Edison Electric INSTITUTE

February 28, 2017

Via Electronic Submission

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

RE: Position Limits for Derivatives
RIN 3038-AD99

Dear Mr. Kirkpatrick:

I. INTRODUCTION

The Edison Electric Institute ("EEI") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") Notice of Proposed Rulemaking on Position Limits for Derivatives ("Reproposal").[1] The Reproposal revises the Proposed Rule on Position Limits for Derivatives issued in December 2013[2] and the Supplemental Proposed Rule on Position Limits for Derivatives issued in June 2016[3] without addressing many of the substantive concerns with the previous rulemakings. The Commission issued its first Position Limits proposal in 2011.[4] EEI has been an active participant in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[5], including all of the position limits proposed rules.[6]

[1] *Position Limits for Derivatives*, Notice of Proposed Rulemaking, 81 Fed. Reg. 96704 (December 30, 2016) ("Reproposal").

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

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

[4] *Position Limits for Futures and Swaps*, Final Rule, 76 Fed. Reg. 71,626 (Nov. 18, 2011).

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

[6] *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.

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.

EEI's 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 EEI's members, will likely result in higher and more volatile energy prices for residential, commercial, and industrial electricity customers. As such, EEI and its members have a direct and significant interest in the Commission's establishment of speculative position limits.

As discussed herein, EEI members are physical companies that use swaps and options to hedge risk. They are not speculators. EEI would assert that a need for position limits to prevent speculation has not been shown. Rather than benefit hedgers such as EEI members, EEI is concerned that the Reproposal will make hedging more expensive by causing a decrease in market liquidity which will reduce available counterparties while the regulatory burden associated with the Reproposal will significantly increase compliance and reporting costs for *bona fide* hedgers. EEI urges the Commission not to proceed with the Reproposal at this time as the need for a position limits rule has not been shown and the concerns outlined in comments in response to the 2013 NOPR or the Supplemental Proposal have not been addressed.

II. COMMENTS

Similar to the 2013 NOPR, the Reproposal establishes federal and non-spot month position limits for 25 core referenced contracts, related futures contracts, and economically equivalent swaps. The federal spot and non-spot limits cannot be exceeded without an exemption. While using substantially the same proposals and structure as the 2013 Proposed Rule and the Supplemental Proposal, the Reproposal contains a few changes supported by EEI. These include:

- Adopting higher levels of position limits for commodities to reflect the growing natural gas market.[7]

- Explicitly eliminating trade options from the definition of referenced contract so that they would not be subject to position limits[8] which will enable end users to continue to use these physically settled transactions to manage supply risk.

- Removing the "incidental test" and "orderly trading requirement" from the definition of *bona fide* hedge.[9]

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 EEI and EPSA to Christopher Kirkpatrick, Sec'y, CFTC (July 13, 2016)(on filed with the CFTC).

[7] Reproposal at 96720.

[8] *Id.* at 96735.

While EEI appreciates the proposed changes, especially the proposal to eliminate trade options from the definition of referenced contract, the Reproposal does not address or correct many of the substantive concerns outlined in EEI comments in response to the 2013 Proposed Rule and the Supplemental Proposal. For example, the Reproposal:

- does not establish a need for position limits;
- does not establish a substantive definition of *bona fide* hedging that is easily understandable and commercially practicable and includes risk management practices used by commercial market participants;
- does not continue to permit all forms of *bona fide* hedging regardless of whether those hedges are executed on an enterprise-wide gross or net basis, or at a portfolio level within a single company.
- continues to rely on specified enumerated and non-enumerated *bona fide* hedges as the mechanism to recognize legitimate *bona fide* hedging activity without providing a comprehensive list of enumerated *bona fid*e hedge activity used by electric utilities to hedge and mitigate commercial risk;
- despite comments from EEI and other end users that the proposal is too limiting and not reflective of all the risks being hedged, continues to indicate that the purpose of a *bona fide* hedging position under the economically appropriate test must be to offset price risk in the conduct and management of a commercial enterprise, but not other commercial or operational risks;
- does not provide a workable delegation proposal that allows exchanges to recognize legitimate hedging activity that would otherwise not be considered "*bona fide*";
- imposes a significant regulatory burden on end users associated with their hedging activities.

In addition to comments filed in response to the 2013 Proposed Rule and the Supplemental Proposal, EEI and the broader energy end user community described these concerns with the proposed federal position limits in detail at meetings of the CFTC Energy and Environmental Markets Advisory Committee ("EEMAC") on February 26 and July 29, 2015.[10] Rather than reiterate the concerns in detail, EEI's comments in response to the 2013 Proposed Rule and the Supplemental Proposal are attached. EEI respectfully requests the Commission

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[9] *Id.* at 96743.

[10] EEI hereby incorporates 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.

consider the attached comments and EEMAC materials when considering the Reproposal. The threshold questions to be addressed prior to imposing a position limits regime are (1) whether there is a legitimate necessity for a federal position limits rule and, (2) if so, is the Reproposal the best way to proceed. As discussed below, EEI submits that the answer to these questions is no.

A. The Reproposal Does Not Establish a Need for Federal Position Limits

The Reproposal does not establish that there is a need for federal position limits at this time. Under Commodity Exchange Act ("CEA") Section 4a(a)(2), as amended by the Dodd-Frank Act, the Commission has the authority to establish, "as appropriate," limits on speculative positions in derivatives contracts that are "necessary to diminish, eliminate or prevent" the burden on interstate commerce caused by excessive speculation (*i.e.*, by commodity price fluctuations that are sudden, unreasonable, or unwarranted).[11] Only **after** the Commission has made a finding that position limits are necessary does the Dodd-Frank Act direct the Commission to set limits "as appropriate" and to ensure that these limits, "to the maximum extent practicable," (i) diminish, eliminate, or prevent excessive speculation; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for *bona fide* hedgers; and (iv) ensure that the price discovery function of the underlying market is not disrupted.[12] Thus, the plain language of the CEA, as amended by the Dodd-Frank Act, authorizes the Commission to impose position limits only after the Commission has found that the limits are necessary to prevent **excessive** speculation that appears likely to harm markets, and then only after designing the limits to minimize their negative impacts on the derivative markets. These determinations of necessity and appropriateness are important to avoid imposing unwarranted costs on commercial parties and other exchange market participants, and to ensure that any limits imposed are well-founded on a fully developed factual record. These determinations have not been made.

The Commission recognizes that "speculation is part of a well-functioning market particularly…as a source of liquidity" and that "position limits address excessive speculation, not speculation per se."[13] Despite this recognition, in attempting to justify a need for position limits, the Reproposal simply indicates that the studies and reports, while not conclusive, at least "do not militate against and, to some degree, support the Commission's reproposal" of positions as a "prophylactic approach."[14] The Commission goes on to simply state that, the studies relied upon "do not dissuade the Commission from its consistent view that large speculative positions … pose risks to well-functioning commodities markets nor from its preliminary finding that speculative position limits are necessary to achieve their statutory purposes."[15]

While the Commission does not indicate that excessive speculation has been seen in the markets as justification for the Reproposal, the EEMAC meetings and their associated records clearly reflect the views of energy market participants that there is no need for a federal position limits rule. This record provides numerous comments from market participants and exchanges indicating that position limits are unnecessary as excessive speculation are not evident in the

[11] CEA § 4a (a) (2).

[12] CEA § 4a (a) (3).

[13] Reproposal at 96720.

[14] *Id.* at 96726-27.

[15] *Id.* at 96727.

energy markets and there is no basis to assume it is likely to occur in the future. Since the issuance of the Commission's first positon limits proposal in 2011, nothing has occurred that would justify a federal position limits rule. Instead, since the futurization of swaps in 2012, many EEI members have transitioned to a virtually exclusive reliance on futures for hedging, which means that the vast majority of energy derivatives are now subject to exchange position limits reducing any basis for federal position limits.

Despite not having established the need for position limits, the Commission also proposes to adopt federal non-spot month position limits in addition to spot-month position limits. EEI continues to assert that the Commission should not adopt federal non-spot month speculative position limits, as there is no supported finding that non-spot month position limits are necessary to prevent excessive speculation in a specific commodity derivatives contract market. Energy markets currently operate efficiently without federal non-spot month speculative position limits under accountability levels imposed by the exchanges. Accountability levels for non-spot months have been used effectively by exchanges for years and the Commission has neither explained a need for hard non-spot month limits nor explained why the current approach for exchange-set limits is not sufficient. The Reproposal also does not indicate how activity outside of the spot month could be deemed "excessive speculation" that would cause "sudden or unreasonable fluctuations or unwarranted changes in the price" of the commodity.[16]

While an empirical basis to impose federal position limits has not been shown, the impact of the Reproposal would be to reduce liquidity in the energy markets and as discussed below, would impose a substantial regulatory burden on hedgers such as EEI members without a clear showing as to need. Accordingly, EEI would urge the Commission not to impose the regulatory burden associated with the Reproposal until it has been shown that federal position limits are needed to prevent excessive speculation in the market.

A. The Reproposal is Duplicative, Complex, and Not Reflective of Hedging Practices

EEI members that use futures for hedging are already subject to exchange position limits for their futures positions. To the degree such hedging requires a quantity of futures in excess of an exchange position limit, electric utilities can seek a hedge exemption from the exchange by demonstrating their commercial risk. The Reproposal does not disturb this exchange position limit process. It does, however, add 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.

