January 20, 2012

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Petition for Commission Order Granting Exemptive Relief for Certain Bona Fide Hedging Transactions Under Section 4a(a)(7) of the Commodity Exchange Act

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms ("the Working Group"), Hunton & Williams LLP hereby submits this petition to the Commodity Futures Trading Commission pursuant to Section 4a(a)(7) of the Commodity Exchange Act.

The Working Group respectfully requests that the Commission take action on these petitions as promptly as possible, but in any event no later than 30 days after the date of this petition, i.e., February 20, 2012.

If you have any questions, please contact the undersigned.

Respectfully submitted,

R. Michael Sweeney, Jr.
David T. McIndoe
Mark W. Menezes
Meghan R. Gruebner
Alex S. Holtan
Counsel for the Working Group of Commercial Energy Firms

Enclosure

cc: Chairman Gary Gensler
Commissioner Jill Sommers
Commissioner Bart Chilton
Commissioner Scott O'Malia
Commissioner Mark Wetjen
Dan Berkowitz, General Counsel
Kenneth Danger, Division of Market Oversight
UNITED STATES OF AMERICA
BEFORE THE
COMMODITY FUTURES TRADING COMMISSION

Working Group of Commercial Energy Firms
Docket: Not Assigned

PETITION FOR COMMISSION ORDER GRANTING EXEMPTIVE RELIEF
FOR CERTAIN BONA FIDE HEDGING TRANSACTIONS
UNDER SECTION 4A(A)(7) OF THE COMMODITY EXCHANGE ACT

I. INTRODUCTION.

Pursuant to Section 4a(a)(7) of the Commodity Exchange Act, as amended (“CEA”), and Section 151.5(a)(5) of the regulations of the Commodity Futures Trading Commission (“CFTC” or the “Commission”), as recently adopted, the Working Group of Commercial Energy Firms (“Petitioner” or the “Working Group”) respectfully petitions the Commission for an Order granting exemptive relief from the Commission’s regulations governing speculative position limits1 (the “Position Limit Rules”). Specifically, the Working Group requests that the Commission:

(i) grant exemptive relief for the classes of risk-reducing transactions described below to the extent that such transactions are not covered by Sections 151.5(a)(1) or (2) of the Position Limit Rules or, in the alternative, clarify that such classes of transactions qualify as “bona fide hedging transactions or positions” within the meaning of Sections 151.5(a)(1) and (2); and

(ii) provide exemptive relief regarding the definition of (a) “spot month” set forth in Section 151.3(c) of the Position Limit Rules, and (b) “swaption” set forth in Section 151.1 of the Position Limit Rules.2

2 The Working Group further requests that, if the Commission determines that granting exemptive relief on all of the matters requested herein would not be appropriate, it grant this Petition in part as though each request was a separate petition.
Working Group respectfully requests that the Commission take action on this Petition as promptly as possible, but in any event no later than thirty days after filing this Petition, i.e., February 20, 2012. Market participants must begin compliance with the Position Limit Rules within sixty days of the date the final definition of “swap” is published in the Federal Register.\(^3\) For such participants to complete this work prior to the effective date of the Position Limit Rules, sufficient lead-time is necessary.

The Working Group does not request confidential treatment of this Petition.

II. **QUALIFICATION OF PETITIONER.**

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to, among others, industrial, commercial and residential consumers. Members of the Working Group and their affiliates actively trade futures and swaps that will be subject to the rules and regulations adopted in the Position Limit Rules and will be materially impacted by those rules.

The Working Group submitted several comment letters in the position limits rulemaking proceeding.\(^4\) In addition, members of and counsel to the Working Group met with the Commissioners and Commission Staff on multiple occasions to discuss the proposed position limit rules and, specifically, exemptions from position limits for *bona fide* hedging transactions and positions.

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\(^3\) 76 Fed. Reg. at 71,632.


III. **AUTHORITY OF COMMISSION TO GRANT PETITIONS.**

The Working Group seeks the requested relief pursuant to Section 4a(a)(7) of the CEA, which provides the Commission plenary authority to grant exemptive relief from position limits. Specifically, under Section 4a(a)(7), the Commission “by rule, regulation, or order, may exempt, conditionally or unconditionally, any person, or class of persons, any swap or class of swaps, any contract of sale of a commodity for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions from any requirement it may establish . . . with respect to position limits.” The Working Group requests that the Commission use its discretion to exercise its broad and unfettered authority under CEA Section 4a(a)(7) to grant the exemptive relief requested herein.

In addition, the Commission has clear authority to grant the requested relief pursuant to CFTC Rule 151.5(a)(5). Rule 151.5(a)(5) permits “any person engaging in other risk-reducing practices commonly used in the market which they believe may not be specifically enumerated in § 151.5(a)(2) [to] request relief from . . . the Commission under section 4a(a)(7) of the [CEA] concerning the applicability of the bona fide hedging transaction exemption.” As demonstrated in Sections IV and V of this Petition, the requests for exemptive relief involve risk-reducing practices commonly used in energy markets that are not specifically covered in the list of enumerated *bona fide* hedging transactions and positions set forth in Rule 151.5(a)(2).

Finally, in granting this Petition, the Working Group respectfully requests the Commission to confirm that any relief granted is generally applicable to the entire market.

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5 Although not required under CEA Section 4a(a)(7), each of the transactions set forth in the ten requests for exemptive relief satisfy the requirements of CFTC Rule 151.5(a)(1).
IV. **PETITION FOR EXEMPTIVE RELIEF.**

A. **REQUEST FOR EXEMPTIVE RELIEF NO. 1 - UNFIXED PRICE TRANSACTIONS INVOLVING A NON-REFERENCED CONTRACT.**

In a hedge of an unfixed price purchase and unfixed price sale of a physical commodity in which one leg of the hedge is a Referenced Contract and the other leg is a non-Referenced Contract, the Referenced Contract leg of the hedge should be treated as a bona fide hedging transaction or position.

