From: Sweeney, Michael [mailto:Michael.Sweeney@sutherland.com]
Sent: Wednesday, September 19, 2012 12:57 PM
To: Sherrod, Stephen
Cc: Danger, Kenneth L; Kass, David; Adriance, Riva
Subject: The Commercial Energy Working Group - Petition for Exemptive Relief on Bona Fide Hedging - Revised and Clarified Facts for, and Explanation of, Request Exemptive Relief No. 7 - Calendar Month Average Pricing

Steve:

Good afternoon. Attached please find a revised and clarified fact set for Request for Exemptive Relief No. 7 of the Petition for Exemptive Relief ("BFH Petition") submitted by The Commercial Energy Working Group ("Working Group"). The purpose of the document is to better explain and articulate the facts identifying the commercial activity underlying Request No. 7, which involves the use of calendar month average pricing.

The attached document was used in discussions between the Working Group and Commissioners' staff in August 2012 regarding the status of the BFH Petition.

In April, we prepared and forwarded a separate document to David Kass that responded to specific questions regarding this request for exemptive relief. However, in our view, the attached document does a much better job at explaining the issue and setting forth the key facts that support granting the requested relief.

I am not sure if you all obtained a copy of this document internally at the CFTC. If you already have it, please forgive this e-mail. However, if you do not have it, we wanted to be sure you had a copy. In the latter case, I apologize for any oversight in not getting it to you sooner.

I will be on travel this afternoon and tomorrow, but can be reached by e-mail or on my mobile at (301) 801-1283.

-- Best. Michael.

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THE COMMERCIAL ENERGY WORKING GROUP

REQUEST FOR EXEMPTIVE RELIEF NO. 7
FOR WORKING SESSION ON BFH PETITION

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.

The scenarios comprising Request No. 7 and set forth below each represent two different commercial possibilities.

Scenario No. 1 represents a refiner looking to lock in calendar month average pricing for the crude oil it intends to run in its refinery in December (*i.e.*, the refiner wants to pay the daily spot market price for crude oil during each day of December, roughly matching the days upon which it actually receives the crude oil). The refiner has two alternative means to achieve this: (i) it could use derivative contracts as described in the example below, or (ii) it could enter into an agreement with a supplier to buy the crude oil at a CMA price. In the second alternative, the supplier would use derivative contracts, also as described in the example below, to hedge its obligation to supply the crude oil at the CMA price.

Scenario No. 2 represents a producer looking to lock in CMA pricing for the crude oil that it intends to produce in December (*i.e.*, the producer wants to receive the daily spot market price for crude oil for each day in December roughly matching the days on which it actually produces the oil). The producer has two alternative means to achieve this: (i) it could use derivative contracts as described in the example below, or (ii) it could enter into an agreement with a crude oil purchaser to sell the crude oil at a CMA price. In the second alternative, the crude oil purchaser would use derivative contracts, also as described in the example below, to hedge its obligation to purchase the crude oil at the CMA price.

CMA pricing is used in a vast amount of commercial transactions because it allows users to: (1) establish a spot price based upon a differential to the forward price where there is no reliable market-established spot price; and (2) convert "trading month average" pricing (*i.e.*, the expiring NYMEX futures contract does not trade through the calendar month) to CMA pricing. In these scenarios, the refiner (supplier) or producer (purchaser) is looking to hedge on a forward basis the differential between (a) the benchmark forward price (NYMEX) and (b) the spot price. The transactions described in the scenarios allow them to do that.

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. 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 19 through November 16, 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 the period, which would result in sixty-three (63) December WTI contracts being purchased.

- As a hedge, on each trading day from October 19 through November 16, 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" 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 3 through December 20, the refiner would buy back all of the January WTI contracts ratably on each trading day.

- From December 21 through December 31, the refiner buys back all of the February WTI contracts ratably on each trading day.

The following charts illustrate these transactions:[1/]