Under the Reproposal, EEI members will need to comply with two position limits regimes for their hedging activity. They will still be required to adhere to exchange limits and seek prospectively effective hedge exemptions when needed. They will also, on a retrospective basis, need to: (1) categorize and track each hedging transaction (is it an enumerated and non-enumerated *bona fide* hedge); (2) aggregate and track all cash transactions, production and stores across the affected enterprise; (3) create processes to file required forms to justify its enumerated and non-enumerated *bona fide* hedges; (4) collect data and prepare filings; and (5) perform

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

necessary administrative activities in support of the foregoing. This duplicative process is costly and burdensome and has not been shown to be necessary.

In addition to this complex and duplicative process, the definition of *bona fide* hedge is narrow and inflexible and does not accommodate the risk management practices used by commercial market participants as detailed in the attached comments. The Reproposal also retains requirements that limit hedging options. For example, in order to qualify as a *bona fide* hedging position, a position in a commodity derivative contract must be, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[17] The Reproposal indicates that the Commission's interpretation of "economically appropriate" will be as set forth in the 2013 Proposed Rule. First, the Reproposal indicates that the term "risks" in the context of the economically appropriate test be limited to offsetting price risk in the conduct and management of a commercial enterprise.[18] In reiterating this interpretation, the Commission acknowledges but does not substantively address the numerous comments stating that the proposal was too limiting and did not accommodate all the different types of risks that need to be hedged. Second, the economically appropriate test also requires an entity to consider all of its exposures in order to qualify for the test when hedging without taking into account exposures on a legal entity or portfolio basis.[19] Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. As long as a company organizes risk-based portfolios on commercially reasonable risk management principles, market participants should have the flexibility to manage risk and hedge on a portfolio level without regard to other portfolios within the same legal entity. This is especially important to EEI members as energy markets are regional in nature which means that an electric utility may have excess physical generation in one region and be short physical power (i.e., it has more load or demand for power than it has generation) in another region. An electric utility's long physical position in one region should not limit its ability to hedge its short physical position in another region. Moreover, forcing end-users to net positions between regions that may have limited commercial relationship with each other will increase risk, not decrease risk.

B. The Recordkeeping and Reporting Requirements for End Users in the Reproposal are Burdensome and Confusing

The Reproposal requires end users to file Series '04 Reporting Forms electronically with the Commission. In addition to the previously required forms, such as Form 204 for applying for an exemption, the Reproposal creates three new forms (Forms 504, 604 and 704) without any clear explanation as to need. The forms are also confusing and would require investments in software and technology. Since the underlying data required to properly and timely submit the forms is significant, the Commission should work with stakeholders, exchanges and software vendors to streamline and clarify the process so that the Commission can get the information that it seeks in a format that end users can provide. As currently proposed, the compliance process is confusing and burdensome. If the Commission continues to require filings from end users then they should adjust the forms to make them less burdensome so that end users that rely on futures and swaps to hedge and mitigate their commercial risk do not bear the regulatory burden of rules

[17] Proposed Rule 150.1.

[18] Reproposal at 96744.

[19] *Id.* at 96746-96747.

created to prevent excessive speculation. Thus, before any forms are required, they should be clarified and revised to ensure that end users, such as EEI members, that are not Commission reporting entities can use them without a substantial investment in technology and other resources. As proposed, entities such as EEI members will bear the brunt of the compliance burden.

III. CONCLUSION

For the foregoing reasons, EEI respectfully requests that the Commission not issue a final federal position limits rule. In the event the Commission chooses to go forward, it should fully consider the issues raised herein and in the attached materials as well as significantly reduce the duplication, complexity and burdens that the Reproposal places on end-users such as EEI members.

Respectfully Submitted,

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ATTACHMENTS

February 7, 2014

Via Electronic Submission

Melissa Jurgens, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Ms. Jurgens:

The Edison Electric Institute ("**EEI**") and the Electric Power Supply Association ("**EPSA**") (hereafter "**Joint Associations**") appreciate the opportunity to provide the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**") with the comments and recommendations set forth below in response to the Commission's Notice of Proposed Rulemaking concerning Position Limits on Derivatives ("**Proposed Rule**").[1] The Joint Associations and its members have been active participants in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"), including submitting comments on prior proposed position limits rules issued by the Commission.[2]

I. Description of EEI and Its Interest in the Proposed Rule

EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry. EEI also has more than 65 international electric companies as Affiliate members and more than 170 industry suppliers and related organizations as Associate members.

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1 Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013).

2 *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).

EPSA is the national trade association representing competitive power suppliers, including generators and marketers. Competitive suppliers, which, collectively, account for 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 Association's members are not financial entities. Rather, they are physical commodity market participants that rely on Referenced Contracts to hedge and mitigate their commercial risk.[3] Regulations that make effective risk management options more costly for end-users of derivatives and will likely result in higher and more volatile energy prices for retail, commercial, and industrial customers. As end-users of commodity derivatives who hedge commercial risk, Joint Association's members have a direct and significant interest in when and to what extent the Commission exercises its authority to establish speculative position limits. As such, the Joint Associations would request that the Commission consider its comments in determining what revisions are needed to the Proposed Rule. In addition, Joint Associations request that the Commission ensure that the forms align with the final rule and that the Commission take into consideration the effort needed to comply with the rules in determining the timeframe within which the forms need to be submitted.

II. The Commission Should Make a Fact-Based Necessity Finding for Each of the 28 Core Referenced Futures Contracts

The Commission stated in the preamble to the Proposed Rule that "the CEA mandates the imposition of speculative position limits."[4] The Commission appears to believe that it need not determine that speculative position limits are necessary in order "'to diminish, eliminate or prevent excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the price of' commodities."[5] Yet, "out of an abundance of caution," the Commission also determined that speculative position limits are necessary.[6]

The Commission's necessity finding is qualitative, lacking in analysis, and thus insufficient to comply with its statutory obligation under the CEA. Joint Associations request that the Commission make a specific fact-based finding of necessity as to each of the 28 core referenced futures contracts in the Proposed Rule[7] as the Proposed Rule does not contain any analysis as to why the 28 core referenced contracts were chosen. Individualized necessity determinations are important to avoid imposing unwarranted costs on commercial parties and other exchange market participants. By including the CEA requirement that the Commission must find position limits are "necessary" and "appropriate" before imposing them, Congress recognized that position limits would impose significant costs on hedgers and that those costs may ultimately be borne by individual consumers and businesses that purchase and use commodity products and by-products. Position limits that are not necessary or appropriate

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3 Capitalized terms used but not defined herein have the meaning given them in the Proposed Rule.

4 Proposed Rule at 75,685.

5 *Id.* (quoting CEA section 4a(a)(1) pre-Dodd-Frank).

6 *Id.* 75,685.

7 *See* CEA section 4a(a)(1).

increase commercial parties' compliance costs and reduce market liquidity, which in turn increases the cost of hedging—costs the Commission did not adequately consider before imposing position limits on Referenced Contracts—without producing corresponding benefits.

In the Proposed Rule, the Commission acknowledges receipt of numerous studies regarding the imposition of speculative position limits that fail to establish a consensus regarding whether limits will be effective. This demonstrated lack of consensus provides objective evidence that position limits are not necessary. However, rather than address and attempt to analyze this evidence, the Commission simply makes a superficial finding based on incomplete market data that position limits are, as a precautionary matter, necessary.[8] Joint Associations respectfully submit that the inconclusive nature of studies concerning the need for, and efficacy of, position limits demonstrates why it is critical that the Commission take additional time to analyze and review each of the core referenced futures contracts to determine whether speculative position limits are necessary and, if adopted, will: (i) prevent excessive speculation; (ii) deter manipulation; (iii) allow for sufficient market liquidity for hedgers; and (iv) permit price discovery.[9]

One of several areas for which additional data are necessary prior to finding that position limits are necessary relates to commodity trade options that are physically-settled contracts upon the exercise of the option.[10] Joint Associations recommend that the Commission continue to collect and analyze data regarding commodity trade options through Part 45 and Form TO in order to determine whether extending its position limits regime to commodity trade options is necessary to diminish, eliminate, or prevent excessive speculation.[11] Indeed, without quantifiable data about how commodity trade options are used, the Commission cannot ensure that its regulations would not inappropriately limit or even foreclose the use of an important hedging instrument by producers, processors, merchants, and commercial users of the underlying commodity seeking to hedge the risks that they incur in connection with their businesses.[12]

Due to the potential impact on markets, Joint Associations respectfully requests that the Commission make the necessary finding of necessity based on quantitative market data.

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8 Proposed Rule at 75,694.

9 CEA section 4a(a)(3).

10 As explained below, Joint Associations recommend that the Commission exclude trade options from the definition of Referenced Contract so they will not be subject to position limits.

11 CEA section 4a(a)(1).

12 *See* CEA section 4a(c)(1) ("No rule, regulation, or order issued under subsection (a) of this section shall apply to transactions or positions which are shown to be bona fide hedging transactions or positions, as such terms shall be defined by the Commission by rule, regulation, or order consistent with the purposes of this Act. Such terms may be defined to 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. To determine the adequacy of this Act and the powers of the Commission acting thereunder to prevent unwarranted price pressures by large hedgers, the Commission shall monitor and analyze the trading activities of the largest hedgers.").