**Explanation:** Section 151.5(a)(2)(iii) of the Position Limit Rules treats as *bona fide* hedging transactions or positions: “Offsetting sales and purchases in Referenced Contracts that do not exceed in quantity that amount of the same cash commodity that has been bought and sold by the same person at unfixed prices basis different delivery months . . . .”

As a result, Section 151.5(a)(2)(iii) would not treat as a *bona fide* hedge a transaction where the offsetting derivative positions were not *both* in Referenced Contracts. This would occur in numerous transactions where a commodity is moved from one location to another and is priced in one location against a Referenced Contract and in the other against a non-Referenced Contract.

For example, crude oil purchased in Europe, transported and sold in the United States may be purchased on a floating price calculated against ICE Brent crude oil futures and sold on a floating price calculated against NYMEX WTI crude oil futures. During the past twelve months, the Brent/WTI spread has had a range of over $30.00, moving from WTI approximately $2.70 over Brent to approximately $28.00 under Brent. That economic risk is real and significant and hedging it is critical to commercial operations. A transaction that locks in the Brent/WTI spread would not qualify as a *bona fide* hedge under Section 151.5(a)(2)(iii) of the regulations because ICE Brent crude oil futures contracts are not Referenced Contracts. Nevertheless, that transaction is a non-speculative, risk-reducing transaction and should be exempt from speculative position limits.
Example: Firm A enters into an agreement to purchase physical oil in the North Sea at an unfixed price, to be determined based upon the price of March ICE Brent crude oil futures on specified days plus or minus a fixed differential (i.e., 50 cents). Firm A sells that oil to a refinery in the U.S. gulf coast at an unfixed price to be determined based upon the price of April NYMEX WTI crude oil futures plus or minus a fixed differential. Firm A is exposed to the risk that between the dates of these transactions and their pricing, the price of Brent will rise relative to the price of WTI. Accordingly, Firm A purchases ICE Brent crude oil futures and sells NYMEX WTI crude oil futures and locks in that differential (known as the “arb”).

Because ICE Brent crude oil futures are not Referenced Contracts, the above transaction would not qualify as an enumerated hedge under CFTC Rule 151.5(a)(2). There are many substantially similar transactions routinely executed in commodities markets that would also be excluded, for example, an export of heating oil, purchased at a price related to the NYMEX New York Harbor contract and sold pursuant to the ICE gasoil contract. The derivatives that lock in the arb perform a *bona fide* hedging function. Without the requested exemption, entities similarly situated as Firm A would be required to treat those positions as speculative, subject to speculative position limits.

B. **REQUEST FOR EXEMPTIVE RELIEF NO. 2 - OFFSETTING UNFIXED PRICE TRANSACTIONS HEDGED WITH DERIVATIVES IN THE SAME CALENDAR MONTH.**

Hedges 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 or for any other reason, should be treated as *bona fide* hedging transactions or positions.

Explanation: The requirement in CFTC Rule 151.5(a)(2)(iii) that the Referenced Contracts must be in different calendar months is likely a historical artifact, based in a time where the hedges could only be in futures and options, and positions in the same calendar month would offset or negate each other for position limit purposes. Recognizing that offsetting physical contracts might reference the same month (i.e., buy in January; sell in January), derivatives in the same calendar month used to hedge these
physical contracts would not offset or negate each other for position limit purposes if the
two legs were in different contracts (such as in the Brent/WTI example in Request for
Exemptive Relief No. 1, above).

**Example:** Using the same example as in Request No. 1, above, assume that the
cargo is expected to load and unload, and therefore, priced in the same calendar month.
The risk-reducing transaction described above would be in the same calendar month. It
should be treated as a *bona fide* hedging transaction or position, not subject to speculative
position limits.

C. **REQUEST FOR EXEMPTIVE RELIEF NO. 3 - UNPRICED PHYSICAL
PURCHASE OR SALE COMMITMENTS.**

*Referenced Contracts used to lock in a price differential where one leg of the
underlying transaction is an unpriced commitment to buy or sell a physical energy
commodity, and the offsetting sale or purchase has not been completed, should be
treated as *bona fide* hedging transactions or positions.*

**Explanation:** In energy markets, it is not the customary practice of firms to
purchase physical commodities on a flat (fixed) price. Rather, the standard convention is
to use a floating price, such as NYMEX plus or minus a differential.

There are any number of transactions where a party enters into a firm unpriced
physical commitment to buy because the economics the party can lock into—
transportation, insurance, cost of money AND current market in a different location—
make it profitable to buy and move the product from a location where it exists to a
location where it is needed. When the opportunity to buy is at an unfixed price (*e.g.*, ICE
Brent plus or minus a differential), the party may enter into that purchase commitment
knowing that it could profitably move and re-sell that product. Even though the purchase
is at a floating price and the sale (expected to take place in the U.S. gulf, for example) has
not been arranged, there is a need to lock in the economics that drove the party to make
the purchase. To do so, the party will buy and sell derivatives to lock in the differential
between the two markets. In this example, the party would buy ICE Brent futures and
sell NYMEX WTI futures. By doing so, the party will protect itself from the risk that the
Brent price will rise relative to the WTI price and undermine its intended transaction. The opposite transaction is equally applicable—sometimes the sale will take place before the purchase.

**Example:** Firm W is offered the opportunity to buy a cargo of crude oil, scheduled to load in West Africa at a price of Brent plus or minus a differential. Firm W calculates all of its costs of the transaction and recognizes that as a result of supply and demand conditions in the U.S. gulf coast, it could make a profit if it bought the product, moved it to the gulf coast and sold it at the current market price of the NYMEX WTI futures contract in the expected month of delivery. If it simply purchased the cargo as offered, it would be exposed to the risk that the price of Brent would increase relative to the price of NYMEX WTI before it entered into an agreement to sell the cargo. Accordingly, Firm W buys the cargo, and buys ICE Brent futures and sells NYMEX WTI futures.

The Referenced Contract legs of the transaction described occur regularly in petroleum markets. In fact, the movement of petroleum products from one market to another to address relative supply and demand fundamentals depends upon this transactional structure. These derivatives transactions are inherently risk-reducing in nature and should not be subject to speculative position limits.

