showing of the need for the differences.

Second, despite prior comments in response to the 2013 Proposed Rule and during the EEMAC meeting, that Form 704 required by §150.7 is commercially impracticable and unduly burdensome because it requires Joint Association members to analyze each transaction to see if it fits into an enumerated hedge category. With each piecemeal review, the regulation would also require a supporting memorandum and the development of new IT software to track transactions and monitor positions. Notwithstanding these concerns, the Commission has retained it for application to the exemptions that would be granted pursuant to proposed section 150.11, without further definition or explanation.

Third, the Supplemental Proposal requires that a market participant must make periodic filings with the exchange that granted a non-enumerated hedge detailing its activity associated with the specific non-enumerated hedge. Since the Supplemental Proposal also requires a market participant to be subject to the federal position limits/enumerated hedge regime (now including the new non-enumerated hedge) and to make the requisite filings with the Commission, this filing with the exchanges is duplicative. To address these concerns, Joint Associations would suggest that a separate filing with the exchange should not be required. If the Commission believes that the exchange would benefit from seeing the information underlying the filing with the Commission, then it could require that the exchange be copied.

Fourth, the Supplemental Proposal requires every commercial firm seeking a NEBFH exemption to file a unique application with a DCM containing specified information. To maintain the NEBFH, a new application would need to be filed annually. It is likely that there will be circumstances where multiple commercial firms face similar risks and require NEBFHs for the same purpose. While the Supplemental Proposal provides that the exchanges issue a report of the approved NEBFHs, it provides no vehicle for a generic approval of a NEBFH for a commercial firm meeting specified facts. Since, unlike a hedge exemption, the exchanges are not granting a firm specific quantity of *bona fide* hedging contracts but, rather, are validating the *bona fide* nature of a hedge transaction, there should be a mechanism for an exchange to announce generic recognition of NEBFHs for hedgers that satisfy certain facts and circumstances.

Fifth, the requirement to re-apply and receive approval in advance of the date that the positions would exceed the limits also causes concerns. This proposal eliminates the current exchange practice of allowing a retroactive increase in a hedge exemption due to unforeseen hedging needs. In light of the volatility in the commodity markets, the current flexibility is helpful for Joint Association members and should be retained.

Sixth, the Supplemental Proposal requires that those exceeding the federal limits file the proposed forms including Form 204. The proposal lacks meaningful guidance regarding the data which must be maintained in order to populate the forms. Joint Association members do not currently record data in a manner that will permit them to capture the data sets (effectively in real-time) needed to file the required forms and there are currently no software vendors offering systems to record data and file the forms. As such, it will take significant resources and time to be able to develop and implement systems to be compliant.

To address these concerns, rather than retain and impose additional costly and burdensome recordkeeping and reporting requirements, the Commission should work with the exchanges and stakeholders to streamline and clarify the process so that the exchanges are able to get the information that they need to grant the exemption without unduly burdening end users.

If the Commission continues to require the filing of the forms as proposed then the Commission should adjust the forms to make them less burdensome; create a comprehensive user's manual for the forms; and provide a phase-in period of at least 18 months before end users are required to comply.

2. A Requirement for Showing for Three Years of Cash Market Data to Justify a Non-Enumerated Hedge Will Place Commercial Firms at a Competitive Disadvantage and Discourage Participation in Exchange-Traded Products and Should Not Be Required.

Proposed § 150.9(a)(3)(iv) requires detailed information regarding the applicant's activity in the cash markets for the commodity underlying the position for which the application is submitted during the past three years.[16] This requirement to show three years of cash market data supporting a firm's positions to justify a non-enumerated hedge exemption is unduly burdensome and unnecessary. Both business circumstances and market conditions are dynamic and there is not a relationship between three years of data and todays' hedging needs.

As such, the focus should be on the commercial risks faced by the applicant – not on a generic backward-looking data set. If the exchange would benefit from seeing three years of data in evaluating a request, it can and will ask for it. There is no need for a Commission mandate. The Commission has noted the exchanges' successful administration of hedge exemptions; it should permit them to continue to use that expertise in granting non-enumerated hedge exemptions. Mandating potentially unnecessary data will only burden both the exchanges and applicants without any associated benefit.