III. The Definition of "Referenced Contract"

Under the Proposed Rule, the position limits set by the Commission would apply to all Referenced Contracts.[13] Referenced Contract is defined in proposed CFTC Rule 150.1 as:

> on a futures equivalent basis with respect to a particular core referenced futures contract, a core referenced futures contract listed in § 150.2(d), or a futures contract, options contract, or swap, and *excluding* any guarantee of a swap, a basis contract, or a commodity index contract . . . [t]hat is:
>
> (i) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of that particular core referenced futures contract; or
>
> (ii) Directly or indirectly linked, including being partially or fully settled on, or priced at a fixed differential to, the price of the same commodity underlying that particular core referenced futures contract for delivery at the same location or locations as specified in that particular core referenced futures contract . . .[14]

In an attempt to further clarify the practical application of the proposed definition, the CFTC's Division of Market Oversight posted on the CFTC's website a list of common exchange-traded contracts that it has concluded would fall either within or outside the definition of Referenced Contract.[15] Although Joint Associations appreciate that the Staff provided market participants with a list of Referenced Contracts, Joint Associations respectfully submit that posting the list of Referenced Contracts does not provide sufficient clarity or legal certainty. As such, Joint Associations request that the Commission incorporate the posted list of Referenced Contracts as an appendix to the final rule issued by the Commission. This will provide additional certainty in a number of ways.

First, if the list of Referenced Contracts is not explicitly incorporated into a final rule, market participants may not be able to determine with certainty whether their swap and other Referenced Contract positions are subject to limits. It is critical that market participants understand precisely which positions will count against the limits. Inclusion of the list in the rule will help ensure that all market participants have the same understanding of the scope of the list and will minimize the compliance and reporting uncertainties and discrepancies that inevitably will be caused by varying good faith interpretations of the definition of Referenced Contract.

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13 Proposed Rule at 75,724.

14 *Id*. at 75,825.

15 *See Position Limits Workbook*, COMMODITY FUTURES TRADING COMMISSION http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/PositionLimitsforDerivatives/ssLINK/poslimitsworkbook (last visited Jan. 13, 2014).

Second, the need for certainty is of the utmost importance as many (probably most) market participants will have to invest in process and IT system changes to ensure that they can identify and track referenced contracts, and comply with the final rule. Since this will result in market participants incurring substantial costs, it is imperative that market participants fully understand the scope of the definition of Reference Contract and have a definitive comprehensive list of Reference Contracts prior to incurring these costs.

Third, by incorporating the posted list into the final position limits rule, the Commission will provide certainty by indicating that it will follow a transparent process and seek public comment prior to making any future changes to the definitive list of Reference Contracts. This will provide market participants with certainty that they will have an opportunity to provide input into the list of Referenced Contracts and have the time necessary to adjust processes and systems to comply with any changes.

IV. The Commission Should Not Regulate Exempt Commodity Trade Options As Referenced Contracts

The proposed definition of "Referenced Contract" would include commodity trade options that technically fall within the definition of a "swap," but that generally are exempt from regulation under Part 32 of the CFTC's rules. Trade options are entered into by commercial market participants and, if exercised, result in the sale of a physical commodity for immediate or deferred shipment or delivery.[16] The Commission has requested comment on whether commodity trade options should be exempt from some or all aspects of the Proposed Rule.[17]

The Joint Associations urge the Commission to exclude trade options from the definition of Referenced Contract. As an initial matter, trade options are not speculative by definition. Under the CFTC's Interim Final Rule, the offeree to a trade option must "be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such."[18] In other words, because a trade option must be related to the offeree's commercial business, it cannot also be a speculative derivative position (much less a cause of excessive speculation) under the position limits regime.

Subjecting commodity trade options to position limits would impose a complex and anomalous new regulatory regime on a category of commercial transactions that have never been subject to position limits set by the CFTC or the exchanges. These regulations would require, among other things, compliance with complex and costly monitoring, recordkeeping, and reporting requirements despite the fact that commodity trade options are typically used by commercial market participants either to ensure access to physical supply of a commodity or to hedge commercial risk, rather than to speculate in derivatives. In addition, as we explain below,

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

17 *Id.*

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

the Proposed Rule fails to take into account the manner in which many trade options are exercised and would effectively preclude utilities and other commercial market participants from using trade options to procure supply or commodity inputs to production.

To illustrate the anomalous and impractical results that the Proposed Rule would have on Joint Associations' members and other commercial market participants, Joint Associations offer the following examples:

Example 1:

Party A, the central hedging and trading affiliate of merchant generation entities, sells a *ten year* capacity product with a daily physical call option on power to Party B, a supplier of power to commercial, industrial and residential customers, that needs a reliable supply of power. The power option provides Party B with the right to require Party A to supply firm On-Peak power on each delivery day. The option must be exercised each business day for the following delivery day(s). In addition to paying for the capacity sold under the contract, Party B pays for the power delivered when it exercises its option based on price calculated for each day by multiplying a specified heat rate (*e.g.*, 7.5) and a specified Gas Price Index. In this example, the Gas Price Index is based on the midpoint price for Louisiana – On-Shore South: Henry Hub natural gas for the relevant delivery day as published by Gas Daily. Accordingly, this trade option falls within the definition of Referenced Contract.

The Proposed Rule effectively would preclude the parties from using the trade option as a means to provide and source power because it does not permit them to carry a physically-settled Referenced Contract position that exceeds the speculative position limit through the spot month. The first exercise date for the trade option is the last business day of the month for delivery on the first day of the delivery month and all subsequent exercise dates for the daily options during the delivery month will occur during the delivery month. Because the transaction, as agreed by the parties, would cause a trade option to exist during the spot month for the NYMEX natural gas contract for each month during the ten-year term of the transaction, it could be prohibited by the Proposed Rule – a result the Commission hopefully did not intend.

The unintended practical consequences of subjecting such a trade option to position limits would severely and adversely affect EEI members and other commercial market participants. First, the ten-year contract would have to be terminated prior to start of the first Spot Month during the contract term. Because this is a bespoke physically-settled transaction, not an exchanged traded product that can easily be reversed, in order to terminate the transaction both parties would have to agree on the termination value. Second, subjecting trade options to position limits would negatively impact electric capacity and power markets because market participants will not be able to structure transactions in a manner that matches their commercial needs. For example, the load serving entity, in the example, will not be able to retain its right to call upon a power supply for its volumetric exposure. Similarly, the power supplier will not be able to use the option to maximize the value of its power generation assets.

Example Two:

The Proposed Rule could eliminate the ability of market participants to enter into multi-month and multi-year trade options. For example, Party A sells a two-year monthly physical call option on natural gas to Party B, a utility or generator that consumes natural gas or resells it to others that consume natural gas. The option gives Party B the right to require the delivery of natural gas at a non-Henry Hub delivery point on each day during a calendar month for which the option is exercised. The option must be exercised on the last business day prior to the delivery month. The gas price is based on the midpoint price for Louisiana – On-Shore South: Henry Hub natural gas for the relevant delivery day as published by Gas Daily. Accordingly, as was the case in the first example, the trade option in this example falls within the definition of Referenced Contract.

The first exercise date for this natural gas trade option above is the last business day of the month preceding the delivery month, which is after the Spot Month for the NYMEX natural gas contract. The same exercise structure applies to all monthly options during the two year period of the transaction. Because the transaction, as agreed by the parties would cause a trade option to exist during the spot month for the NYMEX NG contract during each month of the transaction, it would be precluded by the Proposed Rule to the extent that this Referenced Contract position, plus other non-*bona fide* positions held by either party, exceeded the spot-month limit on physically-settled natural gas contracts. Thus, the Proposed Rule would have essentially the same adverse consequences on the parties to the trade option in this example as it would have on the parties to the trade option in the first example.

Separate and apart from the anomalous impact that subjecting trade options would have on long-standing and important commercial supply and merchandizing transactions, the Proposed Rule would require market participants to develop new systems for monitoring physical options positions, the sizes of which change constantly and rapidly because of the impact of option deltas. It also would complicate the ability of market participants to manage risk because they would be precluded from hedging the risks associated with trade option positions given that one Referenced Contract cannot be used to hedge another Referenced Contract and cannot be netted against financially-settled Referenced Contract positions in the spot month. Furthermore, because trade options, as proposed, would be physically-settled Referenced Contracts, a market participant holding a single trade option would be ineligible for the conditional limit on the same financially-settled Referenced Contract. In short, the Joint Associations respectfully submit that the adverse effects on commercial market participants of subjecting trade options to position limits greatly exceed any regulatory benefits.

V. The Commission Should Regulate Basis Contracts Consistently

The Proposed Rule would regulate two types of spread contracts differently depending on how they are structured. Basis contracts, which are defined as contracts that cash-settle based on the difference in price of the same (or substantially the same) commodity at two *different locations*, would not be subject to position limits.[19] Conversely, inter-commodity spread

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[19] Proposed Rule at 75,823.

contracts, which are contracts that cash-settle based on the difference between the settlement price of a Referenced Contract and the settlement price of another contract based on a *different commodity*, would be subject to position limits.[20] The Commission has not explained the rationale for treating basis contracts and inter-commodity spread contracts differently, even though both types of agreements often have similar characteristics.

Joint Associations support the Commission's decision to exclude basis contracts from the definition of Referenced Contract; however, Joint Associations also recommend that the Commission take a consistent approach for inter-commodity spread contracts. Both categories of agreements tend to be highly structured, customized transactions that do not easily convert into futures equivalent positions and, therefore, are not readily compatible with the Proposed Rule. For example, in cases where only one side of a contract can be converted into a Referenced Contract position, the market participant holding the position would be subject to limits even though approximately half of the position would count for netting purposes or as a *bona fide* hedge. As discussed further in section VII.F, below, this is a particularly troubling result in the electric industry, where inter-commodity spread transactions known as "heat rate" transactions are exceedingly common. Moreover, the bespoke nature of these agreements tends to make the risk of excessive speculation or potential market manipulation remote and impractical. Accordingly, the Commission should continue collecting data regarding basis contracts and inter-commodity spread contracts pursuant to Part 20 and Part 45, but should not subject either type of contract to position limits.