**D. REQUEST FOR EXEMPTIVE RELIEF NO. 4 - BINDING, IRREVOCABLE BIDS OR OFFERS.**

Referenced Contracts used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers should be treated as bona fide hedging transactions or positions.

**Explanation:** With respect to transactions in physical commodities, the Position Limit Rules permit a firm to treat as bona fide hedges transactions that reduce the risk of inventory, fixed-price purchases and sales and offsetting unfixed price purchases and sales. They also permit the hedging of unsold anticipated production, unfilled anticipated requirements and anticipated merchandising transactions in the limited circumstance

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6 As noted above, the Brent/WTI spread has moved over $30.00 in the past twelve months.
where the merchandiser has unfilled storage capacity and is hedging on a calendar spread basis.

In addition to the foregoing, there are circumstances in which a firm must calculate and submit a fixed-price bid or offer either to buy or supply a commodity that does not meet the limited circumstances outlined above in the Position Limit Rules. A firm that provides fixed-price bids or offers must calculate its view of the forward price curve, costs and profit margin prior to placing the bid or offer. Stated another way, the firm needs to lock in the variable price before it commits itself by making the binding bid or offer and, by definition, before it has a fixed-price commitment to purchase or sell the commodity. Entering into a price risk hedge prior to submitting a binding bid or offer is a risk-reducing transaction, and should be deemed as a bona fide hedge, not a speculative transaction subject to speculative position limits.

Example: ElectricCo, a merchant electricity company, supplies electricity to a diverse portfolio of wholesale and retail customers (load) throughout the United States. The Public Utility Commission of State X (“State X PUC”) is conducting an auction for one-third of the estimated total load (power needs) of certain electric utilities in State X for the next three years. ElectricCo and other commercial energy firms that have completed the qualification process, have qualified to participate in the auction process, and have chosen to participate, must submit binding, fixed-price bids (i.e., the price at which they will supply a specified quantity of power). Once a binding bid is submitted under the auction rules, there is a period of days between the submission of such fixed-price bids and the announcement by the State X PUC of the winning bidders. A winning bidder has committed to supply wholesale electricity to the relevant electric utilities in State X at the fixed bid price for three years for the portion of load it is awarded.

ElectricCo will bid on, and is prepared to serve 500 MW of load. Due to the volatile nature of prices in the real-time electricity markets and the binding nature of the auction process itself, ElectricCo will need to hedge the fixed-price risk associated with submitting a binding bid to serve up to 500 MW of load that ElectricCo may be awarded. The need to hedge arises at the time that ElectricCo identifies the relevant market price and related costs associated with submitting a competitive fixed-price bid, which may be
at or immediately prior to the time ElectricCo submits its binding fixed-price bid to State X PUC. ElectricCo carries this price risk, at a minimum, through the time that the winning bidders are ultimately approved by the State X PUC.

In order to allow it to submit a competitive bid, ElectricCo plans to use natural gas futures and swaps to hedge its price exposure and to ensure that its costs are fixed for the full duration of the fixed-price commitment created by the bid. Specifically, ElectricCo buys 13,140 NYMEX natural gas futures contracts (“NG”) or swap equivalents (average of 365 contracts per month over 3 years—the conversion equivalent of 500 MW of electricity for the same period—assuming a conversion rate of ten thousand (10,000) Btu of natural gas per kWh of electricity). Prior to submitting a binding bid, ElectricCo will provide all the required enabling documentation, ensure that it is otherwise in compliance with the bidding rules of the auction, and hedge the price risk associated with its contemplated bid.

Hedging price risk prior to submitting a binding fixed bid or offer is reflective of prudent commercial practice in the physical commodity markets. The Working Group requests an exemption so that the risk-reducing derivatives transactions associated with binding and irrevocable bids or offers are not treated as speculative positions subject to speculative position limits.

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7 It should be noted that, without the hedge, ElectricCo will be exposed to price movements in electricity markets. Under this circumstance, in order to mitigate its exposure to upward price movements, ElectricCo would (i) not be able to offer a binding fixed bid, or (ii) be required to offer a sufficiently higher fixed-price bid to account for the risk of price increases during the time the binding bid is left open. Additional costs associated with an open price risk position would be passed through to consumers through electricity prices that are higher than if ElectricCo were able to use the hedge. The reverse risks would occur in the situation of providing a binding fixed offer.

8 The Working Group is cognizant of potential concerns that the Commission may have that the bidding entity may not ultimately be awarded the full amount of its binding fixed bid, or that, conceptually, a market participant may try to engage in sham bids in order to circumvent the bona fide hedging process for the period of days between the bid and the approval of the final award.

Concerns regarding the possible abuse of the rule should not, however, eliminate the availability of a legitimate hedge exemption when there are numerous ways in which the Commission can verify or audit the legitimacy of the hedge transaction in a Request for Proposal (RFP) or energy auction. In the auction process described in this example, ElectricCo must satisfy extensive pre-bid qualification requirements that reflect the binding nature of the auction process that typically include, but are not limited to:
E. **Request for Exemptive Relief No. 5 - Timing of Hedging Physical Transactions.**

*Referenced Contracts used to hedge a physical commodity transaction that is subject to ongoing, good faith negotiations, and that the hedging party reasonably expects to conclude, should be treated as bona fide hedging transactions or positions.*

- **Provision of Pre-Bid Credit Support and Bid Participation Fee.** Bidders may be required to pay a non-refundable fee in order to pre-qualify as a bidder and may be required to provide pre-bid letters of credit and other required credit support documentation, including, but not limited to, parent guarantees. These credit documents may be drawn upon in the event the bidder fails to honor an accepted bid. These credit support documents typically will not be released until after (i) the auction process is concluded, (ii) the winning bids are approved by the appropriate entity, and (iii) the winning bidder executes pre-negotiated transaction documentation related to any accepted bid.