3. The Proposal for One-Day Unwinding of Positions Following a Hedge Exemption Denial is Unworkable and Poses Broader Market-Wide Risks to the Exchanges' Other Customers.

The Supplemental Proposal only allows one business day to unwind a position if a hedge exemption is denied.[17] This is unreasonable for the many energy products with limited liquidity (in particular electricity). Joint Associations recommend the Commission work with the exchanges to develop a more workable timeframe that accounts for the market participant's need to work with an exchange to develop a commercially viable exit plan, and gives the exchange sufficient discretion to ensure that the exit plan protects the broader contract market from any potential commercial disruptions identified by the exchange as a risk associated with the market participant's exit.

Further impacting the reasonableness of the Commission process is that there is no appeal process for denial of a request for a NEBFH. It appears that the denial would be communicated along with reasoning for the denial only as between the CFTC and the exchange, leaving the market participant on unsolid footing. Due to the importance of this hedging activity to the commercial activity of the applicant and all market participants, the Commission should provide for a more inclusive, interactive process. Since the Commission determination will represent a ruling on whether a transaction is a bona fide hedge, the Commission review process should be a

[16] *Id.* at 38472.

[17] *Id.* at 38476.

public one with notice and the opportunity for comment (while also preserving confidentiality of proprietary information). As any CFTC review resulting in an approval of a NEBFH would represent a Commission finding of a bona fide hedge, the Commission approval should result in a new enumerated hedge for all similarly situated hedgers.

The Supplemental Proposal calls for a discretionary hedge exemption review process that involves the regular interaction of the registered exchanges with the Commission to ascertain the continued validity of a non-enumerated hedge exemption. The Commission's proposal does not, however, state that a market participant has any ability to appeal a hedge exemption revocation or denial and does not provide any ability for the market participants to have sufficient prior notice if the Commission, or a specific exchange, decides to simply revoke or modify hedging levels as to specific referenced contracts – including the NYMEX HH Natural Gas contract, which is a referenced contract used widely by the natural gas and power industries. As such, the Commission should also include a notice and appeal process for market participants.

C. <u>The Final Rule Should Include an Enumerated Bona Fide Hedge Definition that Covers Cross Commodity and Anticipatory Hedging</u>

The Supplemental Proposal sets forth a process under which exchanges could take action to recognize certain *bona fide* hedging positions and to grant certain spread exemptions, with regard to both exchange-set and federal position limits. Exchanges would be able to: "(i) Recognize NEBFHs certain non-enumerated bona fide hedging positions, *i.e.,* positions that are not enumerated by the Commission's rules (pursuant to proposed § 150.9); (ii) grant exemptions to position limits for certain spread positions (pursuant to proposed § 150.10); and (iii) recognize certain enumerated anticipatory bona fide hedging positions (pursuant to proposed § 150.11)."[18] In recognizing positions as bona fide hedges, exchanges would be required to apply the standards in the Commission's general definition of bona fide hedging.[19] In order to provide regulatory certainty, the Joint Associations would reaffirm their request that anticipatory hedges and cross-commodity hedges be included in the enumerated bona fide hedge definition.

1. The Final Rule Should Include an Enumerated Bona Fide Hedge Definition that Adequately Covers Commercial Energy Companies' Cross-Commodity Hedging Activities.

The Joint Associations contend that the lack of a sufficient, enumerated hedge for cross-commodity transactions and positions will increase risks to commercial entities that supply and deliver power. To date, the Commission's proposals have not articulated an enumerated hedge for this basic and fundamental hedging activity. The Joint Associations' members participate in physical energy commodity markets and in the commodity derivatives market to hedge and mitigate commercial risks toward ensuring the reliable delivery of energy to ultimate end use customers, come rain or shine. Importantly, the Joint Associations' members have also long used natural gas futures contracts to hedge the price risk associated with electricity production, particularly long-term electricity price exposure— known commonly as cross-commodity hedging. Regulatory barriers like the 0.8 0 correlation test in the 2013 Proposed Rule need to be affirmatively removed to allow these commonplace commercial risk management options.

[18] *Id*. at 38464 (footnotes deleted).

[19] *Id*.