VI. The Commission Should Revise Its Approach to Spot and Non-Spot Month Limits

A. *Definition of Spot Month*

Under the Proposed Rule spot month is defined differently for physical delivery contracts and cash-settled contracts.[21] Prior to finalizing the list of Referenced Contracts, Joint Associations urge the Commission to make sure that that the definition is consistent with market practices as they exist in the energy industry. This is especially important if the Commission chooses to include commodity trade options in the Proposed Rule. As indicated above, the optionality included in these contracts is necessary for Joint Associations' members to meet their own electricity and gas needs and the needs of their retail consumers. Since electricity cannot be stored and called upon when needed the optionality is necessary to meet changes in customer demand. As such, the spot month limits should take into consideration how power markets operate.

B. *The Commission Should Use the Best Data Currently Available to Set Initial Spot Month Limits at 25 Percent of Deliverable Supply*

The Proposed Rule would establish spot month position limits based upon an estimate of 25 percent of deliverable supply for the commodity in each core referenced futures contract.[22]

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[20] *Id*. at 75,697 fn 163.

[21] Proposed Rule 150.1.

[22] Proposed Rule 150.2(a).

Initially, the Commission would adopt the existing spot month speculative position limits set by individual designated contract markets. However, as an alternative, the Commission is considering setting the initial spot month limits at levels based on estimates of deliverable supply submitted by CME Group on July 1, 2013.[23]

Joint Associations urge the Commission to adopt spot month position limits based upon the CME Group's estimates of deliverable supply. The deliverable supply estimates currently used by the Commission are severely outdated and do not accurately reflect the markets as they exist today. The CME Group's estimates of deliverable supply represent the most current and accurate data regarding the size of the markets for the commodities that underlie each core referenced futures contract. If the Commission relies upon out-of-date statistics, it risks imposing limits that are unnecessarily restrictive and that inadvertently harm the liquidity and utility of the derivatives markets. Since all futures transactions occur on an exchange, the exchanges are in the best position to provide accurate and current information on the market. The Commission should, therefore, follow its established practice of deferring to the exchanges' expertise and adopt spot month position limits based upon the most current and complete information they have provided.

C. *The Commission Should Adopt a More Flexible Approach to Limits for Cash-Settled Contracts*

The Proposed Rule would establish separate spot month speculative position limits for physical-delivery Referenced Contracts and cash-settled Referenced Contracts.[24] In addition, the Proposed Rule would permit a higher spot month limit for cash-settled Referenced Contracts equal to five times the standard spot month limit, provided that the person relying on this conditional limit does not hold any positions in the physical-delivery Referenced Contract.[25] Under the Proposed Rule, market participants relying on the conditional limit would be required to provide the CFTC with daily reports regarding their cash market positions on new Form 504.[26]

Joint Associations request that the Commission adopt a more flexible approach to limits for cash-settled Referenced Contracts because, as the Commission has acknowledged in the context of exchange-set position limits, cash-settled contracts are less susceptible to manipulation and excessive speculation.[27] Joint Associations suggest that the Commission adopt the spot month limit methodology used to determine the physical-delivery and cash-settled spot month position limits for the NYMEX Henry Hub contract in the 2011 Position Limits Rule.[28] Under the prior rule, the Commission established a limit for the physical-delivery Referenced Contract and a separate, aggregate limit of five times the size of the physical-delivery limit for both physical-

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23 Proposed Rule at 75,727.

24 Proposed Rule 150.2(a).

25 Proposed Rule 150.3(c).

26 Proposed Rule at 75,778.

27 *See* 17 C.F.R. Part 38 Appendix B, Core principle 5, section (b)(2) (describing the potential for distortion of prices in connection with cash-settled contracts as "negligible").

28 Position Limits for Futures and Swaps, 76 Fed. Reg. 71, 626 (Nov. 18, 2011).

delivery and cash-settled contracts.[29] The Commission should modify the Proposed Rule and adopt a similar approach, permitting market participants to rely on higher speculative limits for cash-settled contracts while still holding a position in the physical-delivery contract. Without this modification, the conditional spot month limit may cause market participants to choose between holding positions in either the physical-delivery or the cash-settled contracts, which could negatively impact the price discovery and risk management functions of both physical-delivery and financially-settled contracts.

Furthermore, because the Commission has also proposed to subject commodity trade options to position limits as physically-delivery contracts, any person that holds a single commodity trade option for a particular Referenced Contract would be unable to rely on the conditional spot month limit for that commodity. This restriction would make the conditional spot month limit unavailable for many of Joint Associations members and other commercial market participants.

Joint Associations also request that the Commission modify the Proposed Rule to permit market participants that rely on the conditional limit to file monthly *bona fide* hedging reports, rather than a daily filing of all cash market positions. The daily Form 504 filings, as proposed, would relate to a broad range of cash-market positions that, in most cases, are not currently subject to any periodic reporting requirements. Developing the reporting systems needed to identify and report the information required by Form 504 would impose significant burdens on commercial market participants with cash market positions, particularly when compared to purely speculative traders who do not hold cash market positions. Moreover, it is unclear what benefit the Commission would realize from receiving daily, as opposed to monthly, reports. The Commission should more appropriately balance the costs and benefits associated with Form 504 requirements by requiring market participants relying on the conditional spot month limit to submit monthly, rather than daily, reports.

D. *The Commission Should Not Set Non-Spot Month Limits Based on Incomplete Market Data*

The Joint Associations believe that additional limits outside of the spot month are not necessary. Instead, accountability levels would provide the oversight desired by the Commission without imposing limits based on incomplete data, as discussed below, which could harm the market. Accountability levels for non-spot months have been used effectively by exchanges for years and the Commission has neither explained a need for hard non-spot month limits nor explained why the current approach for exchange-set limits is not sufficient.

The Proposed Rule would set non-spot month speculative position limits based on 25 percent of open interest for the first 25,000 contracts and 2.5 percent of open interest thereafter.[30] To calculate specific non-spot month limits in the Proposed Rule, the Commission only relied upon open interest data from calendar years 2011 to 2012 for futures contracts, options on futures contracts, and significant price discovery contracts that are traded on exempt commercial

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[29] *Id.* at 71,635

[30] Proposed Rule at 75,730

markets.[31] Open interest data derived from the CFTC's Part 20 swaps large trader reporting rule and data derived from swaps reported to swap data repositories pursuant to the Commissions swap reporting rules were *excluded* from its calculation due to potential inaccuracies and other concerns.[32]

Joint Associations request that the Commission wait to set non-spot month speculative position limits until it has complete data regarding the markets it seeks to regulate. Omitting data from large portions of the swaps market – including all over-the-counter swaps traded between commercial end-users – incorrectly makes those markets appear to be smaller than they really are, and results in limits that are inappropriately and unnecessarily restrictive. The Commission recognized this limitation when it proposed and adopted the 2011 Position Limits Rule. Rather than impose potentially harmful limits based on data that was substantially incomplete, the Commission determined that it would not establish non-spot month limits until it had 12 months' worth of reliable data under Part 20.[33]

E. *EEI Supports the Proposal to Permit Netting of All Referenced Contracts Outside of the Spot Month*

The Proposed Rule would permit market participants to net positions in physical-delivery and cash-settled Referenced Contracts outside the spot month.[34] Joint Associations support this proposal. Netting positions outside of the spot months permits Joint Associations members and other market participants to efficiently manage their commercial risk, without presenting any of the concerns that the Commission has raised in connection with netting during the spot month. The Commission, therefore, should adopt this provision as it has been proposed.

VII. The Commission Should Revise the Definition of *Bona Fide* Hedging Positions to Fully Accommodate All Legitimate Commercial Risk Management Activity

Joint Associations members are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. If the Commission adopts a definition of *bona fide* hedging that is too narrow or inflexible, it will make important hedging activities more difficult for commercial end users which, as a consequence, may increase the price and volatility of energy for residential, commercial, and industrial customers. Accordingly, Joint Associations urge the Commission to adopt a definition of *bona fide* hedging that is easily understandable and commercially practicable by incorporating the specific recommendations described below.

A. *The Commission Should Not Limit Bona Fide Cross-Commodity Hedges*

The Proposed Rule would permit certain cross-commodity hedges to qualify as *bona fide* hedging positions, "provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are

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31 *Id*.

32 *Id*. at 75,733-34.

33 2011 Position Limits Rule at 71.688.

34 Proposed Rule at 75,710.

substantially related to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract."[35] To further elaborate on when a cross-commodity hedge would be considered "substantially related" to a cash-market position, the Commission provided a non-exclusive safe harbor based on two factors: (1) a qualitative factor, requiring a reasonable commercial relationship between the underlying cash commodity and the commodity underlying the commodity derivative contract; and (2) a quantitative factor, requiring a reasonable and measureable correlation in light of available liquid commodity derivative contracts. Under the Proposed Rule, the CFTC would only presume an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[36] Positions that do not satisfy *both* the conditions of the safe harbor are presumed *not* to be *bona fide* hedging positions; however, a person may attempt to rebut this presumption.[37]

Joint Associations strongly oppose the approach to cross-commodity hedges in the Proposed Rule and urges the Commission to remove the quantitative test from the safe harbor when it finalizes the position limits rule. Rather than defining when a hedge is "substantially related" to the price of an underlying commodity using an arbitrary numeric threshold measured over an arbitrary period of time, the CFTC should permit market participants to make commercially reasonable determinations of which contracts are substantially related.