- **Evidence of Ability to Meet Commercial Obligations and Requisite Regulatory Authority.** Bidders may be required to provide representations by a duly authorized corporate officer regarding its (i) general qualifications to participate in the auction process, (ii) overall financial health as a corporate organization, and (iii) ability to meet its commercial obligations if selected as a winning bidder. As evidence of its financial wherewithal and ability to meet its commercial obligations, bidder may be required to submit for review by State X PUC copies of relevant U.S. Securities and Exchange Commission filings, as well as verifications from independent accounting firms. These specific, pre-bid requirements may vary depending on the type of auctions. In addition, bidder may be required to provide representations that it has requisite regulatory authority (i.e., applicable federal energy regulatory authorizations) to submit the bid and serve the load if selected as a winning bidder.

- **Pre-Bid Execution of a Master Wholesale Service Agreement.** Bidders may be required to execute and submit a binding and irrevocable master wholesale service agreement with State X PUC as part of the auction process. The master wholesale service agreement sets forth the terms and conditions pursuant to which ElectricCo will supply State X PUC with electricity for some or all of the bid for which it is obligated to supply if selected as a winning bidder.

Through these pre-bid qualification processes and comprehensive administration and oversight of the auction process by relevant utility or State PUC, there are strong measures in place that effectively deter and protect against sham bids thus rendering unfounded any concerns about potential gaming. Given the potential commercial, legal and regulatory risks, commercial energy firms place their business and operational reputation on the line in order to participate in RFP and auction processes. In addition, market participants deemed to be engaged in sham bidding activities would effectively be banned from participating in future auctions and see its business reputation marred by such actions. In any binding bid and offer structure, other protections will also likely apply, not the least of which are penalties for evasion of the speculative position limit rules.

Finally, to address potential concerns that no physical transaction is awarded, the Commission may condition the exemptive relief that the above-described hedge transaction is a *bona fide* hedge upon the following: (i) bidder intends to bid into the auction in good faith; and (ii) if the auction results in an award that is less than the amount of the hedge, any portion of the hedge position in excess of bidder’s underlying physical obligations awarded during the auction would no longer be classified by it as a *bona fide* hedging transaction or position.
**Explanation:** Commercial transactions are fluid. Some take longer to negotiate and conclude than others. Parties should be permitted to place their hedges at the time that, in their reasonable, good faith judgment, they believe they will have a transaction that will subject them to price risk. Section 737 of the Act, which provides a *bona fide* hedging exemption to positions that arise from the potential change in the value of assets a person anticipates owning would clearly permit treatment of that exercise as a *bona fide* hedging transaction or position and not subject those risk-reducing transactions to speculative position limits.

**Example:** Firm B is about to conclude a physical oil transaction, but the actual transaction documents have not yet been executed. The deal may be contingent upon a number of factors, such as, (i) arranging a vessel or other transportation, or (ii) the conclusion of negotiations on credit or other outstanding commercial/contractual terms. However, there is a good faith expectation by the hedging party that the transaction will be completed. In order to avoid the risk of adverse market moves affecting the value of the soon-to-be-consummated deal, Firm B desires to hedge the price risk associated with this transaction in advance in the futures or swap markets (as appropriate). The Working Group requests the Commission to recognize this position as a *bona fide* hedging transaction or position.9

**F. REQUEST FOR EXEMPTIVE RELIEF NO. 6 - LOCAL NATURAL GAS UTILITY HEDGING OF CUSTOMER REQUIREMENTS.**

Referenced Contracts purchased by a state-regulated public utility to hedge the anticipated natural gas requirements of its retail customers should be treated as *bona fide* hedging transactions or positions.

**Explanation:** Natural gas utilities often hedge the price of gas that they expect to purchase and supply to their retail customers. They may do this whether or not they have a price adjustment clause or can otherwise pass on the price of gas purchased to these

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9 To address potential concerns that the Commission may have that no physical transaction will be concluded, the Commission may condition the requested exemptive relief upon the satisfaction of the following conditions: (i) the commercial energy firm reasonably intends to conclude a physical transaction, and (ii) if the physical transaction is not consummated within a commercially reasonable time, the commercial energy firm would no longer be permitted to classify the transaction as a *bona fide* hedge.
customers. Hedging natural gas price risk is a prudent risk-mitigating tool that limits volatility in the prices ultimately paid by consumers and should be treated as *bona fide* hedging and not as a speculative activity subject to speculative position limits.

CFTC Rule 151.5(a)(2)(ii)(C) provides for the purchase of Referenced Contracts that do not exceed in quantity: “*Unfilled anticipated requirements of the same cash commodity, which may not exceed one year for agricultural Referenced Contracts, for processing, manufacturing, or use by the same person* . . . .” (Emphasis added). Notwithstanding that the phrase “for use by the same person” implies that the underlying commodity must be consumed by that person in the course of its operations (*i.e.*, the utility and not its customers), the Commission should clarify that the phrase “for use by the same person” in this context is not strictly limited to “consumption by the same person.”

Alternatively, the Commission could recognize that the utility’s purchase of natural gas and its delivery to customers are less akin to the purchase and resale of a commodity (*i.e.*, merchandising) than they are to the provision of a service. The utility’s regulated retail customers are not interested in a commodity so much as they are interested in the reliable and safe provision of heat and hot water for their homes or businesses.

The Working Group requests that the Commission either (i) clarify that the anticipated natural gas requirements of the commercial energy firm’s retail natural gas customers be considered anticipated natural gas requirements for use by such commercial energy firm (*i.e.*, the same person), or (ii) grant exemptive relief either as the hedge of a service or otherwise, so that in any case, the purchase of Referenced Contracts to hedge the volatility in the price of natural gas delivered by a utility to its customers is a *bona fide* hedging transaction or position and not subject to speculative position limits.