DAY	DATE	BUY 3 DEC	SELL 2 JAN	SELL 1 FEB	DIFF
FRIDAY	OCT. 19	89.00	89.15	89.29	0.20
MONDAY	OCT. 22	89.10	89.30	89.35	0.22
TUESDAY	OCT. 23	90.05	90.12	90.14	0.08
WEDNESDAY	OCT. 24	90.04	90.12	90.14	0.09
THURSDAY	OCT. 25	89.93	90.00	90.10	0.10
FRIDAY	OCT. 26	88.00	88.10	88.20	0.13
MONDAY	OCT. 29	88.50	88.60	88.70	0.13
TUESDAY	OCT. 30	88.61	88.75	88.90	0.19
WEDNESDAY	OCT. 31	88.67	88.79	88.93	0.17
THURSDAY	NOV. 1	89.10	89.21	89.32	0.15
FRIDAY	NOV. 2	88.95	89.05	89.17	0.14
MONDAY	NOV. 5	89.07	89.18	89.28	0.14
TUESDAY	NOV. 6	89.20	89.30	89.40	0.13
WEDNESDAY	NOV. 7	89.25	89.35	89.45	0.13
THURSDAY	NOV. 8	89.17	89.29	89.41	0.16
FRIDAY	NOV. 9	89.21	89.32	89.43	0.15
MONDAY	NOV. 12	89.40	89.50	89.63	0.14
TUESDAY	NOV. 13	89.60	89.71	89.85	0.16
WEDNESDAY	NOV. 14	89.58	89.70	89.81	0.16
THURSDAY	NOV. 15	89.70	89.82	89.95	0.16
FRIDAY	NOV. 16	90.00	90.15	90.27	0.19
AVERAGE		**89.24**	**89.36**	**89.46**	**0.15**

DAY	DATE	BUY 3 JAN	BUY 3 FEB	+/- DIFF	DAILY PRICE
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10

FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45
MONDAY	DEC. 31		97.90	(0.15)	97.75
				CMA	**97.33**

Notes to Table:

1. The differential (in $ per barrel) at the time the hedge is put in place is equal to the revenue that would be realized by selling 2 barrels of January and 1 barrel of February, less the costs to purchase 3 barrels of December, all divided by 3. In this scenario, the differential is positive, reflecting the fact that the January and February contracts that were sold were more expensive than the December contracts that were purchased. That is, the market was "in contango." Although cash (other than margin) does not change hands until settlement, this differential is now locked in. When the hedges are lifted by buying the January and then the February contracts, the cost locked in (shown here as a positive number, although it reflects the effective price to be paid) is the value of the respective contracts on the day of purchase, offset by the locked in differential.

On each day during December, the refiner receives a ratable share of 63,000 barrels under the CMA purchase agreement with his EFP counterparty. The price paid by the refiner is determined on a daily basis using the refiner's repurchase of the then-prompt NYMEX futures contract plus or minus the differential that it had locked in (*e.g.*, December 3 – 97.00 minus 0.15; December 4 – 96.90 minus 0.15; and so on) until at the end of the month, it has paid the calendar month average price of prompt December barrels.

The refiner's activity in derivatives falls within the definition of a bona fide hedging transaction or positions set forth in new CFTC Rule 151.5(a)(1) as the activity: (1) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (2) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arises from the potential change in value of assets that the refiner owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

Finally, as stated above, 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 on a CMA basis. To hedge its risk on the sale to the refiner, that supplier would enter into the NYMEX trades identified above. The supplier's activity in derivatives would also fall within the definition of a

bona fide hedging transaction or positions set forth in new CFTC Rule 151.5(a)(1) as the activity: (1) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (2) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arises from the potential change in value of assets that the supplier owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

Scenario No. 2.

Scenario No. 2 is the mirror image of Scenario No. 1.

Energy producer X ("Producer X") produces approximately 2000 barrels of crude oil a day. Producer X wants to receive the daily spot price for crude oil on the day that it extracts the crude oil from the ground. It sells its production monthly and uses CMA pricing to achieve its objective. The following presents a typical transaction for a producer to sell 63,000 barrels of December crude oil at a CMA price:

- On each trading day from October 19 through November 16, Producer X 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 the period, which would result in sixty-three (63) December WTI contracts being sold.

- As a hedge, on each trading day from October 19 through November 16, 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, Producer X 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 and priced at CMA based upon the activity set forth below.

- From December 3 through December 20, sell all of the January WTI futures contracts ratably on each trading day.

- From December 21 through December 31, sell all of the February WTI futures contracts ratably on each trading day.

The following charts illustrate these transactions:[1/]

DAY	DATE	SELL 3 DEC	BUY 2 JAN	BUY 1 FEB	DIFF
FRIDAY	OCT. 19	89.00	89.15	89.29	(0.20)
MONDAY	OCT. 22	89.10	89.30	89.35	(0.22)
TUESDAY	OCT. 23	90.05	90.12	90.14	(0.08)
WEDNESDAY	OCT. 24	90.04	90.12	90.14	(0.09)
THURSDAY	OCT. 25	89.93	90.00	90.10	(0.10)
FRIDAY	OCT. 26	88.00	88.10	88.20	(0.13)