Joint Associations urge the Commission to reconsider the quantitative factor in the proposed safe harbor. In many cases, a quantitative test of correlation based on spot month prices is an unsuitable method of assessing whether a hedge is appropriate because it does not accurately reflect how prices converge across the forward curve. For this reason, many market participants assess and manage their forward price risk using customized analytical models that take into account the characteristics of their particular markets. The Commission should not attempt to reduce this complex, and often subjective, process to a crude mathematical formula which would, in many cases, yield a result that is incorrect. Further, the Commission has provided no explanation for requiring that a quantitative analysis consider 36 months of historical price data. Joint Associations members must be permitted to make commercially reasonable judgments when quantifying risk including normalizing historical data to account for unusual anomalies and using shorter or longer look-back periods. The proposed 36-month look-back period would also restrict the use of new cross-commodity hedging products that may provide a best available hedge, but that do not have 36-months of historical data.

As the Commission is well-aware, utilities and other power generators have long used natural gas Referenced Contracts to hedge the price risk associated with their electricity production. They have done this based upon decades of commercial experience and reasonable

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35 *Id.* at 75,824 (emphasis added).

36 *Id.* at 75,717.

37 *Id.*

business judgment. Nevertheless, according to the Commission, fluctuations in the value of electricity contracts typically will not be substantially related to fluctuations in the value of natural gas.[38] Joint Associations respectfully disagree and submit that the Commission should not attempt to substitute its administrative judgment for the commercially reasonable business judgment of market participants.

The Commission's stated belief about the correlation between power and natural gas prices is incorrect as there is substantial evidence in the assessments done by the Federal Energy Regulatory Commission as well as the system operators responsible for maintaining reliability in the electricity markets about the correlation between electricity contracts and natural gas contracts.[39] According to the Energy Information Administration ("EIA"), natural gas comprised 15.8 percent of the fuel mix for electric generation in 2000 and 30.7 percent of the fuel mix for electric generation in 2012. Due to retirements of coal-fired generation in response to EPA rules and low natural gas prices this trend is likely to continue going forward. This connection between natural gas prices and electricity markets is illustrated in the State of the Market Report prepared by the NYISO independent market monitor: "Average electricity prices fell 16 to 25 percent from 2011 to 2012, which was primarily due to lower natural gas prices. Natural gas prices fell 28 to 35 percent over the same period. Low natural gas prices increased the share of electricity production from natural gas from 38 percent in 2011 to 45 percent in 2012. The correlation between energy and natural gas prices is expected in a well-functioning, competitive market because natural gas-fired resources were the marginal source of supply in 80 percent of the intervals in New York in 2012. Additionally, over 1 GW of new gas-fired generating capacity was installed in New York City (between July 2011 and June 2012), which also contributed to the overall reduction in the energy prices in 2012." This inter-relationship will only increase as natural gas is increasingly used for electric generation and displaces baseload units such as nuclear and coal while still being used as peaking units and to back-up renewable generation such as solar and wind.[40]

There are also other significant problems with the Commission's proposed limitations on cross-commodity hedges. First, using spot prices to make this determination, as proposed by the CFTC, is inconsistent with actual market practice. Many market participants hedge long-term

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38 *Id.*

39 See *e.g.* Winter 2013 -14 Energy Market Assessment, FERC Staff Report to the Commission (slide 11 illustrates correlation between natural gas and electricity prices in New England), Docket No AD06-3 (October 2013); 2013 Special Reliability Assessment: Accommodating an Increased Dependence on Natural Gas for Electric Power, http://www.nerc.com/pa/RAPA/ra/Reliability%20Assessments%20DL/NERC_PhaseII_FINAL.pdf; Coordination Between Natural Gas and Electricity Markets , Docket No. AD12-12 FERC Staff Quarterly Reports, http://www.ferc.gov/legal/staff-reports/2013/A-4-presentation.pdf;; Potomac Economics 2012 State of the Market Report for the ERCOT Wholesale Electricity Markets, http://www.potomaceconomics.com/uploads/ercot_reports/2012_ERCOT_SOM_REPORT.pdf; ISO New England 2013 Regional Electricity Outlook, http://www.iso-ne.com/aboutiso/fin/annl_reports/2000/2013_reo.pdf;

40 Annual State of the Market Report by the NYISO Independent Market Monitor for 2012, Executive Summary page 1.

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. Because the CFTC only evaluated correlation during the spot month, it did not take into account the closer correlation that typically exists between these prices in the non-spot months. As a result, the Proposed Rule would impermissibly and inappropriately limit a necessary, well-established, and beneficial hedging practice. Due to the close relationship between natural gas and electricity, Joint Associations would suggest that the Commission modify the safe harbor provision to require compliance with the qualitative component only and that the Commission remove all statements about a general lack of correlation between electricity and natural gas.

B. *The Commission Should Revise the Orderly Trading Requirement to Make it Consistent with the Disruptive Trading Practices Policy Statement*

The definition of *bona fide* hedging position in the Proposed Rule requires that hedge positions be established, maintained, and liquidated in an orderly manner in accordance with sound commercial practices.[41] In the preamble to the Proposed Rule, the Commission elaborates on this requirement stating that it intends to impose a standard of "ordinary care" on *bona fide* hedgers when "entering, maintaining and exiting the market in the ordinary course of business and . . . in establishing, maintaining or liquidating a position in excess of position limitations."[42] Under this standard, which, to Joint Association's knowledge, has never been previously announced or applied, negligent trading, practices, or conduct would be a sufficient basis for the Commission to disallow a *bona fide* hedging exemption. The Commission also proposes to apply its disruptive trading practices policy regarding orderly markets to its orderly trading requirement for purposes of position limits.[43]

Joint Associations request that the Commission revise the standards in the proposed orderly trading requirement to make them consistent with the Disruptive Trading Practices Policy Statement. Specifically, Joint Associations request that the Commission clarify that it only intends to exercise its authority to disallow *bona fide* hedges that are established, maintained or liquidated in a reckless, rather than negligent, manner. Indeed, the policy statement only focuses on intentional or reckless conduct under section 4c(a)(5)(B) and states "that accidental, or even negligent, trading, practices or conduct will not be a sufficient basis for the Commission to claim a violation . . . ."[44] As a result, the standard of care in the Proposed Rule would disallow *bona fide* hedging treatment based on standard of care that is not well-suited to position limits because each commercial market participant hedges risks that are unique to its particular business. Given the company-specific nature of hedging risks associated with a physical commodity business, the Commission, at a minimum, should apply the higher state of

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41 Proposed Rule 150.1.

42 Proposed Rule at 75,707.

43 *Id.*

44 *See* 78 Fed. Reg. 31,890, 31895 (May 28, 2013).

mind standard in the Disruptive Trading Practices Policy Statement to any determination to disallow *bona fide* hedging treatment, or it should articulate its rationale for why a different standard is necessary or appropriate in the position limits context.

C. *The Commission Should Permit All Forms of Bona Fide Hedging Regardless of Whether Hedges Are Executed on a Gross or Net Basis*

To qualify as a *bona fide* hedging position, a position in a commodity derivative contract must be, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[45] Historically, market participants have had significant flexibility with regards to how they manage their commercial risk, including discretion to determine whether to hedge their risk on a gross or net basis.[46] However, in the Proposed Rule, the Commission suggests that hedging on a gross basis may only be appropriate "under certain circumstances, when net cash positions do not measure total risk exposure due to differences in the timing of cash commitments, the location of stocks, and differences in grades or types of the cash commodity being hedged."[47]

Joint Associations request that the Commission modify the Proposed Rule to continue to permit all forms of *bona fide* hedging regardless of whether those hedges are executed on an enterprise-wide gross or net basis, or at a portfolio level within a single company. Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. As long as a company organizes portfolios of risk based on commercially reasonable risk management principles, market participants should have the flexibility to manage risk and hedge on a portfolio level without regard to other portfolios within the same legal entity. For example, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (*i.e.*, it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region.[48] The same is true for other commodity businesses that deal with other types of physical commodities. For Joint Associations members and other

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45 Proposed Rule 150.1.

46 *See* 42 Fed. Reg. 14,832, 14834 (Mar. 16, 1977).

47 Proposed Rule at 75,709. The CFTC provides an example of a market participant that enters into a fixed price sales commitment and an offsetting fixed price purchase commitment. According to the CFTC, "if such a merchant were to offset only the cash purchase contract, but not the cash sales contract (or vice versa), then it reasonably would appear the offsetting commodity derivative contract would result in an increased value exposure of the enterprise (that is, the risk of changes in the value of the cash commodity contract that was not offset is likely to be higher than the risk of changes in the value of the calendar spread difference between the nearby and deferred delivery period) and, so, the commodity derivative contract would not qualify as a *bona fide* hedging position." *Id.*

48 In the Proposed Rule, the Commission has stated its intention to ultimately subject all physical commodities to federal position limits in the future. Proposed Rule at 75,728. Therefore, the Commission must consider potential impacts on *all* physical commodities, especially electricity, in crafting provisions that form the base of the federal position limits such as the concept of "economically appropriate." The Commission must also consider the impacts on *all* physical commodities, because the proposed rules would also apply to exchange-set position limits, which apply to all commodities.

commercial commodity companies, hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions.