The activity described in this request is distinguishable from “merchandising” activity covered by CFTC Rule 151.5(a)(2)(v) because (i) the underlying risk is not appropriately hedged through calendar spreads, and (ii) it is not dependent upon the utility holding unfilled storage capacity.
The activity described in this request is also distinguishable from hedging activity by agents covered by CFTC Rule 151.5(a)(2)(iv). Based on the regulatory compact with its state regulators, the obligation to serve and, therefore, the underlying commodity price risk, belongs to the commercial energy firm as principal until such time as recovery is subsequently allowed through rates. Prospectively, the requirement to purchase natural gas is not related to or in any way contingent upon the ability of the utility to recover retroactively its costs from retail customers through rates.

Whether the Commission agrees that the derivative transaction should be deemed to be hedging “anticipated unfilled requirements,” hedging “services” or otherwise, the fact remains that it is a risk-reducing transaction engaged in by a typical natural gas utility to reduce risk associated with anticipated requirements of natural gas used to fulfill its obligation to serve retail customers.

Example: Natural gas utility Z (“Utility Z”) is principally engaged in the business of distributing, selling and transporting natural gas to retail customers in its franchised service territory. As a traditionally regulated, natural gas utility, Utility Z is subject to a regulatory compact with its state regulators and is obligated to provide service on reasonable terms to all who desire service within its franchised service territory. Pursuant to this regulatory compact, Utility Z is not free to serve only those customers who are convenient or currently profitable to serve, but is allowed by its state regulators to recover the cost of natural gas acquired to serve its regulated retail natural gas customers through purchased gas adjustment clauses included in approved retail rates. Accordingly, while Utility Z is obligated to acquire an adequate supply of natural gas to meet the needs of its customers, regardless of the cost, as long as the firm is prudent in its procurement practices, its regulated retail natural gas customers generally retain the risk associated with changes in the market price of natural gas.

In order to mitigate the impact of natural gas price volatility on the cost of natural gas acquired to serve its regulated retail natural gas customers, Utility Z enters into purchases of Referenced Contracts to hedge a specified percentage of such customers’ anticipated natural gas requirements over a multi-year horizon. Utility Z’s state regulators consider its hedging practices to be prudent and have allowed gains and losses
related to such hedging activities to be retained by its regulated retail natural gas customers. Based on the foregoing, the Working Group requests that the Commission recognize these transactions as *bona fide* hedging transactions or positions.

### G. REQUEST FOR EXEMPTIVE RELIEF NO. 7 - USE OF PHYSICAL DELIVERY REFERENCED CONTRACTS TO HEDGE PHYSICAL TRANSACTIONS USING CALENDAR MONTH AVERAGE PRICING.

*Referenced Contracts used to hedge in connection with Calendar Month Average ("CMA") pricing are not speculative in nature and should be exempt from speculative position limits. Firms engaged in CMA-priced transactions involving physically-delivered Referenced Contracts should be permitted to hold those positions through the spot month.*

**Explanation:** A substantial amount of commerce in physical commodities is conducted using CMA pricing structures. Although the Working Group has not conducted an empirical study, it is estimated that hundreds of billions of dollars of energy commerce is conducted on a CMA basis annually in the United States. CMA transactions generally involve buying and selling physical delivery Referenced Contracts (*i.e.*, futures contracts) and, in part, holding these positions in the last three days of trading in the expiring Referenced Contract. The scenarios set forth below clearly highlight that CMA transactions are not speculative in nature, but are components of typical physical market commerce. Under the Position Limit Rules, CMA transactions may not fall within the definition of *bona fide* hedging transactions and positions set forth in CFTC Rule 151.5(a)(1) and (2). However, they should not be subject to speculative position limits, and there should be no restriction on holding these hedges into the spot month of the physical delivery contract.

**Examples:**

**Scenario No. 1.**

A refinery will buy crude oil on a CMA basis so that it pays the price of crude oil at the time it receives and runs it, which matches with the then-current value of the refined products it will produce and sell. Similarly, producers of crude oil will sell their
production on a CMA basis, allowing them to receive the value of crude oil as of the date it was produced. The purchaser of that crude will need to lock in its ability to pay those prices. The following presents a typical transaction for a refiner to obtain 63,000 barrels of December crude oil supply:

- On each trading day from October 20 through November 18, purchase three prompt NYMEX Light Sweet Crude Oil futures contracts (“WTI”) (i.e., the December WTI contract). Assume there are twenty-one (21) NYMEX trading days during period, which would result in sixty-three (63) December WTI contracts being purchased.

- As a hedge, on each trading day from October 20 through November 18, sell (a) two (2) WTI futures contracts of the second nearby month, January (for a total of forty-two (42) contracts), and (b) one (1) WTI futures contract of the third nearby month, February (for a total of twenty-one (21) contracts).

- Prior to expiration of the permissible period for the December WTI contract, the refiner would “EFP”\(^\text{10}\) the sixty-three (63) December WTI crude oil futures contracts to 63,000 barrels of physical supply which will be delivered ratably during the month of December.

- From December 1 through December 20, the refiner would buy back all of the January WTI contracts ratably on each trading day.

- From December 21 through December 30, the refiner buys back all of the February WTI contracts ratably on each trading day.

  o *By ratably buying back the short futures as the physical barrels are delivered, one effectively realizes the price of the prompt barrel on that trading day (effectively, removing the hedge on the physical barrel each day).*

At the conclusion of this series of purchases and sales, the refiner has acquired 63,000 barrels of crude oil delivered in December at the average price of the prompt WTI futures contract during the month of December. The refiner’s activity is not speculative, and its use of derivatives should not be subject to speculative position limits.

Additionally, the refiner in this example could lock in its December supply of oil and pricing under the facts set forth above or it could, as is often the case, simply buy the oil from a supplier at CMA, plus or minus a differential. To hedge its risk, that supplier

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\(^{10}\) The term “EFP” refers to an “exchange of futures for physicals.”

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will enter into the NYMEX trades identified above. The supplier’s activity is not speculative, and its use of derivatives should not be subject to speculative position limits.