Joint Associations note that the Supplemental Proposal does not address the 0.80 correlation for cross-commodity hedging contained in the 2013 Proposed Rule. Under the 2013 Propose Rule, certain cross-commodity hedges may qualify as bona fide hedging positions upon a showing, *inter alia*, of a reasonable and measurable correlation between the underlying cash commodity and the commodity underlying the commodity derivative contract. The 2013 Proposed Rule further provided for a presumption of an appropriate correlation "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[20] Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient liquidity in deferred month electricity derivatives contracts. In that case, a market participant will often convert its hedges from gas derivatives to electricity derivatives as the risk moves closer to, or into, the spot month. Requiring the proposed correlation in outer months would eliminate all available tools for hedging at illiquid locations which, in turn, would result in higher risks for market participants and higher costs for consumers. Joint Associations reiterate that this quantitative test should be removed because, due to the constantly changing nature of electricity markets, a 36-month spot month look back does not work. Furthermore, end users that use physical-delivery Referenced Contracts as a cross commodity hedge should be permitted to hold these hedges into the spot month and/or the last five days of trading if determined to be appropriate by the exchange. Failure to address these issues in the Supplemental Proposal will impact the ability of exchanges to recognize common and well-accepted *bona fide* hedging practices of energy end users.

Joint Associations also note that the Supplemental Proposal does not speak specifically to certain requests from the energy industry, and urge that these issues be addressed in conjunction with any finalized position limits rule. First, Joint Associations reiterate the many requests from commercial hedgers that position limits should apply only in the spot month, with accountability levels beyond the spot month. Second, the Commission should clarify in any final position limits rule that the new regulations regarding limits for certain contracts in nonfinancial commodities applies to an exclusive list of 28 core referenced contracts, and would not apply to contracts other than these 28 core referenced contracts enumerated in the federal rule. Finally, any final rule should specify in this regard that if the list of referenced contracts is proposed to be expanded or changed, it may be modified only through a rule amendment proceeding subject to public notice and comment per applicable Commission rules.

2. The Final Rule Should Include an Enumerated Bona Fide Hedge Definition that Adequately Covers Commercial Energy Companies' Anticipatory Merchandising Activities.

The CEA is clear that a rule setting position limits on futures and swaps should ensure sufficient market liquidity to support *bona fide* hedging activity, and thus provide for an adequate level of exemptions from position limits which "permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."[21] In order to establish this goal the Commission

[20] 2013 Proposed Rule at 75717.

[21] Commodity Exchange Act, § 4a(c)(1)-(2), 7 USC § 6a(c)(1)-(2).

should establish a broad exemption for anticipatory merchandising activities that support market participants' business needs. This is a special concern for the Joint Associations' membership, which regularly uses physical-delivery contracts proposed as Referenced Contracts – such as NYMEX HH NG – as a *bona fide* commercial hedge. The Joint Associations continue to believe that "the definition of bona fide hedging transactions or positions is unnecessarily narrow and, as adopted, may discourage a significant amount of important and beneficial risk management activity."[22] As such, the Joint Associations agree with comments expressed by other EEMAC members such as the American Gas Association, and the Commercial Energy Working Group[23] that an enumerated anticipatory merchandising hedge should be added to the list of enumerated hedges proposed in the 2013 Proposed Rule. Proposed Regulation § 150.1 should be amended to specifically include permissible enumerated hedges for storage and transportation and for assets owned or anticipated to be owned as follows:

> ***Hedges of Storage and Transportation***. Offsetting long and short positions in commodity derivative contracts representing the differential in either timing or location with respect to storage or transportation of the commodity underlying the commodity derivative contracts.
>
> ***Hedges of Assets Owned or Anticipated to be Owned***. Positions in commodity derivative contracts that hedge the value of an asset used to produce, process, store or transport the commodity underlying the derivative.[24]

The inclusion of the anticipatory merchandizing hedge in the Final Rules is necessary to protect and preserve Joint Associations members' and their counterparties' ability to freely engage in ordinary commercial hedging activities tied to gas storage assets. Without an enumerated anticipatory merchandising hedge, parties would either (a) be precluded from entering into gas storage hedges and similar hedges of gas assets that rely on the hedge, and/or (b) be forced to petition the Commission, even after the Final Rules, to amend the Final Rules to include the anticipatory merchandising hedge or otherwise approve of the anticipatory merchandising hedge before they enter into such a hedge. Both the preclusion of such activity, or a piecemeal petition process to permit it, would reduce liquidity and create undue risk without any benefit to the Commission's interest in reducing excessive speculative activity.[25] This is an

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[22] Comments of EPSA, EEI, and AGA, at 5, available at http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/eei-aga-epsa_comments.pdf. The Joint Associations also hereby incorporate detailed prior comments on this matter, submitted to the CFTC in March, 2012 in support of a petition of the Commercial Energy Working Group under Section 4a(a)(7) of the Commodity Exchange Act.