The CFTC previously permitted market participants to hedge on a net or gross basis.[49] Although the CFTC appears to rely upon the 1977 proposed rule as the basis to argue that the Commission previously restricted hedging on a gross basis; the 1977 proposed rule permits market participants to hedge their positions consistently with the then existing definition of *bona fide* hedging, which allowed market participants to hedge "their gross cash position irrespective of their net cash position."[50] This is another area where the Commission should not substitute its administrative judgment for the commercially reasonable judgment of market participants who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. Joint Associations respectfully submit that the Commission does not have, and has not articulated, a sound basis for departing from its long-standing policy of permitting market participants to hedge on a gross or net basis.

D. *The Commission Should Provide a Commercially Practicable Process for Requesting Exemptions for Non-Enumerated Bona Fide Hedges*

The Proposed Rule does not provide a dedicated process by which market participants may apply for an exemption for non-enumerated hedges. Instead, the Proposed Rule would require market participants seeking relief to request either: (1) an interpretative letter under CFTC Rule 140.99; or (2) a non-enumerated hedge exemption through a petition under section 4a(a)(7) of the CEA.

Joint Associations are concerned that the two methods that the Commission has proposed for seeking exemptive relief for non-enumerated hedging positions would be too time consuming and cumbersome to be practicable for many commercial market participants. Both procedures require an affirmative determination by either Staff or the Commission. Absent such action, market participants would not be able to treat a non-enumerated hedge as *bona fide*. Because both CFTC Rule 140.99 and section 4a(a)(7) provide no timeframes within which the CFTC must respond, this is problematic for many commercial market participants that need to be able to manage their risk on a real-time basis. By contrast, under current CFTC Rules 1.3(z)(3) and 1.47, the CFTC must respond to a request for a non-enumerated hedge within 30 days for a new filing or 10 days for an amendment to an existing filing. Joint Associations request that the CFTC adopt a procedure analogous to the Staff level exemption process in current CFTC Rule 1.47, including reasonable standards and timing for determining whether to grant a non-enumerated hedge exemption. Joint Associations also request that Staff not be limited to interpreting the existing exemptions. Staff should be able to grant an exemption for a non-enumerated hedge exemption for *bona fide* risk reducing Referenced Contract positions. The alternatives in the Proposed Rule would not provide market participants with the ability to hedge non-standard risks or provide them with responses in a timely or commercially workable manner.

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[49] *See, e.g.*, 42 Fed. Reg. 14,832, 14,834 (Mar. 16, 1977) (proposed rule).

[50] *Id.* See also Proposed Rule at 75,703.

E. *The Commission Should Revise the Definition of Bona Fide Hedging to Include Risk Management Practices Commonly Used by Commercial Market Participants*

Joint Associations support the Working Group of Commercial Energy Firm's ("**Working Group**") request for clarification that various types of common hedging activities qualify as *bona fide* hedging positions and appreciates the Commission's willingness to incorporate certain of these activities into the Proposed Rule.[51] However, Joint Associations request that the Commission revise various aspects of the definition of *bona fide* hedging position to include risk management practices commonly used by commercial market participants.

- Unfixed price purchases and unfixed price sales. The CFTC's proposed definition of *bona fide* hedging positions includes the Working Group's request for a hedge of an unfixed price purchase and unfixed price sale, in which one leg of the hedge is a Referenced Contract and the other leg is a non-referenced contract. The CFTC's proposed definition of *bona fide* hedging positions also includes the Working Group's request for a hedge of an unfixed price purchase and an unfixed price sale of a physical commodity in which the separate legs of the hedge are in the same calendar month, but which do not offset each other, because they are in different contracts. Joint Associations support the inclusion of these underlying transactions as a basis for a *bona fide* hedging position.

- Certain price differentials. The Proposed Rule would *not* include within the definition of *bona fide* hedging positions the Working Group's request regarding Referenced Contracts used to lock in a price differential where one leg of the underlying transaction is an unpriced commitment to buy or sell, and the offsetting sale has not been completed. Joint Associations support the inclusion of this underlying transaction as a basis for a *bona fide* hedging position and requests that the CFTC amend the definition of *bona fide* hedging position to include this as an enumerated exemption. Joint Association note that the statutory definition of *bona fide* hedging position expressly includes anticipatory merchandizing.[52] Moreover, the CFTC could monitor hedging versus speculation based on a review of historical cash market sales to determine if, at the time of the transaction, there was a reasonable basis to infer that an offsetting transaction was likely to occur.

- Market price volatility hedges associated with fixed-price bids and offers. The Proposed Rule would *not* include within the definition of *bona fide* hedging positions the Working Group's request regarding a hedge of market price volatility associated with binding and irrevocable fixed-price bids or offers. Solicitations of binding bids and offers have long been used by utilities and special entities to procure electricity, natural gas, and environmental commodity

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51 Joint Association Comments in Support of Petition for Exemptive Relief for Certain *Bona Fide* Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act (March 1, 2012).

52 CEA Section 4a(c)(2)(A)(i); 7 U.S.C. § 6a(c)(2)(A)(i).

contracts. Despite this well-established and important commodity procurement practice, the CFTC asserts that a binding bid or offer by itself is too tenuous to serve as the basis for an exemption from speculative position limits, because it is an uncompleted merchandising transaction.[53] As a result, the commercial entity submitting a binding, fixed-price bid or offer is effectively subject to a contingent price risk that cannot be hedged.[54] Joint Associations respectfully submit that binding and irrevocable bids create legitimate, reasonably anticipated contractual risk (*i.e.*, risk that the bid will be accepted) that must be hedged. For example, many states in which the utility has been required to divest its generation conduct competitive auctions to select the suppliers for the utility's retail load. Since these auctions are generally conducted under rules and regulations established by the state public service commission, there is delay between the acceptance of the long term electricity offer and official review by the state commission of the auction results. Prohibiting the hedging of a binding and irrevocable bid could increase the costs incurred by utilities and special entities to provide power or gas to their customers by forcing bidders to incorporate into their bids or offers the cost associated with the risk that the Commission will not allow them to hedge.[55]

- Hedges of anticipated contracts based on ongoing good faith negotiations. The Proposed Rule does *not* include in the definition of *bona fide* hedging position the Working Group's request regarding Referenced Contracts used to hedge ongoing, good faith negotiations that the hedging party reasonably expects to conclude. Similar to binding and irrevocable bids and offers, a cash transaction that is the subject of ongoing negotiations is anticipated, but not yet a purchase or sale agreement, and therefore would not satisfy the requirements of the proposed definition of *bona fide* hedging position. Joint Associations request that the Commission include hedges of ongoing good faith negotiations in the definition of *bona fide* hedging position because an anticipated merchandizing transaction, which is part of the statutory definition of *bona fide* hedging transaction,[56] includes a transaction that is not already subject to a binding agreement. As noted above, the CFTC could monitor hedging versus speculation based on a review of historical cash market purchases and sales to determine if there is a reasonable basis at the time to infer an anticipated offsetting transaction.

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53 Proposed Rule at 75,720.

54 The Commission also noted that "some commercial entities submit bids or offers merely to obtain information about the request for proposal, without an intention of submitting a quote that is likely to be accepted." Proposed Rule at 75,720.

55 Although the CFTC noted that it is concerned about undue volatility when the winning bid is accepted and all the losing bidders simultaneously reduce their total position to get below the speculative position limit, Joint Associations note that the Commission cites no historical, objective data substantiating a realistic basis for this concern. Moreover, Joint Associations submit that, even if there is a basis for this concern, it is sufficiently addressed through the existing requirement that market participants exit their hedge positions in an orderly manner.

56 CEA Section 4a(c)(2)(A)(i); 7 U.S.C. § 6a(c)(2)(A)(i).

- A state-regulated public utility hedging the requirements of its retail customers. The CFTC's proposed definition of *bona fide* hedging includes the Working Group's request regarding long positions in Referenced Contracts purchased by a state-regulated public utility to hedge the anticipated natural gas requirements of its retail customers.[57] Joint Associations support the inclusion of this underlying transaction as a basis for a *bona fide* hedge position. However, the Commission should eliminate the restriction such hedging be "required or encouraged to hedge by its public utility commission on behalf of its customers"[58] as public utility commissions by and large do not "require or encourage" hedging, but instead permit regulated utilities to engage in prudent hedging practices.

- Other unfilled anticipated requirements. The Commission should incorporate guidance from CFTC Staff letter 12-07 into the final rule and unambiguously permit unfilled anticipated requirements to qualify as a *bona fide* hedge where a commercial enterprise, such as an electric company, holds "long-term, unfixed-price supply or requirements contracts."[59] As indicated above, the Commission also should eliminate the restriction on utility hedging of unfilled anticipated customer requirements to permit all reasonable and prudent hedging activities, regardless of whether they are explicitly "required or encouraged to hedge by its public utility commission on behalf of its customers."

F. *The Bona Fide Hedging Definition Needs to Accommodate "Heat Rate Transactions" That Are Exceedingly Common Among EEI Members.*

The definition of "*bona fide* hedging position" does not contemplate transactions common to the electricity markets known as "heat rate" transactions. Generally, a "heat rate" transaction refers to a physical or financial transaction in an electricity commodity where the price of electricity (or one leg in the case of a heat rate swap) is determined by multiplying an agreed upon heat rate[60] times a gas index price. The term "heat rate" is generally the measure of efficiency for a power plant. The higher the heat rate, the more inefficient a power plant it is and the more expensive it is to run that power plant. Many power markets around the country trade based upon a market heat rate or implied heat rate, which is calculated by dividing the electricity price by the price of natural gas. Because of the inextricable link between the price of natural gas and the price of electricity, many wholesale and commercial electricity transactions are priced on heat rates.