**Scenario No. 2.**

Small energy producer X (“Producer X”) produces 30 barrels of crude oil a day. At the end of every month, crude oil aggregator Y (“Aggregator Y”) sends a delivery truck to Producer X’s well and collects the crude oil. Producer X sells its oil at the price at which it was valued each day it was extracted from the earth, not the price at which it traded on the first or last day of the month, or any day in between. Accordingly, Producer X’s sales agreement calls for Aggregator Y, his purchaser, to pay him on a CMA basis. Aggregator Y has the same relationship with numerous small producers. For simplicity sake, assume that Aggregator Y purchases 63,000 barrels per month on this basis.

Aggregator Y wishes to ensure the CMA price selling price for the oil purchased from the small producers, including Producer X. A typical transaction for Aggregator Y to lock in the price would be the reverse of the transaction in Scenario No. 1, above. Aggregator Y has hedged the sales price for the crude oil it will purchase from Producer X, if:

- On each trading day from October 20 through November 18, Aggregator Y would sell three (3) prompt NYMEX Light Sweet Crude futures contracts (“WTI”) (*i.e.*, the December WTI contract). Assume there are twenty-one (21) NYMEX trading days during period, which would result in sixty-three (63) December WTI contracts being sold.
- As a hedge, on each trading day from October 20 through November 18, buy (a) two (2) WTI futures contracts of the second nearby month, January (for a total of forty-two (42) contracts) and (b) one (1) WTI futures contract of the third nearby month, February (for a total twenty-one (21) contracts).
- Prior to expiration of the permissible period for the December contract, Aggregator Y would EFP the sixty-three (63) December WTI futures contracts to 63,000 barrels of physical sale commitment that will be delivered ratably during the month of December.
- From December 1 through December 20, sell all of the January WTI futures contracts ratably on each trading day.
• From December 21 through December 30, sell all of the February WTI Futures contracts ratably on each trading day.
  
  o By ratably selling the long futures as the physical barrels are delivered, Aggregator Y effectively realizes the price of the prompt barrel on that trading day (effectively, removing the hedge on the physical barrel each day). Furthermore, at the conclusion of this series of purchases and sales, the Aggregator Y has hedged the sales price for the crude oil it will purchase from the small producers, including Producer X, at the average price of the prompt WTI futures contract during the month of December.

Although physical delivery Referenced Contracts are used to effect these transactions, they are not used in a speculative manner and should not be considered speculative trading activity by the Commission. Given their inherently non-speculative nature, physical-delivery Referenced Contracts used to hedge CMA transactions should not be subject to speculative position limits, and there should be no restriction on holding these hedges into the spot month of the physical delivery contract. Accordingly, the Working Group requests that the Commission use its broad authority under CEA Section 4a(a)(7) to exempt CMA pricing transactions from such speculative position limits.

H. REQUEST FOR EXEMPTIVE RELIEF NO. 8 - HOLDING A HEDGE USING A PHYSICAL DELIVERY CONTRACT INTO THE SPOT MONTH; GENERALLY.

Firms that use physical-delivery Referenced Contracts (in commodities other than metals or agriculture) as bona fide hedging transactions or positions should be permitted to hold these hedges into the spot month.

Explanation. The Position Limit Rules prohibit participants in energy markets from engaging in certain commonly used risk-reducing practices that require them to hold hedges involving physical delivery Referenced Contracts into the spot month. This prohibition applies broadly across the following provisions of Part 151 of the Commission’s regulations:

• CFTC Rule 151.5(a)(2)(i)(B) (Sales of Referenced Contracts; Unsold Anticipated Production)
• CFTC Rule 151.5(a)(2)(ii)(C) (Purchases of Referenced Contracts; Unfilled Anticipated Requirements)
• CFTC Rule 151.5(a)(2)(iii) (Offsetting Purchases and Sales of Referenced Contracts at Unfixed Prices)
• CFTC Rule 151.5(a)(2)(v)(C) (Anticipated Merchandising Hedges)
• CFTC Rule 151.5(a)(2)(vi)(B) (Anticipated Royalty Hedges)
• CFTC Rule 151.5(a)(2)(vii)(B) (Service Hedges)
• CFTC Rule 151.5(a)(2)(viii)(B) (Cross Commodity Hedges)

The Working Group respectfully submits that the provisions identified above in CFTC Rule 151.5(a)(2) prohibiting participants in energy markets from holding a physical delivery Referenced Contracts as *bona fide* hedging transactions or positions into the spot month are neither appropriate nor justified given the unique operating characteristics of energy markets. The restrictions against holding *bona fide* hedging transactions or positions into the spot month appear to be a carryover from Part 150 of the CFTC regulations, which applied to enumerated agricultural contracts. As discussed below, agricultural markets are distinctly different from energy markets.

For instance, in agricultural futures markets, physical delivery Referenced Contracts trade into (and at least partially through) the delivery month. Participants that remain in the agricultural markets during the delivery month are potentially subject to a “delivery notice” during the last five days of trading that would obligate them to make or take delivery of the actual commodity. Thus, there is a policy rationale to prohibit market participants from carrying a hedge-exempt sized position in physical delivery agricultural Referenced Contract positions in the last five days of trading when they may not be prepared to make or take delivery. Being served with a delivery notice under such circumstances could be disruptive to the markets.

Energy markets do not operate in this manner. Physical delivery Referenced Contracts for energy commodities do not trade into the delivery month. Rather, these contracts cease trading and settle days, if not weeks, before the delivery month begins. Consequently, the risk that a party could be called upon during the spot month to fulfill a delivery obligation when it is not commercially prepared to do so simply does not exist.

Given this distinction, concerns regarding potential disruptions during the spot month analogous to those in agricultural markets are not applicable to energy markets. Furthermore, there is no apparent economic justification for forcing participants in energy markets to exit the contract that provides the best hedging tool into a different contract
month\textsuperscript{11} or into a cash-settled contract.\textsuperscript{12} Simply put, carrying these hedges into the spot month is not speculative in nature and, as such, these transactions should not be subject to speculative position limits.

Accordingly, the Working Group respectfully requests that the Commission grant exemptive relief pursuant to CEA Section 4a(a)(7) and permit participants in energy markets to hold physical delivery Referenced Contracts into the spot month.

