U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5000
Facsimile: (202) 418-5521
www.cftc.gov

Division of Market Oversight

CFTC Letter No. 12-07
Interpretation
August 16, 2012
Division of Market Oversight

Paul J. Pantano, Jr.
Cadwalader, Wickersham & Taft LLP
700 Sixth Street, NW
Washington, DC 20001

Re: Your request for guidance regarding the meaning of "unfilled anticipated requirements" for purposes of bona fide hedging under the Commission's position limit rules

Dear Mr. Pantano:

This is in response to your email dated August 6, and hard-copy request dated August 14, 2012, to staff of the Division of Market Oversight of the Commodity Futures Trading Commission ("Commission" or "CFTC"). In your request, you asked staff to provide, pursuant to Commission Regulations 140.99 and 151.5(a)(5), an interpretation addressing whether, under Part 151 of the Commission's regulations,[1] an electric company may treat as bona fide hedging transactions certain derivative transactions that reduce the price risk associated with its unfilled anticipated requirements for natural gas, even though it has entered into some long-term, firm purchases of natural gas at an unfixed price. The electric company entered such unfixed price contracts in order to ensure it will have an adequate supply of a significant portion of its anticipated natural gas requirements. You believe the reference in Commission Regulation 151.5(a)(2)(ii)(C) to "unfilled anticipated requirements" should be interpreted so that contracts to purchase a commodity, in this case natural gas, at an unfixed price (*e.g.*, at an index price that will be determined at a later date) do not "fill" the anticipated requirement, as discussed below.

We agree; unfilled anticipated requirements may be recognized as the basis of a bona fide hedging position or transaction under Commission Regulation 151.5(a)(2)(ii)(C) when a commercial enterprise has entered into long-term, unfixed-price supply or requirements contracts.[2] This is because the price risk of such "unfilled" anticipated requirements is not

---

1 The Commission instructed market participants to seek "interpretive guidance (under § 140.99(a)(3)) regarding . . . whether a transaction or class of transactions qualify as enumerated hedges under § 151.5(a)(2)." 76 Fed. Reg. 71626, 71649 (Nov. 18, 2011).

2 CFTC Regulation 151.5(a)(2)(ii)(C) addresses "unfilled anticipated requirements of the same cash commodity." Similarly, CFTC Regulation 151.5(a)(2)(i)(B) addresses "unsold anticipated production of the same commodity."

offset by an unfixed price forward contract.[3] The price risk remains with the commercial enterprise (the electric company in this instance), even though the commercial enterprise has contractually assured a supply of the commodity, with continuing price risk until the forward contract's price is fixed.[4] Once the price is fixed on the supply contract, the commercial enterprise no longer has price risk and the derivative position, to the extent the position is above an applicable speculative position limit, must be liquidated in an orderly manner in accordance with sound commercial practices.

Background

The concept of offsetting price risk of unfilled anticipated requirements or unsold anticipated production in connection with the application of position limits is not new. Prior to the CFTC's adoption of a definition for bona fide hedging, Congress defined bona fide hedging in the statute.[5] The statutory definition recognized bona fide hedging transactions or positions in futures "to the extent such sales or short positions are offset in quantity by the ownership or purchase of the same cash commodity by the same person or, conversely, purchase of, or long positions in, any commodity for future delivery... to the extent that such purchases or long positions are offset by sales of the same cash commodity."[6] That definition also recognized as a bona fide hedge the offset of "the amount of such commodity such person is raising, or in good faith intends or expects to raise, within the next twelve months..."[7] and "an amount of such commodity the purchase of which for future delivery shall not exceed such person's unfilled anticipated requirements for processing or manufacturing during a specified operating period not in excess of one year."[8]

Each version of the CFTC's bona fide hedging definition has recognized "unfilled anticipated requirements" as a basis for a bona fide hedging transaction or position. In 1975, the Secretary of Agriculture recognized hedges of unfilled annual requirements in CFTC Regulation 1.3(z); that rule also required a "bona fide purpose" that was "to offset price risks incidental to commercial cash or spot operations" (the so-called "incidental test").[9] The CFTC initially

---

3 An unfixed price forward contract is a contract for supply of a commodity at an open price or at a price to be determined at a later date (for example, by reference to an index based on daily settlement prices of a futures contract).

4 Similarly, the price risk remains with a producer who has sold a commodity at an unfixed price.

5 *See*, for example, 7 U.S.C. 6a(3) (1970).

6 *Id.*

7 7 U.S.C. 6a(3)(A) (1970).

8 7 U.S.C. 6a(3)(B) (1970).

9 The newly-established CFTC was required under amended Section 4a(3) of the Commodity Exchange Act to issue by July 20, 1975, a regulation defining bona fide hedging. Prior to that date, the Secretary of Agriculture proposed and issued a regulatory definition of bona fide hedging that deviated "in only minor ways from the hedging definition" in Section 4a(3) of the Commodity Exchange Act. *See* proposed at 39 Fed. Reg. 39731 (November 11, 1974), final at 40 Fed. Reg. 11560 (March 12, 1975), and conforming amendments at 40 Fed. Reg. 15086 (April 4, 1975). *See also*, the discussion of the "incidental test" in the bona fide hedging interpretation, 52 Fed. Reg. 27195 at 27196 (July 20, 1987).

adopted that rule with minor changes as an interim definition of bona fide hedging.[10] Subsequently, the CFTC adopted final Regulation 1.3(z) that retained the requirement that such transactions must "offset price risks incidental to commercial cash or spot operations."[11]

The current definition of bona fide hedging in CFTC Regulation 151.5 incorporates the concept of offsetting price risks incidental to commercial cash or spot operations. Section 4a(c)(2)(A) of the Commodity Exchange Act directs the Commission to define a bona fide hedging transaction or position for a physical commodity, in part, to be "economically appropriate to the reduction of risk in the conduct and management of a commercial enterprise." The CFTC incorporated that requirement in the definition of bona fide hedging in CFTC Regulation 151.5(a)(1)(ii).

The current definition of bona fide hedging in CFTC Regulation 151.5(a)(2)(ii)(C) also incorporates the concept of unfilled anticipated requirements. That rule is based on Section 4a(c)(2)(A)(iii)(I) of the Commodity Exchange Act, which enumerates an acceptable hedging transaction as a position that offsets the risks arising from assets a person anticipates owning or processing.

Under the reporting requirements for persons with a bona fide hedging position under old Part 19 and new Part 151, persons are required to report the quantity of fixed price purchase commitments of the cash market commodity that is being hedged.[12] However, those reporting rules are silent as to reporting of unfixed price purchase commitments, and thus such unfixed purchase price commitments are not required to be reported. This is because such unfixed purchase price commitments do not give rise to outright price risk and do not otherwise fix an outright price; thus, unfixed price purchase commitments do not alter the outright price risks faced by a commercial enterprise. Accordingly, unfixed price purchase commitments do not "fill" an anticipated requirement.

Sincerely,

Richard A. Shilts

cc: David Van Wagner
Matthew Hunter
Stephen Sherrod
Riva Spear Adriance

---

10 *See* concept release at 40 Fed. Reg. 34627 (August 18, 1975). *See* interim final at 40 Fed. Reg. 48688 (October 17, 1975).

11 *See* hearing notice at 40 Fed. Reg. 58684 (December 18, 1975), proposed at 42 Fed. Reg. 14832 (March 16, 1977) and final at 42 Fed. Reg. 42748 (August 24, 1977).

12 CFTC Regulations 19.01 and 151.5(c)(1)(iii) and (g).