MONDAY	OCT. 29	88.50	88.60	88.70	(0.13)
TUESDAY	OCT. 30	88.61	88.75	88.90	(0.19)
WEDNESDAY	OCT. 31	88.67	88.79	88.93	(0.17)
THURSDAY	NOV. 1	89.10	89.21	89.32	(0.15)
FRIDAY	NOV. 2	88.95	89.05	89.17	(0.14)
MONDAY	NOV. 5	89.07	89.18	89.28	(0.14)
TUESDAY	NOV. 6	89.20	89.30	89.40	(0.13)
WEDNESDAY	NOV. 7	89.25	89.35	89.45	(0.13)
THURSDAY	NOV. 8	89.17	89.29	89.41	(0.16)
FRIDAY	NOV. 9	89.21	89.32	89.43	(0.15)
MONDAY	NOV. 12	89.40	89.50	89.63	(0.14)
TUESDAY	NOV. 13	89.60	89.71	89.85	(0.16)
WEDNESDAY	NOV. 14	89.58	89.70	89.81	(0.16)
THURSDAY	NOV. 15	89.70	89.82	89.95	(0.16)
FRIDAY	NOV. 16	90.00	90.15	90.27	(0.19)
AVERAGE		**89.24**	**89.36**	**89.46**	**(0.15)**

DAY	**DATE**	**SELL 3 JAN**	**SELL 3 FEB**	**+/- DIFF**	**DAILY PRICE**
MONDAY	DEC. 3	97.00		(0.15)	96.85
TUESDAY	DEC. 4	96.90		(0.15)	96.75
WEDNESDAY	DEC. 5	96.85		(0.15)	96.70
THURSDAY	DEC. 6	97.25		(0.15)	97.10
FRIDAY	DEC. 7	98.00		(0.15)	97.85
MONDAY	DEC. 10	98.20		(0.15)	98.05
TUESDAY	DEC. 11	97.50		(0.15)	97.35
WEDNESDAY	DEC. 12	97.70		(0.15)	97.55
THURSDAY	DEC. 13	97.90		(0.15)	97.75
FRIDAY	DEC. 14	98.30		(0.15)	98.15
MONDAY	DEC. 17	98.00		(0.15)	97.85
TUESDAY	DEC. 18	97.60		(0.15)	97.45
WEDNESDAY	DEC. 19	97.30		(0.15)	97.15
THURSDAY	DEC. 20	97.10		(0.15)	96.95
FRIDAY	DEC. 21		97.30	(0.15)	97.15
MONDAY	DEC. 24		97.50	(0.15)	97.35
TUESDAY	DEC. 25		97.10	(0.15)	96.95
WEDNESDAY	DEC. 26		96.80	(0.15)	96.65
THURSDAY	DEC. 27		97.25	(0.15)	97.10
FRIDAY	DEC. 28		97.60	(0.15)	97.45
MONDAY	DEC. 31		97.90	(0.15)	97.75
				CMA	**97.33**

Notes to Table:

1. The differential (in $ per barrel) at the time the hedge is put in place is equal to the revenue that would be realized by selling 3 barrels of December, less the costs to purchase 2 barrels of January and 1 barrel of February, all divided by 3. In this scenario, the differential is negative,

> reflecting the fact that the January and February contracts that were purchased were more expensive than the December contracts that were sold. That is, the market was "in contango." Although cash (other than margin) does not change hands until settlement, this differential is now locked in. When the hedges are lifted by selling the January and then the February contracts, the value realized is the value of the respective contracts on the day of sale, less the locked in differential.

On each day during December, the producer delivers a ratable share of 63,000 barrels under the CMA purchase agreement with his EFP counterparty. The price the producer receives is determined on a daily basis using the producer's sale of the then-prompt NYMEX futures contract plus or minus the differential that it had locked in (*e.g.*, December 3 – 97.00 minus 0.15; December 4 – 96.90 minus 0.15; and so on) until at the end of the month, it has received the calendar month average price of prompt December barrels.

The producer's activity in derivatives falls within the definition of a bona fide hedging transaction or positions set forth in new CFTC Rule 151.5(a)(1) as the activity: (1) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (2) are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arise from the potential change in value of assets that the producer owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.

Finally, as stated above, the producer in this example could lock in its December sale of oil and pricing under the facts set forth above or it could, as is often the case, simply sell the oil to a purchaser on a CMA basis. To hedge its risk on the purchase from the producer, the purchaser will enter into the NYMEX trades identified above. The purchaser's activity in derivatives would also fall within the definition of a bona fide hedging transaction or positions set forth in new CFTC Rule 151.5(a)(1) as it: (1) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel; (2) are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and (3) arise from the potential change in value of assets that the purchaser owns, produces, manufactures, processes, or merchandises, or anticipates owning, producing, manufacturing, processing or merchandising.