[23] See February 26, 2015 ("Transcript"), available at http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/emactranscript022615.pdf, at 8-9.

[24] February 10, 2014 Comments of CEWG (RIN 3038-AD99) (submitted by R. Michael Sweeney) at 25-26.

[25] The need for anticipatory hedges to be included as an enumerated *bona fide* hedge has also been discussed in detail by other market participants. See e.g. February 10, 2014 Comments of CEWG) (RIN 3038-AD99) (submitted by R. Michael Sweeney) at 16-20 and 23-26. February 10, 2014 Comments of CME Group (RIN 3038-AD99) (submitted by Kathleen Cronin), at 56-59. February 10, 2014 Comments of Natural Gas Supply Association (RIN 3038-AD99 and 3038-AD82) (submitted by Ryan Berry), at 19-25. June 26, 2014 Comments of Natural Gas Supply Association (RIN 3038-AD99 and 3038-AD82) (submitted by Ryan Berry), at 9-10. August 4, 2014 Comments of CEWG (RIN 3038-AD99) (submitted by Meghan Gruebner), at 2-3 and 5-6. February 26, 2015, "Illustrative Hedging Examples" presentation by Ronald S. Oppenheimer at the EEMAC meeting. Comments by Ronald S. Oppenheimer at the EEMAC meeting, February 26, 2015, at Transcript 156-182.

issue of increasing concern as the use of natural gas for electric generation increases. The use of natural gas for electric generation has increased from 18.8% in 2005 to 32.5% in 2015, and this trend is expected to continue.

As part of its proposal to amend the definition of bona fide hedging position, the Commission indicates that: "In both the current and December 2013 proposed definitions of bona fide hedging position, the incidental test requires a reduction in price risk. Although the Commission is now proposing to eliminate the incidental test from the first paragraph of its proposed bona fide hedge definition, the Commission notes that it interprets risk, in the economically appropriate test, to mean price risk."[26] The Commission denied requests to broaden the interpretation of risk.[27] This interpretation of "economically appropriate risk" is too narrow to result in a workable standard and does not reflect the realities of the commercial markets that energy companies rely on to mitigate risk. This view should be broadened in any final position limits rule to clearly state that "economically appropriate risk" is not solely limited to "price risk" given that commercial hedging encompasses a variety of commercial risks that may not specifically go towards price risk of the underlying commodity per se.

As such, Joint Associations are concerned, that under the Supplemental Proposal, exemptions currently provided to the market based on HH natural gas will be not be maintained because they usually don't revolve around fixed price exposure. Although the exchanges *can* grant non-enumerated hedge exemptions under the Supplemental Proposal, the Commission retains unilateral discretion to take away a non-enumerated hedge exemption without ever having to address its rationale for an adverse decision directly with the market participant. Specifically including anticipatory merchandising hedges as an enumerated hedge will help allay this fear as they will be then be eligible for an exemption under the Supplemental Proposal. Therefore, regulatory certainty would be increased by classifying these transactions as an enumerated hedge.

An anticipatory hedge is a common, routine, and risk reducing hedge. Under the Supplemental Proposal's terms, requiring each market participant to re-cast its current anticipatory hedging activities in applications for non-enumerated hedge recognition on an ad hoc basis is an unnecessary and unjustifiable burden on the commercial energy marketplace.[28]

3. The Final Rule Should Clarify the Availability of Bona Fide Hedging Status for Referenced Contracts Used to Hedge Commodity Trade Options.

The Joint Associations urge the Commission to ensure that commercial market participants will continue to have access to commonplace risk management tools under a future position limits rule, including their use of commodity derivative contracts to hedge risks associated with trade options intended to secure supply of an underlying commodity. Joint

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[26] *Id.* at 38463.