**Examples:**

**Scenario No. 1.**

Company A anticipates producing 2000 barrels of crude oil in July. That production is currently unsold. To hedge its risk that the value of those barrels may decline prior to their sale, Company A will sell 2 July NYMEX Light Sweet Crude Oil futures contracts ("WTI"), which represent delivery ratably during the month of July. The last trading day of the July futures contract is June 21st. The last day that Company A could hold the position as a \textit{bona fide} hedging transaction or position under the Position Limit Rules is June 17th. This means that if Company A holds the contract through the spot month, and delivers its oil under the July futures contract, it could not treat those positions as a \textit{bona fide} hedging transactions or positions during that period.\textsuperscript{13} Alternatively, in order to maintain \textit{bona fide} hedge status, it would be required to roll its hedge into the August contract on June 14th, taking basis risk on the July/August spread for the additional 5 days.

\textsuperscript{11} This is another key distinction between energy and agricultural markets. As agricultural contracts move toward final expiry, the cash market convention is to begin pricing against the next liquid futures contract month. As energy contracts move into the spot month, the cash market convention is still to price against the spot month futures contract. Thus, the historical requirement pushing agricultural market participants to the next delivery month has less economic impact than it would with respect to energy market participants.

\textsuperscript{12} Because cash-settled contracts do not go to delivery and settle prior to expiry of physical delivery Referenced Contracts, the Position Limits Rules leave market participants fully exposed to price risk prior to actual physical delivery.

\textsuperscript{13} The term “spot month” is defined in CFTC Rule 151.3(c) as “the period of time commencing at the close of business on the third business day prior to the last day of trading in the underlying Core Referenced Futures Contract and terminating at the end of the delivery period” for that Core Referenced Futures Contract.
Scenario No. 2.

Company B has a contract to buy natural gas at the Henry Hub in July at NYMEX + $.10 and a contract to resell it at the Henry Hub in August at NYMEX + $.15. To hedge the basis risk, it sells July NYMEX Henry Hub Natural Gas futures contracts (“NG”) and buys August NG futures contracts. Under the Position Limit Rules, this position would not be a *bona fide* hedge if it was carried into the spot month for the July NG futures contract. Company B would be forced to either (i) exit its position entirely and go “unhedged” or (ii) roll its position to a hedge with a different delivery period and, therefore, a different supply/demand and pricing profile.

I. REQUEST FOR EXEMPTIVE RELIEF NO. 9 - HOLDING A CROSS-COMMODITY HEDGE USING A PHYSICAL DELIVERY CONTRACT INTO THE SPOT MONTH.

*Firms that use physical-delivery Referenced Contracts as a cross-commodity hedge should be permitted to hold these hedges into the spot month.*

Explanation: In any circumstance where a party is engaged in *bona fide* hedging that would allow it to hold positions in the spot month, it should be allowed to conduct its hedging with a cross-commodity hedge.

Although CFTC Rule 151.5(a)(2)(viii) allows cross-commodity hedging, it includes a restriction that prevents cross commodity, energy hedge transactions from being *bona fide* hedging transactions or positions if they are held into the spot month. If the Commission retains the limitation on cross-commodity hedging set forth in CFTC Rule 151.5(a)(2)(viii)(B) to remain in effect, it will result in parties owning stocks of physical products that are hedged on a cross-commodity basis using physical delivery Referenced Contracts to (i) remain completely exposed to price risk during the spot month or (ii) replace their hedges with contracts that represent a different delivery period and, therefore, a different supply/demand and pricing profile.¹⁴

¹⁴ Specifically, CFTC Rule 151.5(a)(2)(viii)(B) provides:

(viii) Cross-commodity hedges. Sales or purchases in Referenced Contracts described in paragraphs (a)(2)(i) through (vii) of this section may also be offset other than by the same quantity of the same cash commodity, provided that:
To avoid this result, the Working Group requests that the Commission grant exemptive relief under CEA Section 4a(a)(7) to permit participants in energy markets to hold cross-commodity hedges in any situation in which participants in energy markets are permitted to hold physical delivery Referenced Contracts as bona fide hedging transactions or positions into the spot month. Such positions are not speculative in nature and should not be subject to speculative position limits.

Examples:

**Scenario No. 1.**

In late October, Company A owns barrels of ultralow sulfur diesel oil (“ULSD”) that are in the pipeline in transit for delivery in early November. It seeks to hedge using the most liquid contract reflecting the value closest to the current time period. Accordingly, it sells November NYMEX New York Harbor Heating Oil futures contracts (“HO”) equal to the full value of its inventory. It seeks to hold that short position as long as possible, including into the spot month, as it is the best hedge for its price risk in ULSD. This hedge, even if held into the spot month, is not speculative in nature and should not be subject to speculative position limits.

**Scenario No. 2.**

Commercial Energy Firm J supplies jet fuel to airlines at a variety of airports in the United States, including Houston Intercontinental Airport. It has a fixed-price contract to purchase jet fuel from a refinery on the gulf coast during early June. Because there is no liquid jet fuel futures contract, Commercial Energy Firm J uses the June WTI or HO futures contract to hedge its price risk. It seeks to hold that position as long as possible, including into the spot month, as it is the best hedge for its price risk in jet fuel. This hedge, even if held in the spot month, is not speculative in nature and should not be subject to speculative position limits.

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(B) No such position is maintained in any physical-delivery Referenced Contract during the last five days of trading of the Core Referenced Futures Contract in an agricultural or metal commodity or during the spot month for other physical-delivery contracts.
J. **REQUEST FOR EXEMPTIVE RELIEF NO. 10 - HOLDING A CROSS-COMMODITY HEDGE USING A PHYSICAL DELIVERY CONTRACT TO MEET UNFILLED ANTICIPATED REQUIREMENTS.**

The Commission should reinstate existing CFTC Rule 1.3(z)(2)(ii)(C) to permit firms to hold cross-commodity hedges involving physical-delivery Referenced Contracts into the spot month in order to meet their unfilled anticipated requirements.

