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April 17, 2012

Mr. David Kass
Senior Economist
Market and Trade Practice Surveillance Section
Division of Market Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Re: *Petition Filed with the CFTC on Bona Fide Hedging*

Dear Mr. Kass:

Thank you for your e-mail dated March 29, 2012, and for your continued review of the pending "Petition for Commission Order Granting Exemptive Relief Under Section 4a(a)(7) of the Commodity Exchange Act ("BFH Petition") filed with the Commodity Futures Trading Commission (the "Commission") on January 20, 2012.[1] This letter (i) addresses questions raised in your March 29th e-mail by staff in the Division of Market Oversight ("DMO Staff"), and (ii) further explains the calendar month average ("CMA") transactions set forth in Request for Exemptive Relief No. 7 ("Request No. 7") that the Petitioners believe should not be treated as speculative positions for purposes of the Commission's final rule establishing speculative position limits for futures and swaps.[2]

As the BFH Petition notes, CMA transactions are widely utilized in the energy industry. Although there are a variety of motivations for these transactions, two of which are set forth as illustrative examples in the BFH Petition, the Petitioners clarify that Request No. 7 is intended to be a request to exempt all CMA transactions involving physical deliveries. It is not intended to be limited to the specific fact scenarios discussed therein.

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1 The Commercial Energy Working Group and the Working Group of Commercial Energy Firms are jointly advancing the Petition and are collectively referred to herein as the "Petitioners."

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

<u>RESPONSE TO FACT SPECIFIC ISSUES ADDRESSING SCENARIO NOS. 1 AND 2</u>

In a CMA transaction, one of the parties is seeking to price its purchase or sale on a CMA basis. The motivation to engage in the CMA transaction may take many forms, such as (i) matching a party's inputs to its outputs, (ii) matching its production dates to its sales pricing dates, or (iii) any other business purpose. Using the futures markets to lock in daily pricing over a calendar month poses the difficulty that, in some physically-delivered Referenced Contracts, the prompt month futures contract does not trade on each day of the expiration month, *e.g.*, for NYMEX CL trading during December 2012, the January 2013 contract will be the prompt contract until its expiration on December 19, 2012, and the February 2013 contract will be the prompt contract for the remainder of December 2012. Given this difficulty, a party may need to convert "trading month average" pricing to CMA pricing. Request No. 7 in the BFH Petition provides specific examples of how this may be accomplished.

<u>SCENARIO NO. 1</u>

As described in your March 29th e-mail, DMO Staff's understanding of Scenario No. 1 is essentially correct. Please note that the Petitioners included the fact that the refiner matches "the then-current value of the refined products it will produce and sell" solely to provide an example of its motivation for seeking CMA pricing. However, the refiner's specific motivation for seeking CMA pricing ultimately is irrelevant to the analysis and likely created unnecessary confusion. In order to eliminate any such confusion, the facts referring to the "distillate sale" in this scenario should be ignored.

Simply put, the refiner in Scenario No. 1 (or any other purchaser for the purpose of the BFH Petition) is seeking to purchase crude oil at CMA and use the futures markets to lock in that pricing structure by undertaking the following steps:

1. It purchases crude oil futures ratably through the conclusion of trading (including the spot month period)—for illustrative purposes call it November—in the desired delivery month contract (December).

2. On the same days, it sells crude oil futures contracts in the two delivery months that will be the "prompt futures months" during December in a ratio of the number of trading days that each futures month will be the prompt month.

3. It converts its long futures to a long physical delivery contract *via EFP or by standing long on its NYMEX contracts*, pursuant to which it will receive crude oil ratably through the month of December.

4. It buys back ratably its short hedge in each futures contract month on the dates that such contract month is the prompt trading month on the exchange.

The Petitioners clarify that the refiner could (i) engage in this hedging transaction itself, or (ii) alternatively, turn to its supplier and ask that it deliver crude oil ratably during December at the daily average spot price during the month. In the latter circumstance, the seller would need to lock in December CMA pricing and would likely use the futures market in the manner set forth above, *i.e.*, substituting buys for sells and sells for buys.

<u>SCENARIO NO. 2</u>

Scenario No. 2 provides a "sell-side" example involving CMA pricing. Consistent with Scenario No. 1, the discussion of Aggregator Y's motivation for seeking CMA pricing (*i.e.*, that it was buying from producers "at the lease") is irrelevant to the analysis. Regardless of the specific motivation, Petitioners note that it is sufficient that Aggregator Y wants to lock in CMA pricing for a sales commitment by entering into the reverse of the transactions described in Scenario No. 1.

Further, in the Petitioner's view, the spreadsheet prepared by DMO Staff incorrectly identifies Aggregator Y's purchase of oil as occurring on a daily basis during the month that the futures positions are being placed. Specifically, on each day of the month at issue in Scenario No. 2, Aggregator Y has an unfixed price purchase contract which calls for delivery at the end of that month. Again, the inclusion of facts relating to the purchase side of this transaction is irrelevant and should be ignored by DMO Staff.[3]

The point of Scenario No. 2 is that Aggregator Y was likely to bring this product to Cushing (again, for purposes of example only) and sell it ratably using CMA pricing. In order to lock in such pricing, Aggregator Y engages in the transactions described in this scenario. There is nothing speculative about Aggregator Y's desire to lock in December CMA pricing. This process is simply reflective of the manner in which the commercial markets price such transactions.

Just as Scenario No. 1 has an inverse that is equally valid, Producer X in Scenario No. 2 could also seek to lock in CMA. It could engage in NYMEX transactions itself, or, as in the example, look to Aggregator Y to buy from it at a CMA price. An alternative way to think of the link between Scenario Nos. 1 and 2 is that Scenario No. 2 represents the seller that commits to supply a refinery on CMA basis.

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3 For instance, if Aggregator Y were paying Producer X on a basis other than CMA (*i.e.*, NYMEX WTI November final settlement minus 50 cents), its desire to lock in its sales price would be the same.

<u>Response to Anticipated Merchandising Question</u>

With respect to your specific question in the March 29th e-mail about whether CMA pricing transactions represent a form of "anticipated merchandising," the Petitioners believe that they do not and such characterization would be inaccurate.

CMA pricing simply exists as a matter of energy commerce. Producers price their production on a CMA basis. Refiners price their inputs on a CMA basis. Purchasers from producers and sellers to refiners enter into contracts to purchase or supply on a CMA basis.

In order to achieve CMA pricing, a party may contract for it directly, or it may achieve it using the futures market. The use of the futures market to achieve this result is a classic example of a transaction that "represents a substitute for transactions made or to be made or positions to be taken at a later time in a physical marketing channel."

In order to achieve CMA pricing using the futures market, a party must hold its positions through the last day of trading in the expiring physically-delivered Referenced Contract. Thus, even if such CMA pricing transactions were structured in terms related to an enumerated hedge exemption set forth in CFTC Rule 151.5(a)(1)-(2), the general limitation on holding physically-delivered Referenced Contracts into the spot-month period would remain.

Although the Petitioners have tried to be general enough to provide an understanding of CMA pricing and specific enough to illustrate some of the ways it is used, they recognize from their own business experience that CMA pricing can be a difficult concept to decompose and analyze. Accordingly, the Petitioners would like to request a brief conference call or meeting with you and DMO Staff after Staff has reviewed and digested the response provided herein. Petitioners propose the afternoon of April 24 or 25, 2012, for such call or meeting, but are amenable to other times more suitable to DMO Staff.

If you have any questions, or need further assistance, please contact the undersigned.

Respectfully submitted,

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