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

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57 Proposed Rule at 75,714.

58 Proposed Rule at 75,713..

59 CFTC Interpretive Letter No. 12-07 at 1, Aug. 16, 2012.

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

option to hedge electric and gas price risk associated with physical commodity transactions. Or, a market participant (either a generation owner or merchant) may sell physical electricity priced at a heat rate[61] or sell physical heat rate options, then hedge both the electric and gas components of the physical transaction using a combination of electric and gas derivatives. These types of physical heat rate transactions and heat rate derivatives reflect very common transactions in present-day power markets.

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

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

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

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

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

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

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

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

If heat rate transactions are not granted *bona fide* hedging treatment, heat rate options and swaps will create an unusual situation wherein a derivative in one commodity (*i.e.*, electricity) is priced in a way that, for position limits compliance purposes, also creates a derivative position in another commodity (*i.e.*, natural gas). This could result in a situation in which a single transaction is treated as two derivative positions in two separate commodities—electricity and natural gas—with the electric component satisfying the *bona fide* hedging definition.[62]

The proposed rules will harm energy commodity markets and various types of market participants by not permitting heat rate transactions to either qualify as *bona fide* hedging transactions or providing a basis for treating a natural gas position as a *bona fide* hedging transaction.

Based on these concerns, the Joint Associations recommend that the Commission (i) create a new enumerated hedging position in proposed CFTC regulation 150.1 that includes heat rate derivatives used to hedge physical risk as well as electricity and natural gas derivatives used to hedge physical heat rate transactions, (ii) modify the proposed definition of "*bona fide* hedging position" to make clear that (a) where a cash commodity transaction or anticipated production of a cash commodity is priced by reference to another commodity, a derivative can qualify as a *bona fide* hedging position if it references either the cash commodity or the other commodity on which the cash commodity is priced, and (b) "fixed price" includes a price structure like a heat rate transaction, or (iii) modify the proposed enumerated exemption for cross-commodity hedges to include as *per se* cross-commodity hedges heat rate transactions and electricity and natural gas transactions used to hedge physical heat transactions.

VIII. Exchange Set Limits

Under the Commission's Proposed Rule, market participants do not need to apply for an exemption to net positions for purposes of the CFTC's limits, but must apply to net positions for purposes of exchange-set limits.[63] Joint Associations request that the Commission amend the Proposed Rule to permit the netting of positions for purposes of exchange-set limits on a self-certification basis. This is a practical approach given that entities will already be required to comply with the CFTC-set limits. The costs associated with monitoring netting activity, as well

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

[63] Proposed Rule at 75,774.

as the reporting burden placed on market participants, would be grossly disproportionate to the limited benefits.

IX. The Commission Should Clarify *Bona Fide* Hedging Example No. 7 to Provide That Aggregation Pursuant to an "Expressed or Implied Agreement" Is Only Required Where the Parties Trade or Manage Positions Pursuant to Such an Agreement

Example No. 7 in Appendix C of the Proposal Rule describes the application of the proposed definition of *bona fide* hedging positions to a fact pattern in which a sovereign induces a farmer to sell his anticipated production forward at a fixed price for delivery during the expected harvest. In connection with this transaction, the sovereign: (1) agrees to pay the farmer the difference between the market price at the time of harvest and the price of the fixed-price forward, in the event that the market price at the time of harvest is above the price of the forward; then (2) purchases call options on the Chicago Board of Trade contract to offset its exposure.[64] In its analysis of this example, the Commission states that, because "the [s]overeign and the farmer are acting together pursuant to an express agreement, the aggregation provisions of § 150.4 apply and they are treated as a single person for purposes of position limits."[65]

Joint Associations respectfully submit that the Commission has incorrectly applied the aggregation requirement in this example. Section 4a(a)(1) of the CEA provides, in part, that "limits upon positions and trading shall apply to derivative positions held by, and *trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding*, the same as if the positions were held by, or the trading were done by, a single person."[66] A reasonable interpretation of this provision would be that the "agreement or understanding" at issue must involve trading or managing positions. However, the only "agreement or understanding" in Example No. 7 is the agreement between the Sovereign and the farmer – an agreement that is, in effect, a bilateral swap between two independent legal entities.

Accordingly, Joint Associations request that the Commission clarify Example No. 7 to eliminate the discussion of the aggregation requirement. Without this clarification, Example No. 7 suggests that, contrary to a reasonable reading of section 4a(a)(1) and long-standing commercial practice, common, bilateral transactions may constitute "acting together pursuant to an express [or implied] agreement," which would thereby trigger the aggregation requirement in proposed CFTC Rule 150.4.[67] This would mean that the market participant would be required to aggregate with all its counterparties. Joint Associations submit that this would be a harmful and disruptive interpretation that would limit important hedging activity and create considerable uncertainty regarding the interpretation and implementation of the proposed aggregation rules.[68]

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64 *Id*. at 75,835-39 (emphasis added).

65 *Id*. at 75,837.

66 CEA Section 4a(a)(1); 7 U.S.C. § 6a(a)(1) (emphasis added).

67 Proposed Rule at 75,837.

68 Aggregation of Positions, 78 Fed. Reg. 68,946 (Nov. 15, 2013).

X. Conclusion

Joint Associations appreciate the Commission's consideration of its comments on the Proposed Rule. For the foregoing reasons, Joint Associations respectfully request that the Commission adopt its comments and allow its members to continue to operate in a commercially reasonable manner in the commodities markets.

Please contact us at the number listed below if you have any questions regarding these comments.

Respectfully submitted,

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March 30, 2015

Via Electronic Submission

Chris Kirkpatrick, Secretary
Commodity Futures Trading Commission
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Washington, D.C. 20581

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

Dear Mr. Kirkpatrick:

I. INTRODUCTION

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

EEI and its members have been active participants in the Commission's numerous rulemakings implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and filed comments in response to the Proposed Rule.[4] EEI members are not financial entities. Rather, they are physical commodity market participants that rely on commodity derivative contracts primarily to hedge and mitigate their commercial risk. Regulations that make effective risk management options more costly for end-users of derivatives and will likely result in higher and more volatile energy prices for retail, commercial, and industrial

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

2 EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the U.S. electricity industry, and represent approximately 70 percent of the U.S. electric power industry.

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

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

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

As discussed in more detail in the Comments below, EEI requests that the Commission take affirmative steps to simplify and reduce the burdens placed upon hedgers, such as EEI members, by the Proposed Rule. As entities that engage in transactions primarily as end-users, not as speculators, and that rely upon CFTC regulated markets to hedge their risks, EEI members are among the intended beneficiaries of the Proposed Rule. However, the complexity and burden of the proposal coupled with the limited and pre-determined set of "enumerated hedges" that are found to represent all *bona fide* hedges under the Proposed Rule renders it highly problematic from the perspective of electric company end-users.

II. COMMENTS

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

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

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

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5 Proposed Rule at 75,685.

6 *Id.* (quoting CEA section 4a(a)(1) pre-Dodd-Frank).

7 *Id.* 75,685.

8 Energy and Environmental Markets Advisory Committee, Transcript at 28:14-17 (February 26, 2015) ("EEMAC TR").

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

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

B. Trade Options Should Not be Subject to Position Limits

The proposed definition of "Referenced Contract" would include commodity Trade Options that technically fall within the definition of a "swap," but that generally are exempt from regulation under Part 32 of the CFTC's rules. Trade Options are entered into by commercial market participants and, if exercised, result in the sale of a physical commodity for immediate or deferred shipment or delivery.[12] Trade Options, including physical forward transactions with embedded volumetric optionality, should not be subject to position limits. Trade Options are not transactions that are generally used to manage financial risk relating to changes in prices, but instead are physically settled transactions that are used to manage supply risk. In other words, the primary purpose of Trade Options is to ensure that the physical commodity itself will be available when needed. Subjecting these physically-settled products to position limits could materially harm the efficient operation of physical commodity markets and increase costs for end-users. This is of particular concern in the electricity sector, where after the polar vortex in January – February 2014, there has been increased focus by the Federal Energy Regulatory Commission and other regulators on electric system reliability during extreme weather events, especially ensuring that generators have the fuel available to operate when called upon.

The potential costs to and impact on market participants of speculative position limits on Trade Options is significant. Trade Options are not speculative by definition. Under the CFTC's Interim Final Rule, the offeree to a Trade Option must "be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such."[13] In other words, because a Trade Option must be related to the offeree's commercial business, it cannot also be a speculative derivative position (much less a cause of excessive speculation) under the position limits regime. Market participants would be required, for the first time, to develop systems to calculate the futures contract equivalents for these physical-delivery agreements and,

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

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

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

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

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

for the first time, to associate Trade Option positions in terms of price risk for compliance with applicable limits, even though that is not the risk these products are primarily designed to manage. Furthermore, a position in a Trade Option does not share the same risk profile as a position in a future or financially-settled swap because Trade Options are not used to manage price risk but are instead used to manage supply risk. Therefore, tracking a Trade Option position in the same manner that you track a financial option will deceptively distort (both speculative and hedging) position sizes by mixing in contracts that primarily manage supply risk with those that manage price risk.