[27] *Id.*

[28] Suppl. Comments of the American Gas Association, CFTC Position Limits for Derivatives, RIN No. 3038-AD99 at 6 (filed March 30, 2016) ("With respect to the Petition Issue, declining to include the AMH in the Final Rules would simply delay ruling on allowing the hedge because, if the hedge is denied in the Final Rules, parties seeking to use the hedge would be forced to seek a hedge exemption by petition or another process. This delay is unnecessary because there is sufficient evidence and support for the AMH at this time. Legitimate hedgers need to use the AMH now and in the future, and for that reason alone the AMH must be included in the Final Rules.").

Associations note that although commodity trade options are treated as "swaps" under the Commission's definition of the term "swaps," a commercial market participant's trade option portfolio is functionally equivalent to physical inventory in that it presents a legitimate non-financial, non-speculative commercial risk that the market participant should be able to hedge without running up against speculative position limits. The ability to hold such a hedge is critical not only for managing commercial risk as to commodity trade option positions, but also for collectively hedging both physical forward positions and trade option positions on a portfolio basis. Unless the final rule is clear that core referenced contract hedges of commodity trade options may qualify within the relevant definition of a "bona fide hedge," the rule would make it impossible for a commercial entity to engage in commonplace commercial risk mitigation of both its physical inventory and trade option positions on a portfolio basis. Further, such a result would mean added compliance burden for commercial entities specifically as to their trade option activity – a result the Commission itself has taken strides to avoid: commercial entities would have to separately track and value all hedges of trade options positions from hedges of its physical forward/inventory positions. To avoid such adverse and unintended consequences, the Joint Associations request that the Commission clarify that even while trade options are legally classified as "swaps," hedges of commodity trade options should be eligible for relevant bona fide hedge exemptions as they would be available for hedges of other physical positions. The Joint Associations reiterate that the position limits final rule should support the ability of commercial firms to continue engaging in portfolio hedging and not create inadvertent and costly barriers for accessing this commonplace and ubiquitous hedging strategy uniquely relied upon by commercial end-users in the energy industry.

D. The Commission Should Provide for Adequate Time to Comply

Joint Associations are concerned about the level of data being sought. The CFTC has noted that it expects to receive hundreds of reports from each exchange per year, in addition to what it receives from market participants directly, in requiring weekly and monthly reporting in its Proposal. By this standard, among the six registered DCMs, the Commission would be receiving an additional 3,000 reports a year. The technology buildout required to support such frequent exchange reporting will be cumbersome and costly and the cost for the changes will ultimately be borne by the users of the exchanges, including Joint Associations members. As such, the Commission should provide additional time to the exchanges to carefully consider and develop alternative reporting schemes that would be more practicable, effective, and cost-saving for market participants (*e.g.*, quarterly reporting in lieu of weekly) for the Commission's consideration. This will help provide a balance between delegation of authority to the exchanges and providing information to the Commission in a usable format.

Any final rule codifying elements of the Supplemental Proposal should also provide an adequate period of time to market participants to prepare for compliance, following the period of time which the exchanges will require to file rule changes, receive approval from the CFTC for such changes, and revise systems to ensure a stable transition to the hedge exemptions administration process for their users. Compliance effective dates should be staggered as to the exchanges, then sophisticated CFTC registered entities, and lastly commercial end-users of the exchanges, so that each group of market participants has the appropriate amount of time to prepare for compliance with the new rules.

IV. CONCLUSION

The Joint Associations appreciate the work of the Commission Staff that has resulted in a Supplemental Proposal as well as the Commission's willingness to address end user issues. The Supplemental Proposal is a positive development in that it provides a mechanism for those hedging commercial risk to meet their legitimate hedging needs even if they do not fit within the enumerated hedges listed in the 2013 Proposed Rule. However, as discussed herein, the Supplemental Proposal substantially increases the regulatory burden for Joint Associations' members and exchanges. As such, the Joint Associations encourage the Commission, consistent with these comments, to work with the exchanges to develop an alternate process that reduces the regulatory and reporting burden on market participants and exchanges while meeting the Commission's goals of reducing excessive speculation.

Respectfully Submitted,

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