**Explanation:** Participants in energy markets commonly use physical delivery Referenced Contracts to hedge on a cross-commodity basis their unfilled anticipated requirements for a particular energy commodity. However, as noted above, pursuant to CFTC Rule 151.5(a)(2)(viii)(B) participants in energy markets engaged in such cross-commodity hedges are prohibited from holding these positions in the spot month. This restriction will likely have broad, adverse impacts on markets for certain refined energy products, such as heating oil and reformulated gasoline and their related commodities (ULSD and jet fuel), where there are no recognized liquid, cash-settled swap markets. If the Commission permits the limitation on cross-commodity hedging to remain, it effectively would leave parties fully exposed to price risk for unfilled anticipated requirements during the spot month. In order to mitigate this exposure, participants in energy markets would be required to replace their hedges with contracts that represent a different delivery period and, thus, a different supply/demand and pricing profile.

Prior to adoption of the Position Limit Rules and through their compliance date, persons engaged in purchases of futures contracts were permitted to hold up to “twelve months’ unfilled anticipated requirements of the same cash commodity for processing, manufacturing, or feeding by the same person, provided that such transactions and positions in the five last trading days of any one futures do not exceed the person’s unfilled anticipated requirements of the same cash commodity for that month and for the next succeeding month” pursuant to CFTC Rule 1.3(z)(2)(ii)(C).15

Rule 1.3(z)(2)(ii)(C) appears to have been inadvertently dropped from Part 151 by the Commission when adopting the Position Limits Rules. The Working Group believes

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15 *See 17 C.F.R. § 1.3(z)(2)(ii)(C).*
that there is no policy or legal basis for removing this provision from the Commission’s regulations and the relief that it affords parties seeking to hold physical delivery Referenced Contracts into the spot month to hedge their unfilled anticipated requirements. In order to alleviate concerns regarding the timing of cross-commodity hedging using physical delivery Referenced Contracts, the Commission should reinstate CFTC Rule 1.3(z)(2)(ii)(C).

Accordingly, the Working Group requests that the Commission grant exemptive relief pursuant to CEA Section 4a(a)(7) to reinstate CFTC Rule 1.3(z)(2)(ii)(C) allowing energy market participants to using physical delivery Referenced Contracts as a cross-commodity hedge to hold these positions into the spot month in order to meet up to two months of their unfilled anticipated requirements.

Example:

A gasoline blender uses various feedstocks, (for example, Alkylate, Reformate and Natural Gasoline) to produce gasoline. Some of these feedstocks are sourced in the United States, and others from non-U.S. sources, but prices are fixed when the feedstocks are purchased in January. Sales of the reformulated gasoline will be at prevailing market prices at the time of sale.

The gasoline blender is at risk that the price of the feedstocks will rise before they are purchased. There are no futures or swaps contracts for the components. As a result, the gasoline blender buys NYMEX Reformulated Gasoline futures contracts ("RBOB") in the volume similar to cover the price risk on its unfilled anticipated requirements. This hedge is not speculative in nature and should not be subject to speculative position limits.

V. **OTHER REQUESTS FOR EXEMPTIVE RELIEF.**

A. **PETITION FOR EXEMPTIVE RELIEF CLARIFYING THE DEFINITION OF "SPOT MONTH" SET FORTH IN CFTC RULES 151.1 AND 151.3(c).**

In addition to the relief sought for the *bona fide* hedging transactions provided herein, the Working Group requests that the Commission issue an Order pursuant to CEA Section 4a(a)(7) clarifying that the term “spot month” for Referenced Contracts in energy
commodities as defined in Section 151.3(c) of the Position Limit Rules means only “the last three days of trading of the Referenced Contract in energy commodities.”

CFTC Rule 151.3(c) states, in relevant part, the following:

(c) *Energy commodities.* The spot month shall be the period of time commencing at the close of business of the third business day prior to the last day of trading in the underlying Core Referenced Futures Contract *and terminating at the end of the delivery period for the following Referenced contracts*. . . .

Derivatives markets for energy commodities have traditionally and currently viewed the “spot month” as the last three days of trading. The Commission has not identified any basis, and the Working Group submits there is none, to extend the spot month beyond the expiration of the Core Referenced Futures Contract and depart from the historical view of “spot month.”

**B. Definition of “Swaption.”**

The Working Group also requests that the Commission issue an Order pursuant to CEA Section 4a(a)(7) clarifying that the definition of “swaption” does not include physical commodity options. CFTC Rule 151.1 defines “swaption” as “an option to enter into a swap or a physical commodity option.”

The inclusion of “physical commodity options” within the definition of “swaption” for purposes of the Position Limit Rules is both premature and unnecessary. In the first instance, the Commission has an open rulemaking proceeding to determine whether physical commodity options should fall within the definition of “swap” for all purposes under the Dodd-Frank Act.16 Taking the position under the Position Limit Rules that physical commodity options are swaptions would seemingly pre-empt the Commission’s consideration in the product definitions rulemaking.17

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17 The Working Group submits that the Commission may not have intended to include physical commodity options within the meaning of “swaption.” The Commission had proposed to include such in
Moreover, the inclusion of physical commodity options within the definition of swaption is simply unnecessary. If the Commission determines in the product definitions rulemaking to include physical commodity options within the term “swap,” then physical commodity options will be subject to the Position Limit Rules as swaps. The further reference would be redundant.

VI. CONCLUSION.

The Working Group respectfully requests that the Commission grant this Petition as set forth herein. The Working Group further requests that if the Commission determines that granting exemptive relief on all of the matters requested herein would not be appropriate, it grant this Petition in part as though each request was a separate petition.

The Working Group respectfully requests that the Commission take action on this Petition as promptly as possible, but in any event no later than thirty days from the date this Petition is filed with the Commission, i.e., February 20, 2012.

Respectfully submitted,

R. Michael Sweeney, Jr.
Mark W. Menezes
David T. McIndoe
Meaghan R. Gruebner

Counsel for the
Working Group of Commercial Energy Firms

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