Including Trade Options in the definition of Referenced Contracts also complicates the ability of market participants to manage risk because they would be precluded from hedging the risks associated with Trade Option positions given that one Referenced Contract cannot be used to hedge another Referenced Contract and cannot be netted against financially-settled Referenced Contract positions in the spot month. Furthermore, because Trade Options, as proposed, would be physically-settled Referenced Contracts, a market participant holding a single Trade Option would be ineligible for the conditional limit on the same financially-settled Referenced Contract.[14] As such, Trade Options impact the availability of the conditional limit. Under the Proposed Rule, Trade Options are treated as swaps that do not fit within the *bona fide* hedging positions put forth by the Commission. A regulatory outcome that requires market participants to terminate Trade Options for these reasons is not consistent with the manner in which Trade Options are used. Due to their customized nature, Trade Options typically are not liquid products that can be easily traded. They are typically structured as standing agreements between physical commodity market participants, often for longer durations, that are exercised in order to obtain a physical commodity. A regulatory construct that could force market participants to terminate these agreements will act to disrupt the physical supply chain and creates inefficiencies in managing physical supply risk. In addition, since Trade Options are not easily traded, the transaction must be terminated by mutually agreed negotiations with the other party. This is difficult to accomplish in a timely fashion and may require the party seeking to exit the transaction to pay a premium or penalty. More importantly being forced to terminate a Trade Option position defeats the purpose it was entered into in the first place which was to obtain physically delivered supply. For all of the above reasons, Trade Options do not fit any of the conceptual constructs for being included within position limits.

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

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

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[14] Proposed Rule 150.1(4)

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

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

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

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

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

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

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

EEI members have and follow documented risk management procedures to ensure that hedging transactions are designed to manage the risks incurred in their commercial operations. In addition, since the hedges are based on physical commodities, the value of the hedge changes as the market moves. Many EEI members have front office commercial operations personnel, supported by middle office risk management policies and back office derivative accounting

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

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

processes, who have the responsibility of managing complex and dynamic commercial operations that incur risks from volatile commodity prices. If a hedge is not effective, these controls will identify it and require a change. As long as hedging practices are economically appropriate and consistent with sound risk management principles, the Commission should defer to accepted industry practices. The dynamic and complex nature of energy markets, in particular electricity markets, demands that the Commission provide flexibility to those charged with managing risk in these markets.

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

1. Gross Hedging

To qualify as a bona fide hedging position, a position in a commodity derivative contract must be, among other things, "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise."[19] This implies that an entity has to consider all of its exposures in order to qualify for the test when hedging, and that the entity can't take into account exposures on a legal entity or portfolio basis. Portfolio-based risk management is a common and long-standing commercial practice of producers, processors, merchants and commercial users of commodities and commodity byproducts. As long as a company organizes risk-based portfolios on commercially reasonable risk management principles, market participants should have the flexibility to manage risk and hedge on a portfolio level without regard to other portfolios within the same legal entity.

This is especially important to EEI members as energy markets are regional in nature. As a result, many utilities and independent power producers manage portfolios of risk by region. In one region, a power producer may be long physical generation, and in another region it may be short physical power (i.e., it has more load or demand for power than it has generation). A power producer's long physical position in one region should not limit its ability to hedge its short physical position in another region. The regional nature of the electric power industry also means that hedging on a net basis would be unworkable, requiring costly new technology systems to be built around more rigid, commercially impractical hedging protocols that prevent dynamic risk management in response to rapidly changing market conditions. Moreover, forcing end-users to net positions between regions that may have limited commercial relationship with each other will increase risk, not decrease risk.

As such, the Commission should continue to recognize the industry's risk mitigation practices and permit all forms of *bona fide* hedging regardless of whether those hedges are executed on an enterprise-wide gross or net basis, or at a portfolio level within a single company.

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[19] Proposed Rule 150.1.

2. Cross - Commodity Hedging

The Proposed Rule permits certain cross-commodity hedges to qualify as *bona fide* hedging positions, "provided that the fluctuations in value of the position in the commodity derivative contract, or the commodity underlying the commodity derivative contract, are *substantially related* to the fluctuations in value of the actual or anticipated cash position or pass-through swap and no such position is maintained in any physical-delivery commodity derivative contract during the lesser of the last five days of trading or the time period for the spot month in such physical-delivery contract."[20] To further elaborate on when a cross-commodity hedge would be considered "substantially related" to a cash-market position, the Commission provided a non-exclusive safe harbor based on two factors: (1) a qualitative factor, requiring a reasonable commercial relationship between the underlying cash commodity and the commodity underlying the commodity derivative contract; and (2) a quantitative factor, requiring a reasonable and measureable correlation in light of available liquid commodity derivative contracts. Under the Proposed Rule, the Commission only presumes an appropriate quantitative relationship "when the correlation, between first differences or returns in daily spot price series for the target commodity and the price series for the commodity underlying the derivative contract is at least 0.80 for a time period of at least 36 months."[21] Positions that do not satisfy *both* the conditions of the safe harbor are presumed *not* to be *bona fide* hedging positions; however, a person may attempt to rebut this presumption.[22]

EEI strongly opposes the approach to cross-commodity hedges in the Proposed Rule and urges the Commission to remove the quantitative test from the safe harbor when it finalizes the position limits rule. The Commission should recognize that energy markets are different than financial markets and preserve sound risk management practices that have been developed in the industry. As discussed during the roundtable, hedging electric power is both an art and science with the key factors being time and location. Due to the constantly changing nature of electricity markets, a 36-month spot month look back does not work.

There is a relationship between the price of the fuel used to generate electricity and the price of electricity. As such, utilities and other power generators have long used natural gas Referenced Contracts and other fuel-based derivatives to hedge the price risk associated with their electricity production. This correlation between natural gas and electricity prices is likely to increase going forward as the number of natural gas-fired generation facilities increases due to, among other factors, EPA rules and low gas prices. Many commonly traded physical products such as Heat Rates, which are discussed in detail in EEI's comments on the Proposed Rule, reflect this correlation.

There are also other significant problems with the Commission's proposed limitations on cross-commodity hedges. Using spot prices to make this determination, as proposed by the CFTC, is inconsistent with actual market practice. Many market participants hedge long-term electricity price exposure with natural gas derivatives contracts because there is insufficient

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

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.

Due to long-established risk manage practices using cross-commodity hedges, EEI would urge the Commission to give discretion to other widely recognized risk management practices used in the industry. As noted at the roundtable, EEI members and other sophisticated market participants in the physical energy space have internal risk controls such as managing value at risk (VAR), and hedge effectiveness monitoring to ensure that risk is being managed properly and effectively. Cross commodity hedges are monitored, and if a correlation breaks down, hedges will be adjusted accordingly. As physical commodity end-users EEI members participate in the futures and swap market first and foremost to hedge and manage risk associated with their businesses. Regulations that second guess these accepted industry practices and sound risk management controls will only add risk to the system and ultimately raise costs for energy consumers.

3. Anticipatory Hedging

There are legitimate commercial reasons for anticipatory hedging, and EEI urges the Commission to allow this activity to continue. In some cases, Referenced Contracts are used to hedge ongoing, good faith negotiations that the hedging party reasonably expects to conclude. Similar to binding and irrevocable bids and offers, a cash transaction that is the subject of ongoing negotiations is anticipated, but not yet a purchase or sale agreement, and therefore would not satisfy the requirements of the proposed definition of *bona fide* hedging position. Examples of this type of hedging include hedging done in anticipation of the results of a state run standard offer service auction being certified by a state public service commission and buying in advance of renewing existing or enrolling new retail customers. Taking away suppliers' ability to hedge their binding and irrevocable bid prices will result in the risk being factored into the price, which will raise prices for consumers.

4. Unfilled or Unfixed Anticipated Requirements

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

EEI requests that the Commission incorporate guidance from CFTC Staff letter 12-07 into the final rule and unambiguously permit unfilled anticipated requirements to qualify as a

bona fide hedge where a commercial enterprise, such as an electric utility, holds "long-term, unfixed-price supply or requirements contracts."[23] As indicated above, the Commission also should eliminate the restriction on utility hedging of unfilled anticipated customer requirements to permit all reasonable and prudent hedging activities, regardless of whether they are explicitly "required or encouraged to hedge by its public utility commission on behalf of its customers."

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

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

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

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

Heat rate transactions may take several forms such as forward sales of physical power (either from an electric generator or from a merchant), forward purchases of physical power, options on physical power, or swaps. Heat rate transactions have many uses in the electric

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Discussion during the EEMAC meeting raised the possibility that accountability levels may be a vehicle to provide oversight. Accountability levels for non-spot months have been used effectively by exchanges for years and the Commission has neither explained a need for hard non-spot month limits nor explained why the current approach for exchange-set limits is not sufficient. However, there is a difference between exchange administered accountability levels and such a program administered by the Commission. Exchanges have complete transparency

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

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

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

into their markets and contracts. Exchanges also have a market integrity role with respect to accountability that is narrower than the Commission's broad regulatory role.

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

III. CONCLUSION

The position limits rule as proposed is complex, creates uncertainty and places additional burdens on end-users as they use transactions to hedge and mitigate commercial risk. EEI appreciates the opportunity to submit additional comments on these important issues and the Commission's consideration of these comments as well as its comments on the Proposed Rule. EEI respectfully requests that the Commission adopt the proposed clarifications and allow its members to continue to operate in a commercially reasonable manner in the commodities markets.

Please contact us at the number listed below if you have any questions regarding these comments.

Respectfully submitted,

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July 13, 2016

Via Electronic Submission

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]

[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 exclusively 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. The Final Rule Should Include an Enumerated Bona Fide Hedge Definition that Covers Cross Commodity and Anticipatory Hedging

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

[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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